Federalism and Economic Growth in the OECD

Assoc. Prof. Phil Bodman

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Joint with Prof. Harry Campbell, UQ, and Prof. Robin Boadway, Queen's U. Canada

Preliminary

Introduction

- Issues regarding fiscal relations and structure of government are hot topics in Australia and many other countries, particularly developing economies.

- Goal here is to examine how, and whether, structure of government affects rates of long-run economic performance (growth in output per capita, physical capital, human capital and TFP) across the OECD.

- Relates to the broad literature on determinants of economic growth, in particular that focused on the role of ‘social infrastructure’, institutions and growth

- Economists typically use a production function approach to analysing long run economic performance (growth)

  \[ Y = F(K, N, A, \ldots) \]

  Following Solow-Swan, there was a substantial emphasis on \( A \)
  
  \( (= \text{technology/productivity/efficiency}) \)
  
  and physical capital accumulation (increasing \( K' \)).

- Next step is to disaggregate \( K \) to get a richer understanding of which factors drive growth, and also a better understanding of what determines \( A \).

  - Human capital – very important!
  
  - Public infrastructure capital
  
  - Research and development factors
  
  - Natural resources (non-renewable? Recycling?)
  
  - Other factors – trade, income distribution
More recently a major focus has shifted towards the importance of institutions and so-called ‘social infrastructure capital’

Social infrastructure - “the institutions and government policies that determine the economic environment” Hall and Jones (QJE, 1999)

Substantial literatures have emerged on:
- Trade, institutions and growth
- Aid, institutions and growth
- Natural resource dependence, financial institutions and growth

Naturally there is also a growing literature on public institutions and growth (and economic performance more generally).

Standard economic literature on fiscal policy and (endogenous) growth e.g. Kneller et al (JnlPubEcon, 1999) suggests that both the extent of and structure of taxation and government spending affects long-run economic growth

- standard ‘crowding out story
- distortionary taxation (and regulation) reduces growth
- ‘productive’ government spending raises growth

In terms of the institutional aspects there is a small but growing literature out of the public economics field focusing on the structure of government and its effects on longer term economic performance.

Public economics literatures provide many reasons for the determination of the observed structure of government beyond mere influence of ‘history’ – including possibility that decentralisation might promote growth / higher living standards.

Particular emphasis has been placed on fiscal decentralisation (FD) and how this might affect economic efficiency, factor accumulation and long run growth.

“Arguments for decentralisation are typically based on assessments of what functions state governments can undertake more effectively than national governments, and the arguments are often normative in nature.

However, the outcome of such debates ultimately depends on one’s view of how benevolent governments really are.

A broad generalisation is that decentralisation is more preferred by those who:
- a) put less weight on equity relative to efficiency, and
- b) think of government as more self-serving, inefficient and self-aggrandising.”

(Boadway(2006))
Defining Fiscal Decentralisation

Basic definition - the division of budgetary (tax / spending) responsibilities between different levels of government.

But, true decentralisation is not simply a geographical de-concentration of the central government’s taxation, spending, bureaucracy or service delivery, rather it is essentially linked to the territorial distribution of power.

Commonwealth Secretariat (1985) defines the decentralisation of government as 'the transfer of power and/or authority to plan, make decisions and/or manage public functions from a higher level of government to a lower one'.

We equate fiscal decentralisation to the amount of independent decision-making power involved in subnational expenditure and revenue decisions.

The term ‘subnational’ collectively stands for levels of government below the national government, both lower level governments (municipalities, communes or local councils) and intermediate tiers (regions, states, provinces, counties, territories or districts).

‘Decentralisation’ is used in the static sense to describe systems in which responsibilities are divided among tiers, rather than in the dynamic sense of becoming ‘decentralised’.

The extent of fiscal decentralisation depends on the ability of lower levels of government to make independent revenue and expenditure decisions regarding the provision of public goods and services within a geographic domain, without interference by the central government.

=> The extent of overall government decentralisation depends on such additional factors as the number of tiers within the subnational structure; whether these tiers are elected or not; the size of these tiers (number of employees?); legal / constitutional issues regarding whether the country is a unitary entity or a federation, etc.

OK. Why exactly might the extent of the structure of government and FD affect the long-run rate of economic growth (and the drivers of growth - factor accumulation and rate of TFP)?

Musgrave (1959) stated that the three main objectives of government regarding public finance were efficiency, income redistribution and macroeconomic stability.

- Issue is whether or not changes in efficiency, macroeconomic stability and income inequality resulting from increased (or decreased) FD have a statistically significant impact on economic growth.
In summary, FD might be **growth-enhancing** if it leads to:

- increased efficiency in the supply of public goods by better consideration of local preferences *(consumer efficiency – classical viewpoint)*

or increased efficiency in the supply of public goods if it leads to subnational innovations, cost reductions and higher productivity through improving intergovernmental competition *(producer efficiency – alternative viewpoint)*.

Alternatively, **growth-impeding** hypotheses can be postulated from the suggestion that decentralisation might lead to:

- harmful fiscal competition in the face of mobile factors,
- shift from public capital spending to public consumption spending
- increased macroeconomic instability,
- increased corruption,
- increased rent-seeking by special-interest groups,
- less competency in sub-national decision making.

These arguments apply especially where there are no scale advantages from central provision (e.g. national public goods), no advantages from centralised information gathering (e.g. general revenue collection), or where there are no national social insurance considerations.

Of course there are significant harmonisation advantages from a relatively centralised tax system.

This implies that the case for decentralising expenditures is greater than for decentralising revenue-raising.

As a consequence there is likely to be a vertical fiscal gap.

Should not necessarily expect a monotonic relationship between FD and growth – could be *hump-shaped*.

⇒ Could be that there is an *optimal degree of FD*, usually thought to be some ‘medium degree’, that is less than complete decentralisation.

⇒ Low levels of FD may not provide enough incentive for subnational governments to improve allocative and productive efficiency. In this case, the fixed costs of maintaining subnational governments may outweigh any benefits in terms of efficiency, hindering economic growth.

⇒ Too much FD may lead to macroeconomic instability and inequality, also having a negative impact on economic growth in the long run.
Measuring Fiscal Decentralisation

There is no single, or simple, measure of fiscal decentralisation. Fiscal decentralisation is 'so multidimensional that specification of a formal hypothesis for statistical testing requires stepping down from a view of the general picture, to a level which provides only a narrow slice of the panorama' (Guess, et al, 1997).

- The first dimension of FD (1) considered in this study concerns the formal division of expenditures and revenues between levels of government.
- The second important dimension (2), is the extent to which government decision-making is decentralised.

(1) ‘Budget data approach’ – most studies use the subnational share of general government expenditures or revenues as a proxy for decentralisation (GFS of IMF data)

⇒ Most consistent data set across countries, but problematic – creates various measurement errors such that degree of FD tends to be overestimated.

Stegarescu (CEER DP 2004) provides 6 new useful (but still not perfect!) indicators of tax and revenue decentralisation and two useful measures of expenditure decentralisation that attempt to better capture different levels of subnational autonomy.

We also create various measures (‘Hump-shaped indicators’) to try and examine whether a medium degree of FD (30-45%) is best for economic growth.

Again, none of these improved measures have been used in previous studies of FD and growth.

(In further research we will update and continue to refine these measures where possible).

(2) Other Measures of Public Sector Decentralisation

- The number of subnational jurisdictions in the intermediate and lower tiers of government
- An indicator to account for electoral decentralisation
- An indicator of constitutional structure

This is an index of federalism on a five-point scale: (1) unitary and centralised, (2) unitary but decentralised, (3) semi-federal, (4) federal but centralised, and (5) federal and decentralised. In federal countries, subnational governments are more likely to have a permanent right to govern their own affairs.
Resource decentralisation is considered using the ratio of subnational government employees to central government employees, using data provided by Schiavo-Campo et al. (1997).

These four general aspects of public sector decentralisation provide some indication of the extent to which subnational governments are ‘closer to the people’ and are therefore more efficient in accounting for local preferences in fiscal decision-making.

Empirical Results: Some Example Plots

Next:

Incorporate these decentralisation measures into standard empirical growth analysis – both cross-sectional and panel data analysis.

Include important control variables to account for size of government and macroeconomic shocks e.g. govt consumption to GDP ratio and GDP deflator.

Results are subject to the usual empirical growth caveats regarding measurement / aggregation problems, omitted variable problems, multicollinearity etc.
RESULTS:

No measure of tax/revenue/spending FD found to be significant for this group of OECD countries.

Some evidence that other aspects of public sector decentralisation have a negative impact on performance.

Degree of federalism indicator (FU) found to be significant and negatively related to growth. Same for electoral decentralisation indicator (ELECT).

Results Summary and Policy Implications!

Overall the results suggest that, once other key factors have been accounted for, decentralisation of fiscal policy does not seem to matter too much for longer term economic growth.

If anything, consistent with the more recent findings in the literature, the results here suggest too much decentralisation of government structure in general detracts from economic performance.

Certainly possible that countries can have too much fiscal decentralisation from a ‘drivers of economic growth’ perspective. Need to find the right balance.

- Suggests that in this sample, countries that are more federal and more decentralised (as opposed to unitary and centralised) tend to grow more slowly on average.

- Similarly countries with a greater number of elected subnational tiers of government tend to grow more slowly on average.

• Of course the focus of the research here has been on efficiency and growth

• Results suggest you need to look elsewhere for an economic rationale for maintaining a highly decentralised / Federal system.

• Need a broader view of the effects of FD on equity issues and (price) stability issues.

• Also, social, cultural and political stability / complexity issues

➢ But, implies a possible trade-off with growth in average living standards
Preliminary extrapolation of these results to the Australian case specifically, suggests:

- Current centralist tendencies (council amalgamations, Murray Darling water control, standardisation of school curricula etc.) may be a good thing from an economic growth / efficiency point of view.
- Less decentralisation of fiscal expenditure responsibilities might raise income levels and possibly long run growth rates (by a small amount), primarily through improving investment in capital and human capital and general efficiency.

=> Possibly supports the calls for the Federal government to increase control over health and education?

Federalism results in accordance with the comments provided in Dan Usher's (1995) *Atlantic Economic Journal* article concerning Canadian federalism – Canada much better served as a unitary state like the UK if Quebec were to cecede.

Results here suggest support for moves away from a Federal system for Australia – should we remove all reference to the States in the Constitution and scrap elected bodies at the sub-national level?

Reconstitute as a Unitary State? We don’t have the serious ethno-linguistic fractionalisation issues that federal states like Canada and Russia have that essentially require (‘holding-together’) federalism.

Should be part of sensible and mature debate over a move to a Republic?

- Does not mean move to a highly-centralised state. Does not advocate ‘big government’! Does not mean scrapping municipal government or some form of regional self-government in practice.
- Does not mean an eye on efficiency and no consideration for equity / redistribution issues.
- Australia has regional differences in resource abundance, population density, ethnic composition, climate, etc. and some decentralisation of decision making is needed to adequately recognise this.
- But is there really much evidence of significant heterogeneity of preferences across states?

Moves towards centralisation (or at least MUCH greater cooperation) basically just means greater efficiency through uniformity in (nationalisation / harmonisation of) standards and regulatory practice where appropriate.

- Diminishes unnecessary duplication and potentially harmful fiscal competition.
- Addresses Australia’s serious vertical fiscal imbalance and the distortions it potentially generates.
- Mitigates instability due to the political business cycle coming from the State level.