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Assignment of Responsibilities and Fiscal Federalism

Federalism and Public Sector Performance: An Economist's View [1]

1. Introduction

Both in the industrialised and developing world, moves are afoot for the decentralisation of government in the hope of improving the performance of the public sector. Such moves toward "devolution" are justified both in political terms as a means to bring policy making closer to the people to enhance democratic processes, and in economic terms as a way to adapt public outputs to local tastes and circumstances. But the real issue here cannot be one simply of centralisation versus decentralisation. The public sector by necessity involves different levels of decision making, and the question here involves the proper alignment of functions and policy instruments among the different levels of government. This, incidentally, encompasses not only fiscal structure, but regulatory prerogatives as well. Our objective is to determine the vertical structure of the public sector that can enable it to function most effectively.

There are no absolute rules – or inviolable principles – in such an assignment of functions. But the literature on fiscal federalism has provided some general guidelines that provide a point of departure for thinking about this issue in the context of particular countries, or groups of countries like the European Union (EU). In the first section of this paper, I provide a brief review of these guidelines along with some observations. In addition, the organisers of this conference have asked me to address certain subthemes. In the subsequent sections, the paper takes up these issues: fiscal competition, fiscal equalisation, and fiscal decentralisation in the transition economies and developing countries. This is an imposing agenda, which I cannot hope to cover in a comprehensive way, but I will at least offer some thoughts on each of these issues.

2. On the assignment of functions

In the context of multilevel government, public finance economists have posed the issue of the assignment of functions (e.g. Oates, 1999). What specific jobs or responsibilities are the different levels of government best equipped to handle? Their answer to this question is not a rigid blueprint for governmental structure, but rather some rough guidelines that we should consider in assigning functions to the different levels of government. Let me be more specific. It seems clear, for example, that the primary responsibility for macroeconomic stabilisation policies must be lodged at the central government level. The central government, for good reasons, exercises control of the monetary system and hence the power to regulate the supply of money and credit, and through this important channel to influence the aggregate level of economic activity. Likewise, counter-cyclical fiscal measures are most effectively exercised at the central level. A local government, for example, could not expect to revive a depressed local economy with a local tax cut; the new income generated by the reduction in taxes would be spent largely on goods and services produced elsewhere resulting in very little stimulus to local economic activity. In short, decentralised governments are very limited in what they can hope to accomplish in the way of macroeconomic stabilisation.

Similarly, economists have pointed out some important constraints on decentralised re-distributive policies that suggest a basic role for central government in providing assistance to low-income households. A local government, for instance, that initiates an aggressive program to redistribute income from the wealthy to the poor runs the risk of attracting an inflow of low-income residents, while inducing an out-migration of the well to-do. And the threat of such mobility tends to discourage decentralised programs of assistance to the poor (Brown and Oates, 1987). There is, in fact, some evidence, in the United States at least, that poor households exhibit some mobility in response to local differentials in welfare payments. In a recent and careful econometric study, Jonah Gelbach (2002), for example, finds both that levels of welfare payments in US states have influenced migration decisions of recipients, and that this has led to reduced levels of payments to the poor. This suggests an important role for central government in poor relief.

The case for decentralised finance is found in the provision of public goods and services whose consumption is limited to specific jurisdictions. For such "local public goods", a system of decentralised finance allows each jurisdiction to provide a suitable level and range of public services that is responsive to the demands of the local citizenry and the costs of provision. Such an outcome of differentiated outputs can significantly increase economic welfare as compared to an outcome characterised by a relatively uniform level of provision across the nation.[2] The basic prescription then is that the central government should provide “national public goods” that are consumed collectively by everyone in the country, while provincial (or state) and local governments should provide outputs of those public services whose consumption is specific to their own constituencies.

We could, of course, conceive of a world in which the central government with full information and wide-ranging powers differentiated outputs jurisdiction by jurisdiction to account for geographical differences in costs and demands. But such an outcome is unlikely. Firstly, there are serious informational problems in practice. It is hard for a central agency to know what people want in each locality, what the efficient levels of public outputs are in each place. Decentralisation takes advantage of the more complete information available in each jurisdiction. Secondly, even if central government possessed such information, it would be difficult politically to translate it into differentiated public outputs. There are pervasive political pressures for equality of treatment that make it hard to provide a wider scope of services in some areas than in others (even though it is economically efficient). Thus, centralised provision of many public services is likely to compromise the performance of the public sector.[3]

Let me offer two brief observations on these prescriptions. Firstly, as I mentioned above, these are not firm “principles” but rather some general guidelines. There is some limited scope for decentralised stabilisation and re-distributive activity, but a major central role seems clearly to be needed. Secondly, the general principle for decentralised finance does not translate directly and easily into a precise delineation of specific goods and services to be provided at each level of government. What is deemed to be “local” in some countries may well be regarded as a provincial or even national good in other settings.[4] Nevertheless, there remains a strong economic case for encouraging the provision of public services at the lowest level of government that encompasses spatially the benefits and costs of the outputs.

It is interesting that this basic perspective of fiscal federalism has been developed in the context of the modern nation state. Things become more complicated when it is applied to emerging “federations” like the EU. But it provides some useful insights. In particular, it suggests certain problems confronting the EU. The member states in the EU become, in certain ways, like the states in, say, the United States. Many have now given up their individual monetary and exchange rate prerogatives with monetary union and have taken on certain fiscal constraints that limit their capacity to engage in traditional counter-cyclical policies. In this sense, their position is similar to a state or province in a nation state. The problem is that the new top layer of government in the EU is not in a position to provide the kind of fiscal stabilisation (both automatic and discretionary) that a sizeable central government brings to the typical nation state. The central budget is simply too small to offer much in the way of stabilising forces. The member countries may thus find themselves vulnerable to location-specific shocks that neither they nor the EU can address effectively. It may also be the case that over time, with rising mobility across national borders in Europe, member states will find themselves increasingly constrained in their capacity to carry out needed re-distributive programs. Again, the size and scope of the EU budget (at least as currently envisioned) is simply insufficient to carry out this function. These are issues that the EU, in its evolution, will have to address (Sinn, 1994, 1997; Oates, 2001).

3. Fiscal competition and its implications

A direct challenge to the fiscal federalism “prescription” has emerged in some of the literature on fiscal competition. One segment of this literature contends that competition among governments leads to the under-provision of public services. The argument is that public officials, in their eagerness to create jobs and encourage economic growth, will tend to hold down tax rates and offer subsidies and other inducements to attract new business investment. This results in a so-called “race to the bottom” with inadequate provision of public services.

This line of argument, however, is far from self-evident. I want to stress that there is an enormous literature, mainly theoretical in character that explores this issue. Dozens and dozens of papers and conferences have explored various facets of economic competition among governments.[5] This body of work is in many ways rather unsatisfying: in particular, it does not, in my view, produce much in the way of firm policy conclusions.

Let me explain briefly. There is clearly plenty of competition among governments for new private sector investment. This competition, incidentally, is not limited to fiscal measures: it includes regulatory activities as well. Governments can attract business not only with low tax rates, but also with lax environmental measures (as one example) that do not burden new business enterprise with heavy costs. But the existence of such competition does not necessarily imply under-provision of public services. It is perfectly straightforward, for example, to construct a standard neoclassical model of economic competition among governments in which such competition provides precisely the right incentives for providing efficient levels of public services (e.g. Oates and Schwab, 1988). Competition among governments in such models is a good thing: it encourages efficient decision making. Economists have long praised the virtues of competition in the private sector, and, at least in certain models, this view extends to competition in the public sector as well.

However, it is not hard to introduce various realistic elements into these models (e.g. strategic behaviour of various sorts, or the absence of certain fiscal instruments) such that distortions arise. And these may take the form of the under-provision of public services including not just too little spending on local public goods, but also such things as excessively lax environmental standards. The problem is that it is hard to assess the implications in practice of these competing views. The theoretical models tell us little about the magnitude of potential distortions even if there is a race to the bottom. And things become even more complex when we allow for differing perspectives on the performance of government. Some observers see a tendency in government toward excessive budgetary size (e.g. Brennan and Buchanan, 1980). From this point of view, economic competition is a good thing: it constrains the overly expansive tendencies of the public sector. Thus, it is difficult to come away from this literature with any hard conclusions on the important question of whether we need harmonisation of policies to restrain inter-jurisdictional competition (Oates, 2001).

As I mentioned, this literature is predominately theoretical in character. We don't have much empirical work to complement the theoretical papers and to see what in fact happens. There is plenty of evidence that vigorous competition among decentralised governments exists, at least in the United States (e.g. Bartik, 1991). But this really doesn't address the issue. The question is whether or not such competition has beneficent effects or whether it leads to under-provision of public goods. There is one body of empirical work in the United States. that has examined an episode of devolution in environmental decision making. During the Reagan Administration in the 1980s, there took place a devolution to the states of certain responsibilities for environmental management. There have been a handful of studies of this period to see if this resulted in any kind of a race to the bottom. All of these studies without exception can find no such evidence. They find no reduction in spending on pollution abatement or deterioration in environmental quality. If anything, there is some evidence of a "race to the top".[6]

More generally, there is only one study I know of that explores the likely magnitude of the distortions resulting from inter-jurisdictional competition. Ian Parry (2001) has constructed a computable general equilibrium model in which regional governments have a single tax: a tax on mobile capital. Using representative values of the key parameters from the literature, Parry conducts a series of simulations in which he calculates the welfare losses from competition. He finds, in most cases, that these losses are quite modest with typical estimates of the excess burden per dollar of revenues on the order of 3%. Moreover, he finds that when he allows for some budget-maximising tendencies among public officials, the welfare losses quickly diminish and soon become welfare gains. This seems to me an important line of work in that it gives us some feel for the likely importance of distortions from any race to the bottom. It suggests that they are small and perhaps even negative.

One comes away from the fiscal-competition literature feeling unsatisfied in the sense that it does not really give us a solid answer to the question of whether there is, in fact, a “race to the bottom” (a very sinister sounding outcome!), and, if so, whether it amounts to anything very significant. My own feeling is that the general economic case for fiscal decentralisation has not been seriously compromised. There remains, in my view, a strong case for the decentralised provision of local public goods.[7] There are surely specific instances where some kind of harmonisation can probably improve matters, but I think these must be examined on their own merits, and not adopted simply on the basis of a general presumption of a destructive race to the bottom.

4. On fiscal equalisation

Fiscal equalisation is a prominent feature of many (but not all) systems of federal finance. Equalisation measures take a number of different forms, but their basic purpose is the same: to transfer funds to fiscally weak jurisdictions. It certain cases, fiscal equalisation may be imbedded in a system of revenue sharing in which the central government provides disproportionately large transfers to provincial, state, and/or local governments that have small tax bases relative to some measure of fiscal needs. In other cases, equalisation objectives may manifest themselves in programs of matching grants, where the matching share of the grantor is larger for fiscally weak jurisdictions.

The use and role of fiscal equalisation varies significantly from one country to another. In many systems of federal finance, Canada, Australia, and Germany to mention only three, equalisation measures have been a major feature of inter-governmental finance. In Canada, one can argue that they have played an important political role in holding the federation together. In other cases such as Italy, they have been a source of considerable political tension resulting in resentment from the continuing transfers from the north to the south. In contrast, in the United States, there has been little interest in fiscal equalisation at the central government level. There is no basic, major program of fiscal equalisation to transfer funds from the central government to the states. There are, however, lots of such programs (especially for school finance) under which individual states provide funds to their local governments.

Let me offer a few brief observations on systems of fiscal equalisation. First, although its use is widespread, fiscal equalisation is certainly not a necessary feature of fiscal federalism. Economists typically think of re-distributive measures from the rich to the poor as those that transfer income from relatively high-income individuals to those with low incomes. From this perspective, equalising inter-governmental grants are not a very effective device: they must inherently involve some perverse transfers since some monies are going from low-income households in wealthy jurisdictions to relatively rich individuals in poorer jurisdictions. The transfers may be equalising on average, but they are not so effective as a program that transfers funds directly from rich to poor households. Inter-governmental equalising transfers thus require a somewhat different justification in terms of social values. They must be based on some social sense that it is desirable to provide additional support for the provision of public services in fiscally weak (typically, but not always, poor) jurisdictions.

Second, systems of fiscal equalisation are controversial in terms of their implications for economic efficiency. Some observers contend that such equalisation allows poorer jurisdictions to compete more effectively with fiscally stronger ones. In the absence of such grants, this view holds that fiscally favoured jurisdictions have the capacity to promote continued economic growth at the expense of fiscally deprived areas. Fiscal equalisation, from this perspective, provides some levelling of the playing field. But others see the issue differently. Ronald McKinnon (1997), for example, contends that fiscal equalisation can impede needed regional adjustments that promote growth in poorer regions. McKinnon argues that equalisation can hold back development in poorer regions by impeding a desirable inflow and outflow of resources in response to cost differentials.

At any rate, many countries find, on equity and political grounds, that fiscal equalisation programs are important facets of their systems of federal finance. This typically requires the development of indexes of “fiscal need” and “fiscal capacity” that serve as the key inputs into a formula for the disbursement of funds. There are some inherent ambiguities in the definition of such indices, but they have not proved so formidable as to prevent the establishment of workable systems of fiscal equalisation.

5. Fiscal decentralisation in the transition economies and developing countries

Fiscal decentralisation is currently a major theme of fiscal reform both in the transition economies and the developing world. The failure of central planning has led to moves toward privatisation, on the one hand, and decentralisation of the public sector, on the other. The prevailing sense is one of the need, where possible, to get various activities out of the public sector, and, where this is not feasible, to move them to lower levels of government. As regards decentralisation of the public sector, the problem here is that effective performance in the public sector requires at least two elements. We have already discussed the issue of the appropriate alignment or assignment of functions to the different levels of government. But the assignment of functions isn't enough. A high level of public sector performance also requires the design and working of a coherent set of fiscal and regulatory institutions that embody incentives for effective policy making (Picciotto and Weisner, 1998). In short, we simply can't dump monies on newly formed provincial and local governments and expect them to function well.

This is a broad and complex issue.[8] But let me simply point to what I see as the most critical elements. The literature has stressed, quite properly I think, the importance of "hard budget-constraints" for decentralised levels of government (e.g. McKinnon, 1997). The basic idea here is that effective decision making requires the electorate and their officials to weigh the benefits of proposed public programs against their costs. And this implies that regional and local jurisdictions must bear the costs of proposed extensions of public programs. This means regional or local financing, either through user fees or jurisdictional taxes.

Let me stress that this surely does not rule out systems of inter-governmental grants, perhaps with equalising features. But it does mean that these grants must not be too large and must not be expansible in response to local budgetary decisions. If such grants dominate provincial and local revenue systems, then officials are likely to turn to political channels to get additional funding from above, instead of relying on increases in own revenues.[9] Inter-governmental grants (aside from special programs with spill-over effects) should be lump-sum in character so that decentralised governments must finance at the margin extensions of public programs. There must not be a prospect that decisions to increase the public budget will be ratified by “bail-outs” from higher levels of government.

This also suggests the need for limitations on debt finance. The issuance of bonds to finance state-local expenditures makes economic sense for investment in public infrastructure; it provides a sensible way to spread out the payments for the projects over their useful life. But debt issues must not be available to finance deficits on current account. The concept of a hard budget-constraint for decentralised levels of government thus implies some basic limitations on the forms and scale of both inter-governmental grants and the use of debt finance.[10]

This presents a major challenge in many developing countries, where systems of decentralised taxation are often woefully inadequate. The development of provincial and local revenue systems is, in my view, one of the most pressing fiscal issues in federal finance in the developing world. The data reveal that most developing countries have public sectors that are not only highly centralised (relative to the industrialised nations), but that place a disproportionate reliance on central revenues. Inter-governmental transfers are typically the major source of revenues for provincial and local governments–and this renders very difficult the emergence of effective and accountable public decision making.

It is interesting, in this regard, that the evolution of many of the industrialised countries over the past century or two involved long periods of fiscal centralisation (Oates, 1993). And the point of departure for this evolution in many instances (like the United States) was a setting with a relatively well-developed system of state and local taxation. In the United States, for example, at the beginning of the twentieth century, the central government share in public expenditure and revenues was only about one-third. My point here is that in much of the industrialised world, there has existed a well-established system of decentralised taxation. In the current context, in contrast, the Developing Nations have, as a starting point, a highly centralised system of finance with very limited and weak institutions for local taxation. Much important work needs to be done in the creation and development of institutions of public finance, especially systems of taxation, in the developing world (Bird, 1992; Bahl and Linn, 1992; Bird and Vaillancourt, 1998).[11]

Finally, let me mention briefly the difficult and troubling issue of corruption. Some observers have claimed that fiscal decentralisation in the Developing and transition economies is undesirable because of widespread corruption at decentralised levels of government. The case for this argument is, however, far from clear either in theoretical or empirical terms. In fact, some recent empirical work has explored the association of measures of corruption with the extent of fiscal decentralisation and has found an inverse relation. Raymond Fisman and Roberta Gatti (2002), for example, have regressed various measures of corruption on an number of explanatory variables – one of them being a measure of fiscal decentralisation – and they find that the level of corruption varies inversely with the degree of fiscal decentralisation. Although this is a complicated issue, the view that fiscal decentralisation tends to increase the level of corruption in the public sector thus does not seem to have compelling support.

In sum, the case for the development of decentralised fiscal and regulatory institutions in developing and transitional economies is, in my view, a compelling one. But it is not a simple matter. It will require the design and introduction of a set of decision-making practices and revenue systems that embody the right kinds of incentives for good governance. This will take time.

6. On learning from others

The theme of this conference is “learning from others”. The structure of inter-governmental finance varies widely from one country to another, often for distinctive historical reasons. But there is an ongoing process of evolution of public sectors in which there are opportunities for the realignment of responsibilities and of fiscal and regulatory instruments. This is nowhere more evident than in Europe where there are simultaneously reforms taking place for devolution within member countries, while at the same time a new central level of government is taking shape in the EU: centralisation and decentralisation at the same time! The experience of individual nations can provide useful guidance. For example, Gebhard Kirchgässner and Werner Pommerehne (1996) having examined the effects of tax competition in Switzerland, concluded that it has not seriously undermined the operation of a relatively decentralised fiscal system, an experience with wider implications for Europe.

More generally, fiscal decentralisation itself provides potential “laboratories” for policy experimentation. As pointed out long ago by James Bryce (1888) in his insightful study of the United States, “Federalism enables a people to try experiments which could not safely be tried in a large centralised country” (Vol. I, p. 353). In fact, the United States’ experience involves a number of important and intriguing cases where policies were initiated at local or state levels, and after their successful operation there, were later instituted at the central level (Oates, 1999). These so-called “laboratories of democracy” can produce valuable experience with a variety of different policy options, experience that can be usefully drawn upon elsewhere.

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[1] This paper was the basis for the author's speech at the International Conference on Federalism 2002.

[2]This idea has been formalised as the "Decentralization Theorem" (Oates, 1972, ch. 2). The magnitude of the welfare gains from such decentralisation depends on several factors including the variability of demand across jurisdictions, inter-jurisdictional cost differentials, and the price elasticity of demand (Oates, 1997).

[3]Asymmetric information and various principle-agent problems make this a rich and complex issue. See, for example, Levaggi's treatment (2002) of decentralised budgeting procedures.

[4] Shah (1994, ch. 1) and McKinnon and Nechyba (1997) provide a useful listing of public services associated with different levels of government.

[5]Wilson (1996, 1999) has provided two excellent surveys of the competition literature. For a comprehensive treatment of the theory of fiscal and regulatory competition, see Wellisch (2000).

[6]For a more detailed description of these studies and their findings, see Oates (2002).

[7] Frey and Eichenberger (1996, 1999) offer an intriguing proposal for a restructuring of the public sector in the EU consisting of "functional, overlapping, and competing jurisdictions". Their contention is that competition among jurisdictions in the provision of individual public services would enhance the performance of the government sector.

[8]For an excellent treatment of these issues, see Bird and Vaillancourt (1998).

[9]There is extensive evidence for the United States that inter-governmental grants have provided a strong stimulus to spending by state and local governments; this is known as the "flypaper effect" (Oates 1999). Winer (1983) has found similar evidence for Canada; he finds that the separation of public spending and taxation decisions through grants raised provincial expenditures.

[10]In the absence of such limitations, excessive spending by provincial and local governments resulting in bailouts by the central government can create a serious moral-hazard problem and even destabilise the entire public sector. There are numerous instances of this phenomenon including, for example, recent experience in Argentina and Mexico (Trillo et al., 2002).

[11]There is, incidentally, an extensive literature on taxation in a federal system. This literature addresses the so-called "tax-assignment problem", the issue of which taxes are best assigned to the different levels of government (McLure, 1983; Oates, 1999).