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Notes on Fiscal Federalism

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Task Force on Decentralization

Oates (1999, p. 1120) defines fiscal federalism as a subfield of public finance that addresses the vertical structure of the public sector. "It explores, both in normative and positive terms, the roles of the different levels of government and the ways in which they relate to one another through such instruments as intergovernmental grants."

The above definition suggests a large degree of overlap between the notions of fiscal federalism and of decentralization. Having been asked to write a few pages on fiscal federalism in the context of a broader project on decentralization, I will try to concentrate on those dimensions that are less likely to be treated in the other short papers requested for this meeting. Compared with some treatments of decentralization, fiscal federalism pays special attention to the co-existence of multiple levels of government and to their interactions, especially on the financial side.[1]

Hence, I will be focusing on:[2]
The revenue side (tax assignments),
Intergovernmental transfers,
Intergovernmental relations more generally.

Given the scarcity of time and space, I will be crossing the boundary between facts and normative analysis without flagging each time.

Before jumping into the basics of fiscal federalism, I want to make two related remarks on decentralization and economic/political theory.

The "straw-man" theoretical paper on decentralization seems to compare the provision of <u>one</u> public good at the central level with its provision by local governments, where those local governments are of somewhat optimal size for the good in question. Actual governments, national, provincial or municipal, are multipurpose organizations that provide a large number of goods and services. It is unlikely that the optimal jurisdiction size for different public goods will coincide. Economies of scope, task complementarities, and transaction costs might help explain the fact that so many different goods are provided under the same, one-size, institutional umbrella.[3] Splicing independent issues together widens the scope for bargaining by lowering the transaction costs of political trades; splicing has the advantage of increasing the surplus realised by political cooperation.[4] But it is likely that the underlying heterogeneity in "geographical scope" of different "public" goods will still demand special-purpose governments (such as school districts) and

[1]The statement in the text is of course a simplification. There is important recent work that argues that the effects of decentralization depend on how subnational expenditures are financed (Bardhan and Mookherjee, various papers). Also, "*decentralization*" includes *fiscal* (i.e. *tax*) decentralization. This brings us to the terminological problem that the same word is used to refer to so many different experiments that it might become an obstacle for intelligent communication.
[2] For brevity I will be also focusing on the relation between the first two tiers (*"Centre"* – *"province"*) in a three-tiered system, i.e., in a federal country. Some of the things we say, but not all, apply also to the relation between two levels in two-tiered systems or to the relation between provinces and municipalities. I am also focusing on cases in which subnational governments are already elected, and just discussing the relation of fiscal federalism with the decentralization of particular government functions maintaining a given democratic structure.
[3] Not to mention the fact that actual local governments (especially at the intermediate tier!) are historical accidents, which are unlikely to be of optimal size for anything. (One could also look into these dynamics from a transaction-cost perspective.)
[4] Of course this multidimensionality can bring in some other problems such as cycling, unless prevented by institutional design.

intergovernmental interactions (a point to which I come back in section C). An extreme proposal along the lines of special-purpose governments is Bruno Frey's notion of Functional, Overlapping and Competing Jurisdictions (FOCJ); see for instance Frey and Eichenberger (1999).

If politicians were perfect agents of the citizens that elect them, and there were no transaction costs in political markets, then scale economies, spillovers and other "technical/physical" properties of public policies could be handled equally well by any allocation of "political jurisdiction" -- the Coase Theorem applied to (federal) political markets. Hence, we should be very explicit about "our political economy" from the start. This includes questions such as: (a) how well is the principal-agent (citizen-politician) problem handled at each tier, and (b) what are the characteristics of the environment for the transactions among politicians (especially those representing different jurisdictions; Spiller and Tommasi, 2000).

Basics of Fiscal Federalism

Fiscal federalism deals with the assignment of expenditure responsibilities and of revenue powers, with the design of intergovernmental transfers, and with the macroeconomic implications of subnational (and national) fiscal behavior.

The most basic normative guidelines contend that the central government should have the basic responsibility for the macroeconomic stabilization function and for redistribution (due to the mobility of economic units), while decentralized levels of government have their raison d'être in the provision of goods and services whose consumption is limited to their own jurisdictions.[5]

It is a common practice in federations around the world to allocate the major taxing powers with the federal government,[6] while some of the most expensive expenditure responsibilities such as health, education and social services, have been allocated to subnational governments. The latter is precisely justified by all the arguments for decentralization of the public sector put forth in the literature, and it is a feature that has been strengthened in the last couple of decades. While it is argued that decentralizing expenditures leads to more efficient service delivery, it is not clear that there are equivalent fiscal efficiency advantages of decentralizing revenue raising.[7] As a matter of fact, the strongest argument for decentralizing tax collection seems to be "*fiscal accountability*" or "*fiscal responsibility,*" an argument that already includes the "failures" associated with intergovernmental grants systems (and other political economy considerations not always completely spelled out.)
The centralization of revenues and decentralization of spending creates important vertical fiscal imbalances, which are a basic reason for intergovernmental transfers. Additionally, all federations are characterized by horizontal fiscal imbalances, i.e., differences in the revenue capacities (or in spending needs) of different subnational governments. There are

[5] Yet see remarks (1) and (2) in the introduction.
[6] China seems to be an exception.
[7] Conventional wisdom states that economic and administrative efficiency suggests that taxes on mobile factors, value-added taxes, and taxes on international trade should be assigned to the central government. Similarly, local governments should presumably tax only immobile factors (such as land and real state) in addition to applying user charges. Because the central government has a large role to play in achieving redistribution and stabilization goals, it seems logical for it to be responsible for progressive taxes, as well as those taxes most sensitive to economic fluctuations.

arguments in the literature that call for transfers to compensate for horizontal imbalances. The third most popular reason for intergovernmental transfers is addressing interjurisdictional spillover effects.

Thousands of pages have been written on intergovernmental transfers, conditional, unconditional, matching grants, revenue-sharing formulas, etc. From a normative point of view, the most appropriate form of a transfer depends on its objectives; but it is commonly stated that an effective transfer system should satisfy several criteria: (Shah, 1994)

Revenue adequacy: the subnational authorities should have sufficient resources, with the transfers, to undertake the designated responsibilities.
Local tax effort and expenditure control: ensuring sufficient tax efforts by local authorities. The transfer system should not encourage fiscal deficits.
Equity: transfers should vary directly with local fiscal needs and inversely with local fiscal capacity.
Transparency and stability: the formula should be announced and each locality should be able to forecast its own total revenue in order to prepare its budget; and the formulae should be sufficiently stable to allow long-term planning at the local level.

The intergovernmental transfer systems in Latin America that I know in some detail are quite far from satisfying those criteria. (Saiegh and Tommasi, 2000)

Incentive Problems

Intergovernmental fiscal systems which include large amounts of transfers from the centre to subnational governments <u>can</u> create many incentive problems. I will focus here on one of the most salient ones, the so-called *bailout problem.* [8] As the collected volume by Rodden, Eskeland and Litvack indicates, sub-national budget constraints are often "soft." When an entity such as a subnational government faces a soft budget constraint, it means that it can implicitly or explicitly pass on its liabilities to other entities such as higher-level governments. This leads to a situation of moral hazard in that it provides incentives for subnational governments to overspend, undertax, overborrow, underprovide services, and accumulate arrears, in the hope that local public expenditures will ultimately be subsidized by taxpayers in other jurisdictions. Imagine an unexpected adverse fiscal shock at the local level. Instead of implementing politically painful expenditure cuts, local politicians might choose not to adjust, even if it leads to a debt crises, if key constituencies (voters, creditors) believe that ultimately the local government will be bailed out by the centre.[9]

Notice that the dynamic fiscal irresponsibility just described is one possible justification of the "fiscal accountability" argument in favour of tax decentralization of the previous section.
When faced with a negative shock, it is relatively easy for local governments to convince voters and creditors that the costs of adjustment should fall on the central government if 70 or 80 percent of local government revenue comes from grants or shared revenue.

[8] Other problems include rigidities for national macroeconomic and tax policies, inefficiencies in the fiscal mix and in the provision of local public goods, etc. (Tommasi, Saiegh and Sanguinetti, 2001).
[9] In countries such as Argentina and Brazil, expectations of bailouts have repeatedly been confirmed throughout the last decade.

Not only the federal fiscal structure, but also the structure of political institutions affects the likelihood of moral hazard problems. In all federal countries the structure of the central government includes representation of the subnational constituent units. Depending on the details of such representation, and on other aspects of the country's political institutions,[10] this can give rise to logrolling by which a central government would opt to provide bailouts to certain states, even though the policy is inefficient for the federation as a whole.

This leads us to the next and final point.

Intergovernmental Relations more generally[11]

In every federal polity, federal arrangements constitute a complex intermixing of powers and responsibilities between national and subnational governments. The assignment of policy responsibilities is never unambiguous or frozen, as the very *process* of decentralization suggests, and intergovernmental interactions are always taking place.

These interactions can take very different forms with varying degrees of institutionalization. Many issues are often carried out informally through various means of direct communications between ministers, officials, and representatives of different levels of government. This day-to-day management of intergovernmental affairs is complemented by the maintenance of certain councils where national and subnational officials meet to discuss policy in areas of nonexclusive jurisdiction, such as health, education, social programs, and infrastructure. Finally, adjusting the distribution of power between the national and subnational governments to political, economic, and fashion changes sometimes requires additional mechanisms such as formal intergovernmental agreements. These agreements usually take the form of treaties, compacts, or memorandums of understanding. Such agreements might formalize the intention of the different levels of government to adopt a particular policy and establish the procedures for implementing it administratively. Another type of agreement might specify that the signatory executives will use their best endeavours to ensure that their respective legislatures adopt a law, whose terms have been agreed by the parties.

In most countries, the various informal mechanisms and even the written undertakings between governments within a federation, have an unclear legal effect. That is, many of these agreements do not create legal obligations. The value of the intergovernmental agreements therefore depends on the ability of the different parties to enforce whatever they have agreed on; countries differ widely in this regard. These interactions are bound to be quite complex, involving numerous political actors with very different interests. The overall institutional environment – and not just the mechanisms through which intergovernmental relations occur – is crucial to understanding why in some countries the different levels of government strike mutually beneficial bargains and in others they do not.[12]

[10] See Iaryczower, Saiegh and Tommasi (2001).
[11] I use *intergovernmental* to encompass both centre-province relations and relations among provinces (sometimes called intergovernmental and interjurisdictional relations respectively).
[12] This brings us back to the point made in the previous section, that the central government can be seen as a governance structure that includes regional representation, and hence as one of the (overlapping) arenas in which the inter-provincial distributive game takes place (Iaryczower, Saiegh and Tommasi, 2001).

This brings me to the last point I want to make in these rushed few pages. Decentralization (the assignment of jurisdictions of policy) is a complex matter. Whether a particular component of the bundle of policy decisions better pertains to a certain decision-making level depends on a variety of circumstances, likely to vary from country to country. I imagine that broadly identifying those sets of circumstances is the Task of this Force. Furthermore, those circumstances are also likely to change over time, as technologies and preferences change. What we would like is for countries to have good mechanisms for deciding and instrumenting institutional changes, such as decentralizing or centralizing a certain function, when it is deemed beneficial.

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