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A POLICYMAKER'S GUIDE TO FISCAL DECENTRALIZATION

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Fiscal decentralization has been an important topic among public finance economists for nearly 40 years now, but recently it has become important in the real world as well. The United States has, in effect, implemented a decentralization strategy as it has tried to cut its federal government budget deficit, largely by reducing state and local grants. For Canada, fiscal decentralization is tied up closely with the Quebec issue, and, for Germany, with the unification issue. The European Community is beginning to worry about fiscal decentralization issues in connection with policy harmonization—what policies and/or conventions should be harmonized and what need not be? Many developing countries are also groping with decentralization issues as they try to find a way to manage the public sector side of their growth process.

Decentralization has always been understood to mean the proper location, by level of government, of various taxes, spending programs, grants, and regulations. What types of spending should be conducted by what levels of government, what types of taxes should be assessed by what levels of government, how should grants help fill in gaps, and how should regulations be harmonized? On the one hand, taste differences across jurisdictions argue for separate policies—governments in jurisdiction x should do what the voters in jurisdiction x want. On the other hand, the existence of benefit spillovers across jurisdictions and the potential migration of taxpayers and spending beneficiaries across jurisdictional lines make things complicated. These factors suggest that indvidual jurisdictions do not operate in a vacuum, can make things easy or difficult for other jurisdictions, and should not behave independently. The tension between cooperation and competition among jurisdictions has always been the key element in analyzing fiscal decentralization strategies.

Bird's paper in this volume tries to develop a handy guide to decentralization strategies for policymakers. Bird focuses particularly on taxes and grants—what principles should be kept in mind in designing sensible policies for each? I want to develop a similar guide to decentralization strategies but from a different perspective. I look at guides for policy with respect to each of Richard Musgrave's (1959) three public sector branches of government—allocation, distribution, and macroeconomics. Most of my specific policy suggestions are similar to Bird's, though there are a few differences. But whether the suggestions are the same or different, it is illuminating to develop this guide from a different perspective.

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[redacted] National Tax Journal
Vol. 46, no. 2, (June, 1993), pp. 229-35

ALLOCATION BRANCH

On the spending side, the basic allocation issue involves the spatial domain of benefits from public service programs. Oates (1972) showed how jurisdiction size can be determined by the balance between competing forces—the welfare loss from taste differences, which argues for small jurisdictions, and the welfare gain from burden sharing, which argues for large jurisdictions. His decentralization theorem called for public services to be supplied by the jurisdiction covering the smallest area over which benefits are distributed. A corollary says that, if the decentralization theorem is followed, efficiency can be further promoted by having central government grant arrangements to insure that those living outside the jurisdiction pay their appropriate marginal share of the benefits of public services.

Using this logic, schools, roads, police, and fire services affecting only one area would be provided by the local government or a special district covering that area, perhaps with matching grant support. On the other hand, interstate highways, national defense, and foreign aid affecting larger groups of areas would be provided by the national government. This split of spending responsibilities, in fact, does seem to be more or less that realized in most countries with federal structures. Normally, there are even matching grants to finance the local services, though, as pointed out subsequently, the structure of these grant programs generally falls short of the efficiency ideal.

On the tax side, the key issue is factor mobility. Suppose some factor is mobile across local boundaries but not across national boundaries. Trying to extort fiscal residuals from the factor at the local level or have local governments tax the factor more than the value of local public service benefits received by the factor will simply drive the factor out of the jurisdiction. The lesson is almost the opposite of the spending decentralization theorem: once they have paid for their benefits received, factors or activities should be taxed at the highest level possible to cut down on mobility effects.

This disjuncture leads to what Bird calls the vertical imbalance problem. If many spending programs are conducted by lower levels of government and most taxes are assessed by higher levels of government, lower levels of government may find it impossible to finance themselves without grants from the higher level. This provides one rationale for general purpose grants from higher levels of government to remedy this vertical imbalance.

But before instituting such grants, there are several caveats. As implied previously, mobile factors should respond as much to benefits received as to taxes paid; hence, local service user fees or taxes can be assessed to pay a portion of the costs of government. Second, as Bird argues, user fees on households are also an excellent form of local finance. Among other advantages, user fees automatically solve the spillover problem because outsiders automatically pay their appropriate marginal share of service benefits received. Third, even if local user fees have been used as much as possible, there are still other local taxes, many of which can be assessed on immobile bases and which can finance a broad array of local public services. Fourth, Walsh (1985) has argued against vertical imbalance grants on management grounds: with these grants, government officials at lower levels of government become primarily grant procurers or rent seekers rather than economical managers of public affairs. With all these caveats, it is unclear how important a rationale for general purpose grants is provided by the vertical imbalance argument. There may ultimately be some imbalance and rationale for general purpose grants, but it may also be that, over the relevant ranges, local

National Tax Journal
Vol. 46, no. 2, (June, 1993), pp. 229-35

user fees and taxes on immobile sources can provide plenty of revenue to finance all lower level government spending called for by the spending decentralization theorem.

Beyond user fees, what taxes on immobile sources can be used to finance local governments? Bird praises the local income tax, which is certainly worthy of more serious consideration and use around the world. The most common existing local tax is, of course, the local property tax. This should be acceptable too because it falls largely on land or relatively immobile homeowners, but some property wealth does consist of mobile industrial capital. This suggests a split treatment for local property taxes: while homeowners can be assessed full property taxes, industrial capital should only be assessed property taxes equal to the marginal costs of provision of sewers, roads, and other public services.

On the grant side, even if there were no vertical imbalance grants, there should still be grants to correct for benefit spillovers. Especially if the decentralization theorem is followed, there will be outsiders who benefit from local public spending and should pay some of the cost. Coasian bribes are possible, but central government grants are a more feasible way to handle these spillovers.

Using this rationale, central government grants should be open-ended price subsidies for particular types of spending, with the central matching rate roughly equal to the share of marginal benefits realized outside the jurisdiction. Throughout the world, most central government matching grants are not of this form. Existing central government grant programs generally feature very high central government matching rates, enough to encourage overspending at the local level, but then have this subsidy capped so that, at the margin, there is no price subsidy at all. As has been pointed out many times, this form turns a supposed price subsidy grant into an income subsidy grant and definitely does not solve the spillover problem. The remedy is to uncap the grant and make the central government matching rate conform to the marginal share of benefits received inside and outside the jurisdiction.

There is one unconscious way in which central governments often give open-ended price subsidies. If state or local taxes are deductible against the national income tax, the marginal tax cost of a dollar of local revenue is the complement of the marginal central government income tax rate. It may be that this slight reduction in local tax cost is an appropriate correction for externalities in general, but there are many problems. First, there is no obvious reason why the national marginal income tax rate gives the proper externality correction. Moreover, if many income taxpayers do not itemize deductions, deductibility is horizontally inequitable, lowering tax costs in wealthy jurisdictions but not poor jurisdictions (Gramlich, 1985).

Bird makes the common claim that it will be difficult to estimate the marginal share of outsider benefit and thereby to determine ideal central government matching rates on grants. Obviously, these shares will not be easy to estimate, but based on the United States experience, I have always felt that even crude estimates will make such efficiency improvements that the attempts should be made. For highways and other transportation projects, it is possible to count users, license plates, truck weight, *etc.* to determine marginal benefit shares. For pollution control projects, it is possible to measure the changes made by the project and determine the location of gains. For human investment projects, users can be counted directly. There will be some grants where the estimation is difficult, but these matching rates could be set at average shares, one-half, or other politically acceptable numbers. The issue certainly is not

[redacted] National Tax Journal
Vol. 46, no. 2, (June, 1993), pp. 229-35

insuperable, and the potential efficiencies are significant.

A different sort of real world puzzle under the allocation heading involves the role of intermediate governments, such as states in the United States and Australia, provinces in Canada, and Lander in Germany. These governments all have historical institutional roles in federal systems, they have often come together to form the nation, and they are often constitutionally responsible for their local governments. From the standpoint of historical evolution or administrative convenience, perhaps it makes sense to have these intermediate governments, but from an economic standpoint, the rationale could be questioned. There do not seem to be many spending programs that confer benefits over a statewide area, as opposed to a local, regional, or national area. Perhaps the evolution of federalism and/or decentralization will see states and other intermediate governments gradually decline in power; perhaps there could be a development of grants that go directly from the national government to local or regional authorities. The United States already has a few such grants.

DISTRIBUTION BRANCH

There are generally two types of distributional programs in modern societies—human capital type programs aimed at helping people earn higher incomes in the long run and income transfer type programs aimed at protecting peoples' incomes in the short run. Both types of programs could be lodged at either a higher or lower level of government and both raise a series of policy issues.

The key issue for income transfer programs is the spatial horizon of altruism. Taxpayers give income transfer benefits in the first place either as a form of social insurance or because they care about the welfare of their fellow citizens suffering poverty. If the motive is social insurance, over what geographic span is that to be—do taxpayers want programs that operate throughout their locality, state, or nation? If the motive is altruism more generally, again which fellow citizens are these—those in the same locality, state, or nation? If the relevant area is a nation, transfer benefits should be nationwide, or at least there should be a nationwide floor on benefits. If the relevant area is a state or locality, transfer benefits should extend just to that area.

There are further complications on the recipient side. Recipients do seem to migrate across jurisdictional lines in search of higher transfer benefits, at least to some degree. This raises the cost to any state or locality in raising its own transfer benefits to the level its own taxpayers might prefer—the higher benefits attract recipients from other areas and thus extend the geographic domain of benefits beyond what the voters might have preferred. It is possible to have residency rules that eliminate this distortion, but many intermediate governments do not have or cannot enforce such rules. This is an effective externality, and, in fact, Boadway and Wildasin (1984) have proposed dealing with it by open-ended matching grants from the central government to the sponsor government, just as if there were normal benefit spillovers.

Another issue has been raised in the United States, where pure unconditional income transfer programs have never been very popular with voters. In recent years, there have been attempts to combine income transfers with work—to make benefits contingent on working, to put recipients through job search training or skills training, and so forth. There are many ways in which such combinations can be effected, and there is no one preferable way for all regions of a country, for all types of labor markets. The United States has let states experiment with innovative work-transfer programs, hence giving added programmatic justification for lower

National Tax Journal
Vol. 46, no. 2, (June, 1993), pp. 229-35

level involvement. Similar arguments could be made for homeless shelter or other service programs where local conditions would matter greatly.

Because all potential transfer recipients may not reside in one local or state area and because there is some migration, transfer programs should not be left entirely up to lower state or local governments. At the same time, because feelings of taxpayer altruism may be somewhat stronger for residents of one area than across the whole nation, because local conditions matter in service programs and because states or localities might be valuable innovators, transfer programs should not be entirely national either (as Bird seems to assert). To me, the optimal design is for mixed programs with some base national level of benefits and optional state supplementation and other mechanisms for combining services with transfers.

The most prominent human capital program is elementary education, though there are others as well. The tradition in most countries is to conduct public schooling at the local level, with parental involvement in the operation of the schools.

The local role is an established tradition that is likely to persist and has a justification similar to that for programs that combine transfers with work. But there is a long-run income distribution impact of public schooling that argues for some broader interest as well. Local communities vary widely in wealth and/or income, and if, as is suggested by econometric evidence (Inman, 1978; Feldstein, 1975), public schooling is a normal good, rich communities will in general spend more on education and have better public schools than poor communities. This quality disparity will be magnified if, as seems likely, the public safety costs of schooling depend inversely on community wealth or income. Leaving the financing of public schooling entirely up to localities will then lead to systematic differences in the quality of schooling received by students from rich and poor districts and will tend to perpetuate income differences.

There are essentially three ways to break this link. One approach is simply to centralize some base level of spending on public schools. The problem with this approach is that there would be no equalization above the base level. A second approach is to give unconditional grants to bring spendable resources in poor jurisdictions up to those in wealthy jurisdictions. The problem with this approach is that if grants are unconditional, they are unlikely to be spent entirely on public schools and spending disparities will persist. The best third, and preferred, approach is to use the district power equalization approach of Feldstein (1975), which features open-ended matching grants with the matching rate set so that, on average, spending will be equalized across rich and poor jurisdictions. There could also be a hybrid approach, with uniform base level spending and district power equalization above that.

As one final point regarding education, Hanushek (1991) has been arguing that focusing entirely on education finance, as opposed to the structure of incentives, may actually set back the cause of educational reform. Since spending is only very loosely tied to educational output, reforms that focus only on spending are unlikely to be successful. Financial reforms may be a necessary condition for broader educational reform, but they are only that—attention to the underlying incentives for teaching and learning is also important. If nothing else, this reemphasizes how important it is to have lower levels of government involved in the process of educational reform.

MACROECONOMIC BRANCH

Musgrave (1959) actually called this the stabilization branch, but I use the broader

[redacted] National Tax Journal
Vol. 46, no. 2, (June, 1993), pp. 229-35

macroeconomic branch because the requirements of macropolicy have changed in recent years. The traditional closed-economy Keynesian view of macroeconomics was that fiscal policy should stabilize the economy around full employment, period. The newer view, really open economy view, is that now that economies are open with flexible exchange rates and free mobility of capital, fiscal policy has very weak stabilization effects and stabilization should be primarily the role of monetary policy. What fiscal policy then does is to set a country's national saving rate, which determines the composition of its output between consumption and investment and its living standards in the long run. Fiscal policy does have stabilization impacts when exchange rates are fixed, but most of the world is now ultimately on flexible rates (or at least fixed rates that often must be changed in response to shocks).

In the traditional closed economy Keynesian view, macropolicy was viewed as the responsibility of central government monetary and fiscal policy and not at all the responsibility of lower levels of government. Even in those days there was apparently no thought that macrodemand or supply shocks might operate differentially across different regions of a country—raising output and employment in some regions and lowering it in others. Now that economies are open, it is quite clear that macrodemand or supply shocks can often have these differential effects (Courant and Deardorff, forthcoming), and, since central government fiscal policy has a limited stabilization effect anyway, the time seems right for some new thinking about decentralization strategies.

I have tried to argue (1987) that the appropriate way to discharge responsibilities in the new world is to let the world economy set interest rates, have the national government set fiscal policy to determine the nation's saving rate, and then give lower governments the ability to operate some limited fiscal stabilization policies. This permits these governments to counter demand or supply shocks to some degree. Unlike the national government, since lower governments are on fixed exchange rates, lower government fiscal measures are likely to have stronger output effects than national measures, contrary to the previous impression. The way in which lower governments can operate stabilization policy is for governments to build up their asset stocks in good years and run down these assets in bad years, or to borrow in bad years and repay in good years. The United States has a scheme whereby states can and do borrow from the unemployment trust fund to implement such a system, and it seems important for areas, such as the European Community, to plan similar arrangements.

POLICY SUGGESTIONS

Since this paper is ultimately a guide for policymakers, I wrap things up by collecting the main policy suggestions resulting from the discussion. I also compare my position on each issue with that of Bird.

(1) I am in general agreement with Bird that public services should be provided by the lowest level of government possible, or the jurisdiction spanning the smallest area over which benefits are distributed. If those outside the jurisdiction receive some of the marginal benefits of these public services, the best cure against underspending is open-ended matching grants, with the matching rate equal to the share of the marginal benefits received by outsiders.

(2) I am also in agreement with Bird that user fees and local income, land, and property taxes are valuable forms of local finance and should be adopted to the extent possible, hopefully with enough revenue potential that vertical imbalance grants would not be necessary. But local property taxes should not be assessed on mobile industrial capital beyond the level of services

National Tax Journal
Vol. 46, no. 2, (June, 1993), pp. 229-35

received, for such taxes will just drive that capital out of the jurisdiction.

(3) Whereas in his preferred fiscal federalism model, Bird takes the traditional view that distributional programs should be entirely a national responsibility, I feel these programs should be a mixed responsibility. The national government should set a base level of benefits and use matching grants to equalize tax prices for human capital programs. Local governments can then supplement the national floor transfer benefits and manage both these transfer programs and the human capital programs.

(4) Like Bird (again in his preferred fiscal federalism model), I see no strong rationale for unconditional grants anywhere in the system. Matching grants are preferred ways of dealing both with benefit spillovers and with disparate abilities to finance human capital distributional programs.

(5) In a proposition that Bird takes no position on, I feel that the national government should take responsibility for manipulating fiscal policy to determine national saving rates and generally not worry about discretionary fiscal stabilization policy. National business cycles can be counteracted by monetary policy and regional cycles by subnational governments running rainy day funds or borrowing from designated trust funds.

ENDNOTE

I have benefitted from the helpful comments of Richard Bird, Paul Courant and Joel Slemrod.

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National Tax Journal
Vol. 46, no. 2, (June, 1993), pp. 229-35