FISCAL FEDERALISM AND COMPARATIVE RESEARCH: CONCEPTUAL AND ANALYTICAL ISSUES

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Abstract

In today's world, the socioeconomic dynamics induced by globalism diminishes the control and capacity of many centralized and formerly centralized states. In response, large-scale administrative reforms have been adopted—especially by East Asian countries—to enhance government efficiency and effectiveness. As an essential part of each country's administrative reform efforts, decentralization measures have been designed to realign the power relations between national and sub-national governments. Fiscal decentralization in particular has affected the way in which public sector resources are shared and allocated between different levels of government.

This paper discusses the conceptual and analytical issues pertinent to the changes caused by fiscal decentralization around the world. The discussion proceeds in two steps. First, different theories and concepts of fiscal federalism are compared and contrasted to reveal the progression of ideas and debates surrounding the increasingly complex dimensions of intergovernmental fiscal relations. Second, the paper delineates a comparative research agenda for the studies of intergovernmental fiscal relations in both unitary and federal states.

Keywords: **Fiscal Federalism, Fiscal Decentralization, Comparative Research**

INTRODUCTION

While Russia in the 1990s demonstrated how ill-planned decentralization could compromise a country's economic development, Great Britain and Spain have consistently jumped on the band wagon of devolutionary movement. These changes are not exclusive to Europe; decentralization and centralization diffuse throughout the world. In the Far East, China follows an administrative approach that is a hybrid of market liberalism and interventionism. Blanchard and Shleifer (2000) refer to this hybrid as market-preserving federalism in which the country's central government gives decision-making autonomy to some local governments, while imposing punitive measures on the local entities that do not meet the national mandates. In post-Suharto Indonesia, Jakarta gradually decentralizes its revenue-raising and administrative authority to local self-governing bodies in the outer islands of the archipelago. The decentralization movement emerged for the first time since Indonesia gained its independence.

As we witness numerous cross-country variations of intergovernmental relations, dissatisfaction with the inadequacy and inefficiency of government seems to be the underlying rationale of the administrative reform movement. The pursuit for a better government however is nothing new in human civilization. Throughout history, mankind has tried different approaches to improve governments; some yielded satisfactory results, while others only exacerbated the problems. In this century, fiscal federalism which seeks to ameliorate a country's intergovernmental fiscal relations is the prominent model of governance that has varying degrees of success and destruction. In understanding these contrasting results of intergovernmental relations, it is important to analyze each country's contextual factors that shape the design of intergovernmental fiscal relations.

The complexity of government also manifests itself in its multiple layers. Conventional political science literature categorizes nation-states into federal and unitary states. In this view, only federal states exhibit the characteristics of a multi-layered government system because these states have constitutional provisions that explicitly delineate responsibilities of each government level. Conventional political scientists emphasize the formal framework of sovereignty as groundwork for the analysis of intergovernmental relations. Yet, emerging evidence shows that the informal structure of government matters as much as the formal one. Rodden (2004, 427) contends that "sovereignty is actually murky and dynamic; "it is often implicitly or explicit shared." Even in countries with the government structure as centralized as China, local self-governing bodies at the village level are ubiquitous and play a vital role in administering village affairs. Some unitary states (e.g., Thailand and Great Britain) have recently amended their constitutions to include clauses that specify the scope of responsibilities for local governments. These responsibilities include revenue-raising authority and the decision-making autonomy. Thus, intergovernmental fiscal structure is *not* a phenomenon entirely exclusive to federal states. In modern time, unitary states are subject to the same influences of intergovernmental relations as their federal counterparts (Bird and Smart 2002). In short, the prominent difference between federal and unitary states with regard to intergovernmental relations is not entirely the formal framework of government. Instead, it is likewise important to consider the informal structure that underlines the alignment of incentives and disincentives of national and sub-national governments in forging their fiscal relations.

Apart from the political aspect, economic considerations are also important determining factors. As Bland and Smart (2002) note, the main goal of intergovernmental fiscal relations is to influence policy outcomes, such as allocative efficiency, distributional equity, and macroeconomic stability. Different forms of intergovernmental fiscal relations have dissimilar effects on these policy outcomes. For example, fiscal decentralization in the framework of fiscal federalism intends to affect the effectiveness and efficiency of local government operations. Among the notable scholars in fiscal federalism, Oates (1972) proposes the intergovernmental transfer design that induces local governments to be accountable to both their citizens and the higher levels of government. Bland and Smart (2002), on the contrary, observe that conflicting values of efficiency and equity often dictate the design of intergovernmental system in many situations. For instance, in many countries, equity dominates the collective decision-making process that administers intergovernmental financing. Canada and the Philippines are among the countries that explicitly use equalization transfers to establish domestic fiscal equity.

In addition to equity and efficiency concerns, intergovernmental fiscal relations are not immune from factors such as political expediency, popular culture, and socioeconomic disparity. The socioeconomic disparity in particular influences both revenue-sharing arrangement and the design of intergovernmental transfers, particularly in the developing world. Examples of these different socio-economic conditions are ethnic antagonisms, linguistic and cultural diversity, and regional economic disparity.
Equally important is the impact of political system on intergovernmental fiscal system. Developing countries reveal a diversity of political systems, ranging from liberal democracy

to authoritarianism. A notorious and common practice in the developing world is a coup d'état which results in suspension or abrogation of a country's constitution. Usually, political deadlock, rampant corruption, and conflict between the military and the civilian government are among the factors that trigger a coup. After overthrowing the civilian government and rescinding the constitution, coup leaders write a new constitution that, in many cases, changes the entire structure of government. With the new rules of the game, the impetus of intergovernmental relations in that particular country is likely to alter.

In light of the ongoing decentralization reforms in many countries, this paper discusses the progression of conceptual frameworks and theoretical debates in fiscal federalism—a subfield of public finance and public administration that deals with intergovernmental fiscal relations. In addition, even though no empirical evidence is provided, this paper offers a new research agenda (e.g., research problems, variables of interest) to advance the comparative studies of intergovernmental relations around the world.

CONCEPTS AND THEORIES OF FISCAL FEDERALISM

Market roles of government

The proper role of government in the economy is the subject that has occupied public attention for centuries. Today, the debate remains vibrant with the laissez-faire economists and socialists tirelessly toiling to promote what they consider as "optimal" and "efficient." Despite the capitalist-socialist dichotomy, it is too simplistic to judge which model is superior to the other. Yet, what appears conclusive from this ideologically-driven debate is that both the government and market have their spheres of responsibility (Alt and Chrystal, 1983). Adam Smith (1776) in his magnum opus, *An Inquiry into the Nature and Causes of the Wealth of Nations,* recognizes three roles of government: national defense, maintenance of law and order, and provision of public works and institutions. Notwithstanding his reputation as the father of *laisser-faire* economy, Smith does not specify the type of public works and institutions that necessitate government intervention.

Building on Smith's vague definition of public works and institutions, Musgrave (1959) proposes three important functions of government[1]. Although the Musgravian framework clarifies the economic roles of government, it stimulates contentious discussion about assigning these responsibilities to each level of government. The national government should be responsible for income distribution and macro-economic stabilization, while the allocative function should rest with sub-national governments (Musgrave, 1959). Musgrave's normative model of intergovernmental relations serves as the foundation for fiscal federalism. As Oates (1972) elaborates in *Fiscal Federalism,* his theory examines the appropriate fiscal relationships among different levels of government. And as fiscal decentralization now dominates the development scene in many countries, it is similarly important to analyze the cross-country variation in the design of an intergovernmental fiscal structure.

[1] These three functions are: allocation of resources to production and provision of goods, distribution of income to achieve equity, and stabilization of macro-economic conditions such as employment, inflation, and GDP growth.

Fiscal Federalism: Theoretical Comparison.

Foundational ideas. In addition to Musgrave, Samuelson (1954) and Tiebout (1956)[2] offer two powerful, albeit contrasting, frameworks for the development of fiscal federalism. Samuelson addresses the free-rider problem that stems from provision of public goods. He contends that the market is not a good candidate for efficient provision of public goods; government intervention in some form is necessary in compelling individuals to internalize the costs and benefits of public goods. While Samuelson alludes to the necessity of a centralized government structure, Tiebout (1956) suggests otherwise. When autonomous local governments rigorously compete for residents with their bundles of revenues and expenditures, provision of public goods and services would be in equilibrium. In "voting with their feet," citizens reveal their preferences for public goods and services. The Tiebout model ultimately resolves the free-rider problem without political intervention from the central government.

*First-generation theory***.** Despite their philosophical differences, Samuelson and Tiebout identify two issues which Oates (1972) extensively addresses in his fiscal federalism theory: heterogeneous preferences for public goods and externalities from consumption of those goods. As Tiebout and Oates demonstrate, sub-national governments are more accountable to citizens than national government due to local control of the allocation of resources to provision of public goods. In this context, accountability is the "sensitivity of varying preferences among the residents of the different communities[3]" (Oates 1972, 11). Oates further articulates this argument by offering the decentralization theorem; if the citizen tastes for a particular public good are heterogeneous and the cost of producing the good is the same for all governmental levels, local governments will produce such good more efficiently than the central government (Oates 1972, 35). Besides the heterogeneity issue, fiscal federalism is also concerned with the intercommunity spillover effect. Some public goods and services extend their benefits over widely different geographic areas (Mikesell 2003, 509; Stiglitz 1988, 638). For instance, while a neighborhood park benefits a community of households around it, foreign policy generates benefits throughout the nation.

Fiscal federalism emphasizes the alignment of service provision and spillover range. The mismatch between the spillover effect and government jurisdiction can engender resource misallocation, inappropriate spending for some services, and free-ridership. Oates presents the theory of intergovernmental transfers as a normative model of a fiscal institution that deals with the interjurisdictional spillover effect. He emphasizes the advantages of matching grants as the most effective form of intergovernmental transfers. By inducing the localities to match the benefit range of a particular good with an appropriate level of expenditure, matching grants help to avert allocative inefficiency.

Second-generation theory. The design of an intergovernmental fiscal system is no simple task. An intergovernmental fiscal system is ultimately a collective decision-making process replete with many influential factors and unanticipated events. Aware of this complexity, Oates (2005) acknowledges two weaknesses of his first-generation theory. First, Oates (1972)

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[2] Samuelson's *Pure Theory of Public Expenditure* (1954) introduces the notion of a public good that is non-rivalrous and non-excludable. Tiebout's *A Pure Theory of Local Expenditure* (1956) explains how perfect residential mobility could induce interjurisdictional competition at the local government level to offer the optimal bundle of revenues and expenditures.

[3] Even in the case of homogeneous preference, Oates (2005) still sees decentralization as more desirable than centralization due to its control mechanism that constrains the behavior of local government officials.

assumes that public agents (e.g., bureaucrats, elected and public officials) act on their citizens' behalf. The second-generation theory entertains the notion that public agents do not necessarily serve the public interest (Oates 2005, 364). Second, the first-generation theory of fiscal federalism emphasizes the availability of perfect information between national and sub-national governments. Oates (2005) and Garzarelli (2004) borrow the principal-agent model from organizational economics to demonstrate that asymmetric information exists between national and sub-national governments. In this situation, a national government is a principal who delegates its allocative function to sub-national agents through intergovernmental fiscal relations (Oates 2005, 367). Oates (2005) contends that information about sub-national governments' spending behavior may not always be available to the national government.

Despite its efficiency in solving interjurisdictional externality, Oates' intergovernmental fiscal structure poses two problems. First, the mandates that accompany federal matching grants could confound sub-national governments' budgets and priorities. Once the matching funds retire, the burden of maintaining public goods and services could become political discord. As a result, the localities may view mandates as the central government's intrusion on their autonomy (Oates, 2005). Second, by providing fiscal transfers to lower-level authorities, the national government implicitly provides sub-national governments with a soft-budget constraint. As organizational economic theory points out, the central government may not always have complete information about sub-national governments' use of transfers to relieve fiscal stress. This opportunistic behavior at the local level could ultimately entail serious consequences for the entire federal system.

***Economic Federalism and Cooperative Federalism*.**

Inman and Rubinfeld (1997) refer to Oates' fiscal federalism as economic federalism. The two authors identify economic federalism as a government structure "capable of internalizing economic externalities", but subject to "the constitutional constraint that all central government policies be decided by an elected or appointed central planner" (Inman and Rubinfeld 1997, 45). This economic federalism resembles Blanchard and Shleifer's market-preserving federalism that requires a centralizing role of national government in promoting economic efficiencies[4] (Blanchard and Shleifer, 2000). Oates' fiscal federalism is an economic federal system because it emphasizes the national government's capacity to resolve the spillover effect (Inman and Rubinfeld 1997, 47-48). On the contrary, cooperative federalism is skeptical about the central government's ability to address the interjurisdictional inefficiencies. Cooperative federalists prefer a political system that accommodates agreements between sub-national governments. The policies that result from intergovernmental agreements will then serve as vehicles to resolve the interjurisdictional spillover effect.

Vertical and horizontal imbalances. Recent development in fiscal decentralization literature involves the differentiation between vertical and horizontal imbalances. Bahl (2001) refers to vertical fiscal imbalance as "an imbalance between the expenditure responsibilities of sub-

[4] Blanchard and Shleifer (2000) conducted a comparative study of fiscal decentralization in China and Russia. Their conclusion underlines the necessity of political centralization as a prerequisite for successful fiscal federalism. With the Communist party's centralizing role, China has been able to induce its sub-national governments to efficiently provide goods and services. Russia, on the other hand, pursues both rigorous political devolution and fiscal decentralization. In the absence of a clear revenue-sharing structure and fiscal control mechanisms, intergovernmental fiscal relations in Russia failed and eventually triggered national economic recession.

national governments and their revenue-raising powers" (Bahl 2001, 1). In other words, vertical imbalance occurs when there is fiscal imbalance between levels of government. Bird (1993) and Bird and Smart (2002) state that the central government could mitigate vertical imbalance by balancing expenditures and revenues in the richest locality, "measured in terms of its capacity to raise resources on its own" (Bird, 1993; Bird and Smart 2002, 2). Nonetheless, fiscal imbalance exists for poorer localities; this is the issue of horizontal imbalance. Achievement of horizontal balance requires "equalizing the actual outlays of local governments in per capita terms, [raising all to the level of the richest local government]" (Bird and Smart 2002, 3). In other words, while vertical fiscal balance emphasizes the spending and revenue-raising capacity, horizontal balance is possible when actual budget outlays of local governments are equal across jurisdictions.

Soft budget constraint. The second-generation theory addresses the problem of information asymmetry between sub-national and national governments. This asymmetric information results in the soft budget constraint problem (Oates, 2005). Kornai (1986) explains that "the softening of the budget constraint occurs when the strict relationship between expenditure and earnings has been relaxed because excess of expenditure over earnings will be paid by some other institution typically by the State" (Kornai 1986, 3). Oates (2005) points out that in the intergovernmental setting, soft budget constraints could be in the forms of grants, borrowing autonomy, subsidies, intergovernmental loans, and debt assumption by the central government. In the presence of these soft budget constraints, "local governments have a virtually irresistible incentive to expand their programs and spending beyond their means" (Oates 2005, 373). In Figure 1, Rodden (2002) illustrates the positive relationship between the level of soft budge constraint and the expectations of fiscal bailouts by the central government. Further, these bailout expectations accompany sub-national fiscal indiscipline, which is the culprit of economic instability in many Latin American countries (Oates, 2005).

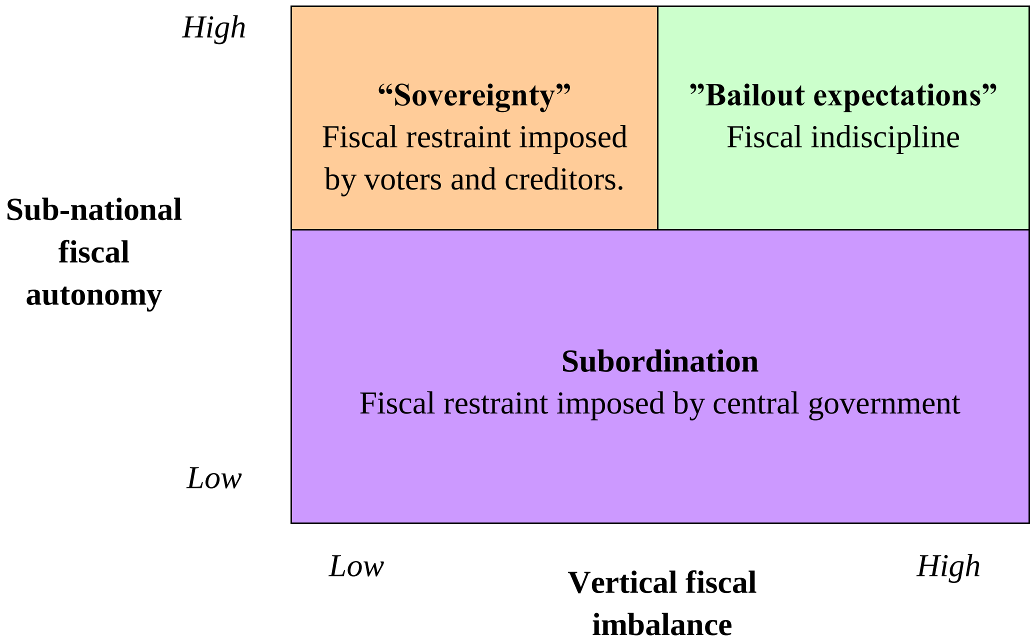

Fig. 1. Relationships between vertical fiscal imbalance, borrowing autonomy, and budget constraint.

COMPARATIVE RESEARCH AGENDA FOR FISCAL FEDERALISM

Literature on fiscal federalism pays considerable attention to the normative framework of a fiscal institution that addresses heterogeneous preferences and intercommunity externalities. Yet, the design of intergovernmental relations is a collective decision-making process which abounds with many influential factors. The previous section distinguishes between efficiency and effectiveness in the decision-making process. While economic rationality determines efficiency, many contextual factors determine the effectiveness of a fiscal institution. The concept of efficiency varies from country to country; what is efficient in the United States might not be efficient (or socially desirable) elsewhere. Careful analysis of factors (e.g., political economy, culture, constitutional tradition, leadership) is crucial in understanding the cross-country variation in intergovernmental relations.

Semi-Sovereignty

Musgrave and Oates posit that a federal government is a multi-tiered polity in which each level has a decision-making autonomy. Some political scientists have proudly made an implicit reference to the United States as a prototype of multi-layered federal government; they liken the U.S. federal system to a layer cake (Rodden 2004, 427). Many scholars convincingly argue that fiscal federalism is only appropriate for federal countries. Sharma suggests otherwise; fiscal federalism does not imply the establishment of a federation. Rather, fiscal federalism seeks to strike a balance between centralization and decentralization (Sharma 2003, 173). Lijphart (1999) points out that federalism is different from decentralization. In a federal state, constitutional provisions guarantee local autonomy.

On the other hand, in a decentralized country, the scope of decentralized responsibilities is the goal and may not accompany the constitutional guarantee of sovereignty. Nonetheless, the notion that constitutional guarantee of sovereignty is an important analytical factor is misleading. Rodden (2004) argues that sovereignty is actually murky and dynamic; “it is often implicitly or explicit shared” (Rodden 2004, 427). Even American federalism is not close to a pure federal state because all levels of American government exhibit interdependence rather than complete autonomy (Chubb, 1985; Rodden, 2004). Departure from this sovereignty issue is therefore important for a rigorous analysis of cross-country variation in intergovernmental fiscal relations. As Figure 2 shows, the magnitude of national and sub-national government expenditures provides a more comprehensive view of a country’s intergovernmental relations. For instance, Malaysia, a constitutionally federal state, exhibits a more centralizing tendency than France, a strong unitary state.

Information-Driven Decision-Making Model.

The previous sections describe fiscal federalism as a collective decision-making process that establishes intergovernmental fiscal relations. Easton (1953) argues that a policy-making process has a specific boundary; it takes inputs (e.g., social demands, electoral mandates) from the electorate and processes them. The outputs of this decision-making process are policies. After policy implementation, feedbacks from society (i.e., new demands) generate a new round of policy-making. This model largely depends on information (about the social demands) and precise decision-making procedures. The decision-making procedures may take the forms of a presidential democracy or a Westminster-style parliamentary system. Thurmaier and Willoughby (2001) characterize this policy-making model as the “cognitively driven style of decision-making” (Thurmaier and Willoughby 2001, 33).

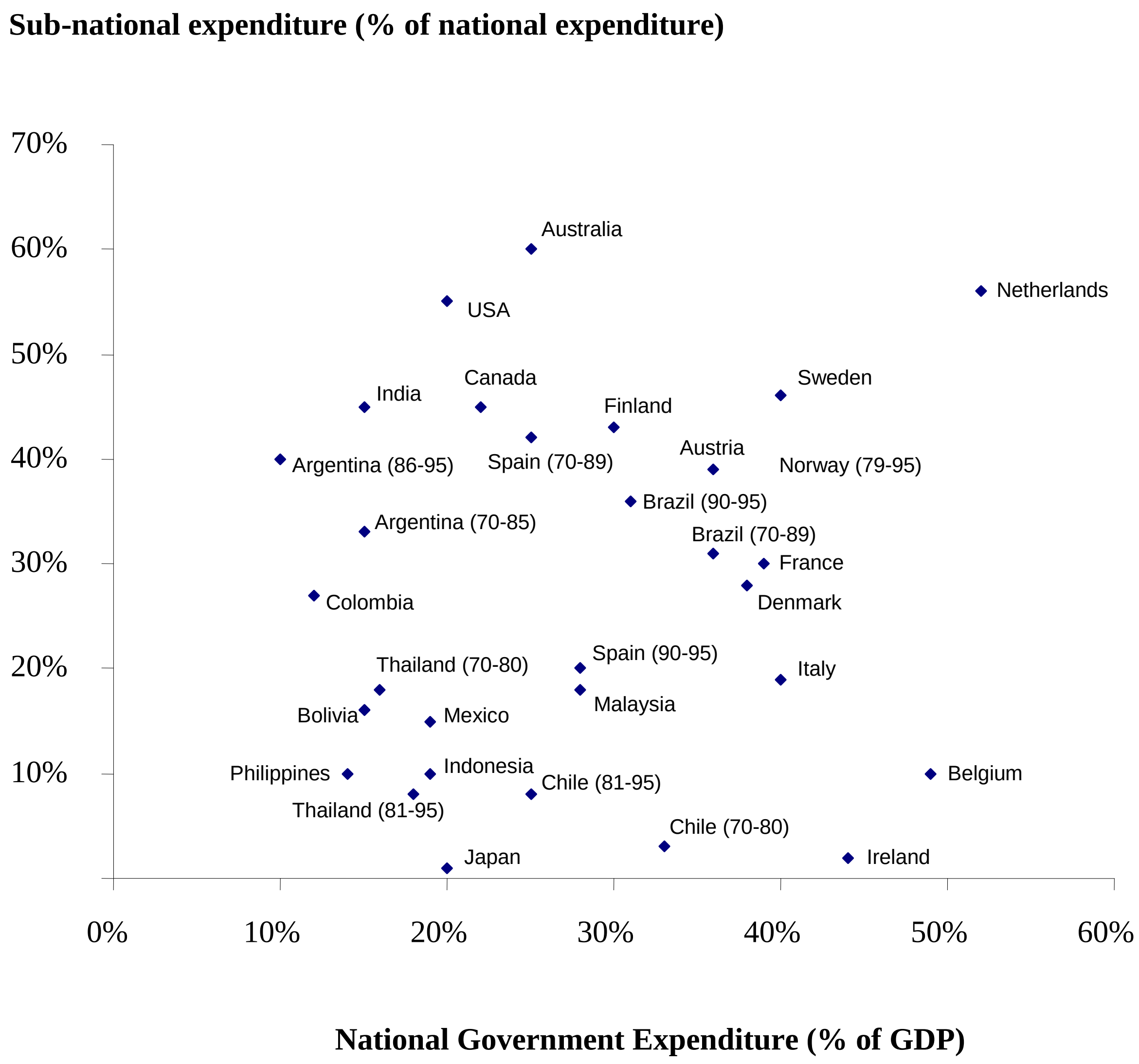

Fig. 2. Magnitude of intergovernmental fiscal relations in selected developed and developing countries.

The same decision-making procedures (e.g., a parliamentary democracy, a balance-of-powers system) may exist in many places. Dissimilar outcomes are however likely due to variation in cultural, social, and political relationships that affect the decision-making process. In contrast to Easton's information-driven style of decision-making, Wildavsky (1978) is more interested in the social relationships that influence policy-makers. In many countries, information about the citizen demands may not translate directly into actual policies due to a multitude of constraints on the policy-making process. Elected and non-elected officials alike are unlikely to process the citizen needs if doing so might threaten their status quo (Thurmaier and Willoughby 2001, 33). One cannot rightfully detach social, political, and cultural contexts from the decision-making process, especially from the design of an intergovernmental fiscal structure.

***Research Agenda for Comparative Fiscal Federalism*.**

Wildavsky states that the policy-making process is the product of both social interactions and information-driven procedure. Comparative fiscal federalism based on Wildavsky's suggestion provides remarkable insight into the diversity of intergovernmental relations in the world. To this end, this section lays out a multidisciplinary model of comparing fiscal institutions in different countries. The philosophical foundation of the multidisciplinary model is that a stylized policy-making process does not operate in a vacuum. The model classifies the contextual constraints into exogenous and endogenous variables.

Endogenous variables. Four endogenous constraints influence the design of an intergovernmental structure. These constraints (i.e., political/historical factors, legal tradition, economic condition, culture) are interrelated. Rodden (2004) explains that a regime type determines the structure of intergovernmental relations; an authoritarian regime has a centralizing tendency that limits sub-national taxation. For instance, tax centralization took a strong hold in Germany, Argentina, and Brazil during periods of authoritarianism. Similarly, the regime type in many developing countries reflects their colonial experiences. For example, Malaysia, a constitutionally federal state, has a strong centralized national government. Malaysia's sub-national expenditure rivals that of Thailand, a neighboring unitary country. This is due to the British colonial rule which was notorious for the strong centralized administration. Also a product of colonialism, interregional economic disparity and ethnic antagonisms affect the intergovernmental relations. The interregional disparity is endemic in many Latin American and Southeast Asian countries, while ethnic antagonisms are ubiquitous in African countries. In Nigeria, for example, the air of interracial suspicion and fear of ethnic domination result in fiscal imbalances between national and sub-national governments.

Exogenous variables. The most significant exogenous variable that affects a country's fiscal structure is war, particularly the Second World War. Through its impact on the economy, a war propels the national government to centralize the fiscal structure, thereby reducing the revenue-raising authority of sub-national governments. For instance, Germany (under the Third Reich), Australia, and Canada succumbed to fiscal centralization during WWII. Equally potent is the contemporary wave of decentralization movement on the global stage. Bardhan (2002) succinctly states that the decentralization of governance and development is the global phenomenon in the late twentieth and twenty-first centuries. This movement significantly influences the structuring (and restructuring) of intergovernmental fiscal relations in many countries.

Temporal context. What lurks behind the interaction between endogenous and exogenous variables is the time context. It is important to note that both types of variables change over time; this complicates the comparative analysis of intergovernmental relations. However, the diachronic comparative analysis lends more complete insight into the nature and dynamics of intergovernmental fiscal relations across different countries.

THE NEW WAY FORWARD

Fiscal federalism is a normative framework that seeks to strike a balance between centralization and decentralization (Sharma 2003). In a well-developed fiscal federal system, both national and sub-national governments have their own positive characteristics. While a central government can effectively manage interjurisdictional externalities, local governments can efficiently cater to the heterogeneous tastes of citizens. However, the more complex dilemma is the cross-country variation that defies conventional theories of fiscal federalism (De Mello, 2000). This cross-country variation is understandable; the design of an intergovernmental fiscal institution involves a multi-stage decision-making process that abounds with many interdependent elements and unanticipated outcomes. Public finance scholars have only discussed the efficiency aspect of fiscal federalism; they generally overlook the effectiveness of a fiscal institution. Alt and Chrystal (1983, 10) argue that efficiency is context-bound; application of economic efficiency depends on "an appropriate specification of the constraints under which decision-makers operate." This argument does not relegate the role of economic analysis. Instead, it offers an analytical framework that supplements the economic theory by examining all contextual factors which altogether constrain the decision-making process.

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