

# Infrastructure Notes



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## Decentralized Government and Macroeconomic Control

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*There is wide agreement that decentralized government can improve the allocation of public resources by bringing decision making closer to consumers and by enhancing the accountability of public officials and bureaucrats. However, multiple layers of government can cause problems for national macroeconomic control. This is because local accountability does not only imply decentralized decision-making; it typically entails financial competencies as well-together with the right to borrow for lower-level authorities. Uncontrolled access to capital markets and mismanagement of budgets by local government could thus jeopardize macroeconomic stability and a case can be made for centralizing the stabilization function. This note discusses problems of macroeconomic control under decentralized government from a theoretical point of view. It concludes that the decentralization of public functions is not necessarily at variance with stabilization objectives.*

### THE CASE FOR CENTRALIZING THE STABILIZATION FUNCTION

Generally, the case for centralizing macroeconomic stabilization policy is based on the following reasoning:

- The use of a national currency implies centralized monetary policy. Since monetary and fiscal policies are intertwined, centralized monetary policy seems to entail the need for centralizing fiscal policy.
- The monetization of public debt at local levels is likely to interfere with monetary policy. This may diminish the central bank's ability to pursue its national policy objectives.
- Debt created through demand management is internal for the nation, but external for regions. This entails inefficiency of decentralized stabilization policy through higher costs of borrowing.
- Regional stabilization initiatives usually have negligible impacts at the national level-because of their small size relative to the national budget. Furthermore, the openness of regional economies limits the

effectiveness of local fiscal policy because any fiscal stimulus is exported to a high degree.

- Given regional spillovers of fiscal stimuli, local authorities will never provide enough stabilization because the costs are too high compared to the internal benefits of the policy.

## EXAMINING THE CASE FOR CENTRALIZED STABILIZATION POLICY

The traditional wisdom of a centralized stabilization policy has been questioned recently. The case for Keynesian demand management has overstated the need for centralized macroeconomic policies because:

- *It assumes regionally symmetrical shocks.* One may well ask what the central government should do in the presence of regionally asymmetrical shocks that sum to zero for the nation. There is no clear rule for fiscal policy in this case.
- *It assumes a closed economy.* As Mundell (1963) has shown, in an open economy, any national fiscal stimulus would be offset by a change in exchange-rate. The fiscal stimulus thus evaporates where the exchange rate is flexible. If there were an appropriate state fiscal response to regionally varying, but zero-sum shocks, this could eventually be neutral as to the exchange rate and still exhibit significant employment effects (Gramlich, 1986).
- *It assumes segmented capital markets.* The idea that decentralized fiscal policy is more costly because of higher borrowing costs for regional governments is baseless for an economy where open, competitive capital markets establish a single interest rate for whatever debt is held by bondholders-abstracting of course from specific risk premia. Thus the debt of both tiers of government will, in principle, bear identical financing costs as expressed by the fixed interest rates. Although specific risk premia may exist for regional tiers of government, the assumption of centralized fiscal policy being less costly is unsound because such costs may have been borne by the central government-through explicit or implicit bail-out guarantees or some type of 'national insurance'. Worse: stabilization policy as national insurance against regional shocks may entail additional costs that could eventually exceed the cost of specific regional risk factors (see below).
- *It neglects supply-side effects of fiscal policy.* Fiscal policy is not simply 'demand management'. It will usually have an impact on the supply of goods and services. This is particularly true for local public investment programs where the regional incidence of the supply effects is more evident. Here local governments are commonly better equipped to cope with local unemployment as they have easier access to pertinent information, can respond more speedily to local needs, and often control appropriate policy instruments for immediate implementation.
- *It neglects built-in stabilizers.* Fiscal stabilization is in great part automatic through built-in elements of the tax-transfer system. This is true in particular for highly elastic revenues (like the income tax) and selected expenditure components (e.g., unemployment benefits). But built-in stabilizers are not confined to the central government alone; they can work at all levels of government, depending on the assignment of revenue and outlay functions.
- *It assumes non-cooperative behavior of lower tiers of government.* The case for centralized fiscal policy makes strong assumptions about the non-cooperative behavior of local governments. This is often based on the assertion that local government budgets are more cash-flow oriented, which can be pro-cyclical and hence destabilizing. Even if this thesis is accepted, any predilection to finance budgets from current revenue can be controlled through appropriate fiscal arrangements, a suitable assignment of revenue and outlay responsibilities, and a well-conceived system of intergovernmental transfers. In practice, effective coordination mechanisms exist for decentralized fiscal policy. The problem is to avoid perverse incentives in the coordination machinery.

- *It assumes that local borrowing impinges strongly on monetary policy.* In practice, centralized fiscal constitutions often consider money creation as an alternative means of financing the budget, and national governments then have to keep a firm grip on their central bank. It can be shown that central bank independence is usually greater under decentralized government which implies the possibility of stronger monetary discipline and macroeconomic stability when fiscal policy is decentralized. Centralization of fiscal policy is then likely to put monetary stability more at risk than under decentralized government.

As mentioned before, central fiscal policy is tantamount to an insurance contract where the higher-level government promises to even out income variations across regions that result from regionally asymmetrical shocks. Alternatively, regional governments could borrow 'abroad' in order to stabilize their regional economy through appropriate local investment. However, as noted below, the case for insurance compared to borrowing is relatively weak.

- In the case of supra-regional insurance of local economies, the risk of 'moral hazard' behavior always exists. Local authorities may inflict economic shocks upon their economies (e.g., by granting unrealistic wages) because they hope to be 'bailed out' eventually by the insurer-the central government. Equally, national insurance may encourage excessive consumption by regional economies and governments when budget constraints are relaxed through the implicit or explicit guarantees of the 'contract'.
- Even where regional shocks are truly exogenous, insurance may be counterproductive where shocks are permanent rather than transitory. It is often difficult to determine whether unemployment is simply a response to a cyclical downturn or whether structural adjustment is needed to restore full-employment. Insurance could deepen a recession by 'relaxing' hard budget constraints and by postponing the necessary structural adjustment. Conversely, borrowing by regional governments is likely to encourage more rapid adjustment policies because of the need to convince capital markets (and parliaments) and because the costs of non-adjustment are unfettered and more striking.
- Equally important is the possibility that an insurance scheme could collapse under a long-lasting shock that was misinterpreted as temporary. This is particularly true if structural adjustment had not been initiated.
- And finally, macroeconomic shocks are not independently distributed among regions but highly correlated, which reduces the need for mutual insurance. Trade among open but independent regions works as an implicit insurance device in this case.

## **REVENUE AND EXPENDITURE ASSIGNMENT**

There are essentially two distinct approaches to achieve stabilization under decentralized government. These hinge on the philosophy that guides the assignment of revenues and expenditures within the nation.

- In the first approach, 'steadily flowing' revenue sources and cyclically invariant outlay functions are assigned to lower tiers of government. These assignments facilitate their budget planning and avoid pro-cyclical budgetary policies. The steady behavior of local governments will then act as an embedded, cyclically neutral, and hence stabilizing force, and demand management (if any) can be left entirely to the central government.
- In the second approach, the Constitution assigns elastic outlay functions and volatile taxes to local tiers of government. In this case, local budget flexibility is needed and special management tools must be employed. Budget flexibility includes, of course, the right to borrow. And, regional governments must have sufficient 'own sources' of revenue in order to minimize pressures for national bail-outs.

Since there is a clear case in favor of decentralizing the allocation function of government-and the provision of public goods and services at the local level (e.g., basic education and health) is by its very nature steadfast and persistent-the first model of stabilization under decentralization is often adopted which avoids conflict with the objectives of macroeconomic stabilization. Under this model, the financing of local budgets must be based on stable local revenue sources (like a property tax or local fees for services) and on intergovernmental transfers that are ideally invariant to changes in the business cycle. Grants have an advantage here over shared revenues because the latter typically include cyclically sensitive taxes. Local borrowing can be confined to financing revenue-generating, public investment at the subnational level that lie within the realm of local responsibilities. This model requires a set of institutional rules and central government monitoring, but little budget flexibility is needed for lower tiers of government.

If, however, local governments follow the second model and provide services that are sensitive to the business cycle (e.g., social assistance), flexibility is needed on both the revenue and expenditure sides of local budgets. This flexibility should not encourage local governments to pursue an activist macroeconomic stabilization policy. Rather, it should only secure the full workings of built-in stabilizers at lower levels of government.

Budget flexibility is reduced

- when the budgeting process is rigid, e.g., when the magnitude and structure of the budget are hampered from reacting to a changing business environment;
- when outlays and revenues are 'captured' in funds, or if transfers across programs or objects of a budget is impossible;
- when revenue is earmarked to certain functions, in particular if the revenue is volatile (e.g., oil revenue tied to a road fund); and
- when local borrowing is restricted or disallowed.

Only the last point is somewhat controversial and needs further, albeit limited, discussion. In spite of the fact that institutional restrictions on local borrowing reduce budget flexibility and potentially jeopardize the built-in stabilizers of the fiscal system, many countries limit local borrowing ability in some way or another. The European Union even attempts to restrain *national* government borrowing through standard budget criteria and the onus of financial sanctions in the case of leniency. These limits are motivated essentially by concerns that local governments could-either through moral hazard or a misinterpretation of cyclical developments-incur debt that would be unsustainable in the long run, and the national government would be expected to "bail out" the defaulting local government. Unless lower tiers of government have a sufficiently high level of own resources, the central government may face pressure to bail-out local authorities. However, the 'no bail-out' outcome is essential for private capital markets to assess specific lending risks correctly, and it may implicitly discipline regional governments through higher risk premia on interest.

## **INTERGOVERNMENTAL TRANSFERS**

Local own source revenue is the cornerstone of fiscal decentralization because it installs an efficiency-enhancing tax-benefit link and fosters local accountability. But whatever local tax system is established in a country, there will be a need for grants or revenue sharing because local expenditure needs typically exceed local resources. This gap is particularly true in countries where social infrastructure is considered to be a public or merit good-for

instance primary education or basic health-and responsibilities for such functions are decentralized-which they commonly are. Where such functions can be privatized (and outsourcing is socially accepted) the scope for mobilizing resources is, of course, much higher.

The design of any grant system is of prime importance. Whatever solution is adopted, intergovernmental fiscal relations should be based on stable, transparent, non-arbitrary, universal, and non-negotiable rules. These rules should avoid destabilizing incentives and must not interfere with the principle of accountability. The following may serve as general guidelines:

- If there is a fiscal imbalance between local fiscal capacity and outlay responsibilities assigned to lower tiers of government, the gap is typically bridged through financial transfers in the form of unconditional revenue grants or through revenue sharing with the central authority. No strings are attached to these funds, but the transfers should be based on standard criteria of fiscal capacity or expenditure needs that cannot be influenced through strategic behavior of recipient governments. These transfers, together with the lower tiers' ability to pursue an independent tax policy, guarantee that local governments can freely respond to variations in demand for local public services without penalty in the form of reduced transfers to the jurisdiction. It allows tax financing at least at the margin, which is a precondition for public sector efficiency. In contrast, pure 'gap filling' would be tantamount to a full bail-out, and it would encourage inefficient spending and waste.
- Whether the emphasis is on the local provision of standard public services-with 'steady' behavior of lower level governments-or a more flexible budget approach, intergovernmental transfers should ideally avoid volatility. This stability allows local activities to evolve steadfastly within the stable-policy framework, and, in the flexible approach, it focuses their attention on those budget elements that are under their direct control: local taxation, expenditures, and borrowing. Grants can be stabilized more easily than revenue sharing through 'closed funding'. Revenue sharing is usually based on rigid formulae and is therefore difficult to untie from the buoyancy of the national tax system. Therefore, the sharing of highly volatile taxes, in particular the sharing of natural resource taxes (e.g., on minerals or oil), should be limited.
- In order to render revenue sharing more steadfast, a 'stabilization scheme' is needed eventually. Under such a scheme, the lower tiers of government would not lose their entitlements to a shared tax, but the actual transfers are based on rules that 'sterilize' part of their revenue in periods of boom and release it in periods of shortage.
- Narrowing the scope of revenue sharing onto the less volatile taxes does not solve the foregoing problem because all buoyant taxes are typically revenue elastic. Moreover, this practice would focus the federal government's tax policy on taxes that are excluded from sharing and thus introduce a distortion into the national tax system.
- However, the federal government should preserve the right to levy and vary non-shared taxes in order to have an instrument for macroeconomic stabilization at the margin.

A general-revenue grants system based on standard fiscal capacity and need criteria can establish vertical fiscal balance, it is neutral as to fiscal (dis)incentives, it can be made consistent with the idea of fairness among regions (equalization), and it can be conceived to be cyclically neutral and to foster macroeconomic stability. Australia has established such a system for the Commonwealth's general-revenue grants to the states, but the Australian system is overly ambitious and very onerous in terms of information requirements. Simpler criteria will achieve similar results and still be efficient, equitable and stabilizing.

## CONCLUSIONS

Decentralization does not necessarily jeopardize macroeconomic stability. Casual empiricism to the contrary neglects the fact that local tiers often operate in an unstable macroeconomic framework and their behavior thus reflects adaptive, but not necessarily unstable, budget performance. The severe problems that Argentina and Brazil have faced, for example, in controlling lower tiers of government after the introduction of their stabilization plans in the 1990s reflect the fact that 'old' institutional arrangements are dysfunctional and that institutional reform is required.

The destabilizing behavior of local governments can be avoided through appropriate incentive structures and effective mechanisms of intergovernmental cooperation. Economic incentives are directly related to the assignment of revenue and outlay responsibilities among the tiers of government. Intergovernmental transfer systems can be designed that avoid disincentives and achieve fiscal balance, efficiency, equity and macroeconomic stability at the same time.