**Comments on "Fiscal Federalism and Decentralization:**

**A Review of Some Efficiency and Macroeconomic Aspects"***

**by**

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**Comments on "Fiscal Federalism and Decentralization: A Review of Some Efficiency and Macroeconomic Aspects," by V. Tanzi**

Vito Tanzi has written a useful survey summarizing many of the main ideas in the area of fiscal federalism. Many of these ideas will be familiar to those of us who grew up reading Oates (1972) and other important literature of the late 1960s and the 1970s, but issues of fiscal decentralization have attracted much new attention since then and Tanzi's introduction to the major themes in this field will be helpful to those in need of an overview. Of course, this paper is particularly focussed on the issues of fiscal decentralization that arise in the developing- and transition-economy context where policymakers and scholars face many distinctive and complex questions. Especially in this context it is difficult to escape the linkage between fiscal decentralization and macroeconomic policy, a topic that has been unduly neglected in the fiscal federalism literature. Tanzi devotes substantial and welcome attention to the macroeconomic implications of fiscal decentralization and it is to be hoped that his discussion will stimulate new research in this area.

Because of its breadth of coverage, it is natural that the paper passes rather lightly over certain topics. My comments will identify some issues that may warrant somewhat more attention, or perhaps a different emphasis, than they receive in the paper. I will not belabor the many points in the Tanzi paper where I find myself in broad agreement with the author. I will discuss some general issues at first and then turn to some more specific points.

First, because fiscal decentralization is partly about government structure, it is useful to recognize explicitly the interplay or tension between the normative and public choice approaches to issues of fiscal decentralization. [1] For policy purposes, we often wish to assess, normatively, whether fiscal decentralization is a "good thing" from the viewpoint of allocative efficiency or distributive equity. In order to do this, we need some *predictive* or positive theory of how decentralized governmental institutions do or might work. Part of the conventional wisdom, reiterated in the Tanzi paper, is that preferences for public services will be more effectively expressed through lower levels of government and thus that fiscal decentralization is conducive to allocative efficiency. But this presumption seems to depend critically on the decisionmaking mechanism of lower-level government, for example whether or not it is democratic or dictatorial, and on the constraints on local decision-makers, for example, the ease with which households and firms can escape or enter localities in response to their fiscal attractiveness or lack thereof. If "exit" is constrained and there are no effective channels for "voice," there is no particular presumption in support of the view that fiscal decentralization enhances allocative efficiency. In the most general terms, there is probably a fair presumption that exit, voice, or both may be more easily attained under fiscal decentralization, but enhancing the responsiveness of local institutions, either by democratizing them or by making them more competitive is a task that warrants explicit

[1] Political economy considerations figure prominently in the literature of fiscal federalism. For discussion and references, see, *e.g.*, Rubinfeld (1987) and Wildasin (1986).

consideration in the developing country context. [2]

Second, following Oates (1972), it is useful to distinguish between *economic* and *political* decentralization. By the former, Oates means any geographically non-uniform policy, whether implemented through decentralized political institutions or not. Bearing this distinction in mind, we see that there is really no such thing as a truly economically centralized system, since even centrally-planned economies must recognize interregional economic differences and take them into account in policy formulation. This is important to remember when discussing fiscal decentralization because it alerts us to be aware of the interactions between outwardly decentralized policies and the policies of central governments that are themselves non-uniform in their impact. For example, Schiff and Valdés (1995) finds that the agricultural sector in many developing countries has been subjected to heavy taxation, often through the implicit mechanism of price controls administered by agricultural marketing boards and the like. These policies are frequently implemented by central governments, as are transportation policies that may benefit rural and urban transportation sectors unevenly. These central government policies then may in themselves distort the allocation of resources, for example in the direction of contributing to excessive urbanization. If so, they need to be taken into account in the formulation of intergovernmental grant policies, the assignment of taxing authority to local governments, and other fiscal decentralization policies. In China, the process of economic decentralization naturally involves the "localization" of state- owned enterprises, which cannot but interact with the geographical distribution of fiscal burdens and benefits. Deregulation of the labor market, in the form of a loosening of the household registration (*hukou*) system, is bound to have major implications for urbanization and thus for the public finances of lower-level governments. In South Africa, the redress of inequality is a crucial and potentially explosive issue. While it is obvious that substantial pro-poor and interracial redistribution is necessary, there may be both economic and political dangers associated with excessive concentration of fiscal power. The strengthening of provincial and local institutions may provide a credible institutional constraint on the exercise of the redistributive powers of the public sector and thus provide a degree of reassurance to the potential losers from the dismantling of the *apartheid* regime. Examples could be multiplied, but the main point is to appreciate that fiscal decentralization is not a process that occurs in isolation from the evolution of other policies.

Third, the paper appears in some respects (though very judiciously) to be "leaning against the wind" of recent trends toward fiscal decentralization. Whether decentralization is "good" or "bad" is perhaps one of the grand normative questions and it is natural that policymakers might wish to have a concise bottom- line answer to this question. Perhaps the attempt to provide such a concise answer has led to some overly-simplistic pro-

[2] As the example of the competitive firm shows, democratization is *not* always crucial for allocative efficiency. Democratic political reform may be important for the success of some types of fiscal decentralization but not necessarily for all. From an economic viewpoint, the crucial issue is the linking of benefits and costs of resource allocation in the decisionmaking process.

decentralization views, such as "more decentralization is always better." As a counterweight to this view, one could argue that "less decentralization is always better." Dr. Tanzi would not, I am sure, subscribe to either of these overly-simplistic positions. It is important to recognize that the "right" degree of decentralization depends on what it is we are considering decentralizing and on the particular economic, historical, political, and other circumstances within which decentralization is contemplated. Another way to say this is that the "big question" about decentralization is really poorly posed. There is a continuum of alternatives along the decentralization/centralization spectrum, with the individual at the extreme decentralization end and world government at the other end. Somewhere in the middle are countries, states and provinces, and localities. To stake out a position at either polar extreme of this spectrum by asserting that all economic decisions should either be completely centralized or decentralized is obviously untenable. Some activities clearly reside within the sphere of the individual. There are some activities – global environmental issues come to mind – where uncoordinated decisionmaking at the level of the nation is probably too decentralized and some sort of global coordination mechanism is needed. Other activities should fall somewhere between the two polar extremes. From an economic viewpoint, there is nothing special about the point on the spectrum called the "nation." [3] Some activities might best be assigned to that level of government but certainly not all. The crucial issue is to identify which level of decentralization is appropriate for each kind of activity, and it just does not make much sense to hope for any sort of bottom-line presumption in favor of "more decentralization" or "more centralization."

I will now mention some more specific points in the paper.

First, on the macroeconomic side, Tanzi emphasizes the issue of "structural deficits." His discussion rightly highlights the importance of information, control, and accountability for decentralized borrowing. It is useful in this regard to bear in mind as well the problem of proper measurement of the net worth position of governments (see Eisner (1986), Kotlikoff (1992), Boadway and Wildasin (1993), and others). Lower-level governments often play an important role in accumulation of capital (for example, through public infrastructure). In addition to explicit liabilities (in the form of formal debt obligations), they can also incur

[3] Although it is conventional to refer to national-level policies as "centralized," the country does not necessarily provide a very natural unit of analysis. Parallel to Dr. Tanzi's statement that "California and Texas, on one hand, and Delaware, on the other, cannot both be optimal given their large difference in size," we might say the same about China, the US, Germany, and Luxembourg. For many purposes of public economics, such as the analysis of tax and transfer policies, the economically-natural unit of analysis is the area covered by the markets for factors of production. (Krugman (1991) has recently emphasized that the country is often not the natural unit of analysis for issues of trade and specialization.) At certain times and places, capital and labor market boundaries might roughly coincide with national political boundaries, a stylization that presumably underlies the view of many writers that tax, transfer, and other redistributive policies should be undertaken by national rather than lower-level governments. But if factor markets become international in scope, as seems increasingly to be the case, national governments are no longer central governments in the relevant sense. See and Tanzi (1995) and Wildasin (1992, 1994a, 1994b) for further discussion of factor-market integration and redistribution policy.

implicit liabilities, for instance in the form of underfunded pension obligations to public employees. It is the change in the *comprehensive* net worth position of lower-level governments that is most important for growth, equity, and efficiency. Measuring the deficit or capital position of lower-level governments by examining only officially-measured local borrowing while neglecting other local government liabilities and assets is about as meaningful as trying to measure monetary growth by tracking fluctuations in the stock of $10 bills. It's part of the story, to be sure, but we had better recognize its limitations if we don't want to be seriously misled. If controlling lower-level government borrowing squeezes badly-needed infrastructure investment, the net effect could be not to *reduce* the fiscal burden passed along to the next generation but to *increase* it. Improving accounting systems for all levels of government in order to track government net worth positions more accurately is an important priority.

Second, Dr. Tanzi raises the issue of soft vs. hard local budget constraints. As he notes, if localities expect to be bailed out when running deficits, there will be an incentive or moral hazard problem that is likely to contribute to structural deficits. A local or provincial government that is "too big (or too important) to fail" may necessitate central government intervention, perhaps in the form of borrowing constraints or other regulations. However, one should also consider greater *decentralization* as a possible alternative to centralization (or recentralization). Breaking up lower-level governments either on geographic or functional grounds may credibly harden their budget constraints. For example, separating the provision of electricity from other general functions of local governments by establishing independent electricity enterprises or the breakup of large urban governments into a more fragmented system of local governments may make these bodies "small enough to fail." We generally do not bail out households and firms that get into trouble with their creditors, and this of course is the reason why we can afford to let them have access to the capital market on whatever terms they can obtain. An interesting question for research is to identify what sizes or types of lower-level governments can reasonably be viewed as sufficiently small that their budget constraints are "hard." To take some US examples, Orange County, California seems to be small enough to fail: there is little sympathy for a Federal government aid package to bail it out. By contrast, it appears that the current fiscal crisis in Washington, DC, may lead to higher-level government intervention, as also occurred in the 1970s with New York City. One can only imagine how soft the budget constraint would be for New York City if it were also the national capital. Although this might sound somewhat fanciful, there are in fact many countries where capital cities are also leading national economic centers, a situation that can easily turn municipal financial crises into national ones. Separating major governmental and economic urban centers (functional decentralization) or breaking large municipal governments into multiple jurisdictions (spatial fragmentation) may provide an effective means to harden the budget constraints of lower-level governments. As capital market conditions permit, it might then make sense to allow more unrestrained borrowing powers to lower-level governments in order to meet needs for infrastructure and other critical financing needs – with the understanding, of course, that the central government provides no guarantee to the creditors of lower-level governments.

Third, in several places, Dr. Tanzi discusses the use of "benefit taxation" in a decentralized setting. It is important in this context to distinguish carefully between taxes or charges that reflect true *benefits* from public services (whether total or marginal benefits) and those that reflect the *costs* that households or firms impose on public service providers. To establish the "right" locational incentives, it is crucial to charge for services on the basis of *marginal congestion costs*, irrespective of the benefits that household or firm may or may not receive from public services. These congestion costs arise from the "rivalness" of public services, that is, from that fact that they may not be "pure" in the Samuelson sense. These congestion costs may but need not be related to the benefits that people receive from public services. The two are often confused because it is often those who participate in the utilization of public services (for instance, children in classrooms, patients in clinics) who both receive benefits from them and impose costs on them, but for proper pricing and taxation it is important to distinguish between them. The 50-person bus and the one-person *becak* may impose equal delays on other vehicles but the benefit of one bus trip may be 50 times greater than that of one *becak* trip; an infant and an aged person may both require 15 minutes of a doctor's time for treatment but the value of the service may be drastically different; a single adult immigrant to an urban area imposes no burden on the school system whereas a couple with children does. In such cases, taxes, fees, and charges based not on subjective benefits but on the cost of service provision or utilization (more specifically, based on the *marginal* cost) are required to avoid incentives for inefficient migration and facility and service utilization. The optimal congestion toll on a Samuelson-pure public good is zero for all users, no matter whether it provides high or low benefits, in total or at the margin. Per capita cost sharing is the optimal way to internalize the congestion costs associated with the provision of quasi-private public goods (goods whose cost of provision is proportional to the number of consumers), and, again, this is true for all users irrespective of the benefits that they receive from consuming these goods. [4]

A final comment concerns the issue of administrative capacity, corruption, and other institutional factors in fiscal decentralization. It is certainly true that these factors are important in assessing the feasibility of decentralization. However, one might conjecture that a sort of "law of conservation of administrative capacity" would apply, according to which decentralization of public sector functions neither creates nor destroys administrative talent, in and of itself. [5] The issue may not be so much the availability of talent and administrative skill in the public sector but rather the fact that it, too, may have to be

[4] These congestion-pricing rules are first-best rules; I have abstracted from second-best considerations that might require their modification. Basic principles of taxation to achieve locational efficiency, and references to relevant literature on this topic, are discussed in Wildasin (1986, Sec. 2).

[5] Decentralization or other institutional change may of course destroy institution-specific human capital. Sometimes this is indeed the purpose of institutional reorganization, but of course it may also be costly.

decentralized along with public sector functions. This transition may take some time, and it may require some rethinking of the reward structures for administrative service both at the level of the lower-level governments and for higher-level governments. I would be reluctant to accept the general notion that higher-level governments always have better administrators; for instance, it is not obvious that the UN or the European parliament have better politicians or bureaucrats than some national governments. Given time to adjust, I would expect administrative talent to flow to the locus of administrative responsibilities. We should be careful about letting the tail of current administrative capability wag the dog of the proper assignment of public sector functional responsibility. As far as corruption is concerned, we have as usual fertile ground for speculation since corruption tends by its nature to be somewhat hidden. One could imagine that central government bureaucrats might be more effectively monitored and inspected and that there are numerous opportunities for local officials to get away with various types of graft. However, it is very difficult for local officials to engage in really enormous corruption schemes, whereas a corrupt minister of a central government may be able to do massive harm. So there may be a tradeoff between local corruption on a small scale and central corruption on a large scale. It seems impossible to say *a priori* which would dominate the other.

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