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Dividing the Public Fisc: Rethinking the Allocation of Tax Room in Fiscal Federalism

The division of tax room for shared tax bases, such as income taxation in the United States and Canada, is a frequent cause of political conflict between national and sub-national governments. Economists and political economists have developed a normative theory of an efficient division of tax room, but federal nations often substantially depart from this prescription by allocating too much or too little tax room to national governments. This article argues that problems with the assignment of political credit by voters can partially explain the divergence between theory and actual practice. To illustrate, it develops a political economy model to identify the incentives governments face when dividing tax room. The model’s central observations are that 1) efficient fiscal federalism requires robust intergovernmental contracting; but 2) the necessary contracts are difficult or impossible to perform due to a variety of credit assignment problems. The common result is an inefficient division of tax room. The article considers a number of legal responses to 1) improve intergovernmental contracting and 2) reduce the welfare effects of an inefficient division of tax room. These legal responses include reconsideration of several constitutional law doctrines, such as the federal spending power and various doctrines that enable or limit concurrent expenditure jurisdiction.