# "THE DANGERS OF DECENTRALIZATION" ACCORDING TO PRUD'HOMME: SOME FURTHER ASPECTS

*David O. Sewell*

The article by Rémy Prud'homme in the August 1995 issue of the *Research Observer* presents his views on "the dangers of decentralization from the viewpoints of redistribution, stabilization, and allocation" (p. 201). Although a response by Charles McLure accompanied the article, my commentary is intended to focus attention on additional issues raised by Prud'homme. I find it quite appropriate that subnational governments should participate in redistribution, as they do in practice; indeed, I suggest that subnational governments are best suited to perform some types of interregional redistribution. Some participation by subnational governments in stabilization policy is also sensible. Finally, the case for decentralization is fundamentally based on efficiency considerations, and I see no reason to accept the paradoxical proposition that central governments would be more efficient in providing such local services.

## Interpersonal Redistribution of Income

Whereas Prud'homme considers that "it is hard to think of a country that carries out redistributive policies at subnational levels" (p. 202), this writer finds it hard to think of one that does not! Regulatory policies widely allocated to local governments, such as land use and rent controls, have profound distributional implications, as do functions often assigned to subnational governments in general, most notably public health care and public education. The constitutions of many federal states often explicitly assign responsibilities for social welfare functions and redistributive tax instruments to subnational governments. The failure to discuss federal systems of government, which include some of the largest developing and transition countries, such as Brazil, India, and Russia, constitutes one of the more puzzling shortcomings in Prud'homme's article. Nowhere, perhaps, does the assignment of responsibilities for redistribution differ more strikingly from the centralist model than in Switzerland, where functions of health care, education, and welfare are for the most part exclusive duties of the cantons and

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where the cantons have priority in levying taxes on personal income and wealth. The Swiss example illustrates most clearly that there are workable alternatives to assignment of distributional authority to a central government.

The constitutional assignment of distributional functions to subnational governments is not limited to federal states, however. The relatively large size of local governments in the Scandinavian countries is explained in part by their responsibilities for distributional programs. In Denmark, for example, where local governments account for more than half of general government expenditures and about a third of gross national product, social security and welfare account for more than half of local government budgets (McMillan 1995). These local governments are substantially financed by local income tax rates, which are, in turn, "piggy-backed" on a central government tax base that is progressive in incidence. The Scandinavian example exerts a substantial influence on the development of neighboring countries in transition, particularly the Baltic states.

There is also plenty of evidence that subnational jurisdictions systematically incorporate distributional preferences into choices on spending decisions (see, for instance, Behrman and Craig 1987) and that these preferences may differ substantially by subnational jurisdiction. On the latter point, Wildasin (1991) notes that monthly average benefits for Aid to Families with Dependent Children vary by a factor of five among U.S states, observes that such differences have persisted over long time periods, and asserts that "decentralized redistribution is a fact of life that must be dealt with as a practical matter" (pp. 768–69). Such evidence poses problems for the traditional analysis that assigns responsibility for interpersonal income redistribution to central governments.

Prud'homme's arguments incorporate several assumptions about labor market adjustment, some of which appear to be in conflict. He assumes that the response of migration to income differentials is reasonably swift, so that "the generous jurisdiction [in terms of income redistribution] will *soon* be unable to sustain its policy" (p. 202, emphasis added). And he goes on to say that "regional disparities exist in most countries . . . and, contrary to standard economic theory, they do not disappear with economic development" (p. 202). It is precisely because migration takes place to equalize incomes and factor prices, however, that the conventional wisdom asserts that decentralized redistribution of income is self-defeating and the function should be assumed by central government.

Many would also dispute Prud'homme's assertion about regional disparities not narrowing over time. He uses the United States as an example and argues further that net fiscal benefits from subnational governments make income disparities worse, "increasing the gap in income between regions. Decentralization can therefore be the mother of segregation" (p. 203). In fact, the evidence appears to point to a substantial narrowing of regional income differentials in the long run (Barro and Sala-I-Martin 1991, 1992; Wysocki 1995).

As Prud'homme points out, however, considerations of factor mobility have traditionally been taken to imply that redistribution has to be carried out by higher levels of government. When working taxpayers and transfer recipients can move among jurisdictions, differences in distributional policy among these jurisdictions may attract transfer beneficiaries, repel taxpayers, and create externalities among areas in response to changes in taxes and services. Some recent contributions to this literature reconcile the implications of such labor market mobility with the assumption that local preferences for redistribution differ. Redistribution reemerges as either a desirable central function or one that should be coordinated, but with some interesting differences from the traditional analysis. In particular, Wildasin (1991) argues that an optimal solution is to provide grants that, because of differing subnational preferences for redistribution, are non-uniform by jurisdiction but lead to identical levels of transfer payments.

A further practical consideration is that, although factor markets influence the appropriate locus for distributional policy, the relevant factor markets may be subnational in cases in which, say, language or migration costs impose barriers to mobility or even supranational in cases where such factors are not important, as perhaps for some skills in the European Union. Thus in most of the countries in transition, where mobility is still limited because of lack of housing, local redistributional policies may acquire added importance and be less constrained than in other countries. The fact that housing is a responsibility of local governments in most of the countries in transition means that these local governments may be much more important than their counterparts elsewhere in affecting the distribution of income.

## Interregional Transfers

Differences in net fiscal benefits (the benefit taxpayers receive from public services minus their tax payments) that result from the activities of subnational governments create problems for central government goals of equity and efficiency. These differing net fiscal benefits may arise because those subnational governments whose residents have higher per capita incomes can finance a given amount of public services with less residence-based tax effort (for instance, lower tax rates on income taxed where the recipient resides) or for other reasons (a subnational government may have access to source-based taxes such as natural resource revenues, for example; see Boadway and Flatters 1982). An efficiency problem occurs if there is "fiscally induced migration" to collect these net fiscal benefits. The significance of such efficiency losses, however, is in some doubt (see Mieszkowski and Toder 1983; Watson 1986). The case for a redistribution of net subnational fiscal benefits to ensure equity probably deserves more weight than that arising from their efficiency costs. The equity problem for the central government derives from the "horizontal" equity goal of treating likes alike no matter where they reside in the country. The problem is that the central government's attempts to attain this goal are implemented through tax and transfer systems that deal only with the *market* or taxable incomes of individuals. The net fiscal benefits from subnational government activity may, however, lead to substantial differences in the real or comprehensive incomes of their residents over and above those arising from their market incomes. It is difficult to think of practicable ways in which a central government can deal with such local benefits by adjusting its own *personal* taxes and transfers. It would be impractical and politically unacceptable to levy different central government income tax rates in different jurisdictions, for instance. The practical solution that has been advocated is to undertake intergovernmental transfers to equalize subnational per capita fiscal capacities so that it is financially possible to achieve horizontal equity goals. In developing countries, Shah (1994) lists equalization as a factor in revenue-sharing transfers from central to local governments in Brazil, Colombia, India, Mexico, Nigeria, and Pakistan, and one could add Chile and Morocco to this list (World Bank 1993; Sewell 1994).

Financing such transfers with central government revenues may be inappropriate, however, if the revenues are raised from different sources than those received by subnational governments. (Following the usual principles of tax assignment, higher level governments tax more mobile resources, and local governments tax more immobile resources, such as property.) In some cases subnational governments own natural resources that yield substantial revenues—a state of affairs that led to great difficulties for Canada's centrally financed program of equalizing provincial government revenues when oil prices rose substantially in the 1970s. The obvious method of dealing with this problem is for *direct* redistribution to take place between subnational governments so that the "have" subnational governments contribute to a revenue pool that is then redistributed to the "have not" localities. A well-known example occurs between the länder (state governments) in the Federal Republic of Germany, and the Swiss version of equalization is similar (Spahn 1994). There are also examples of voluntary direct transfers among local governments, such as among the 201 municipalities in the Minneapolis–St. Paul area. Alternatively, central governments, among them Sweden and Denmark, have required such transfers to be undertaken between local governments based on fiscal capacity. Nor are all examples of direct transfers limited to mature industrial countries; Chile has a system of direct transfers from rich to poor *municipios*.

## Stabilization Policy

Prud'homme states that fiscal policy "is an instrument that only the central government can manipulate, because local authorities have few or no incentives to undertake economic stabilization programs" and that economic stabilization is in any case an unsuitable function for a subnational government because "most of the impact would be outside its jurisdiction" (p. 205). Further, he asserts that for a central government's fiscal policy to be effective, its budget must be large in relation to the budgets of local governments and must account for a substantial share of gross domestic product. He also cites examples of countries in which he believes subnational actions have been fiscally perverse and have adversely affected stabilization goals.

In contrast, findings from examination of this question in Canada, where the subject has received close examination, suggest that the growth of subnational budgets has generally had a stabilizing effect on the economy (Economic Council of Canada 1977, 1982; Fortin 1982a, 1982b; Rabeau 1986; Sheikh and Winer 1977; Royal Commission on the Economic Union and Development Prospects for Canada 1985), and that "relatively extreme assumptions about discretionary non-cooperation by junior jurisdictions are needed to conclude stabilization by the central authorities would not work at all simply because of this lack of cooperation" (Sheikh and Winer 1977, p. 195).

Although arguments about specific cases may not settle anything, the reasons why subnational fiscal activity has been found to be stabilizing in this literature may apply elsewhere. For instance, the major expenditure responsibilities likely to be assigned to the larger subnational governments in industrial and developing countries—such as public funding of health and education—act as automatic stabilizers because they are recurrent and not very flexible. Increased reliance on direct taxes (such as personal income taxes) in subnational financing has also been found to have a stabilizing effect. Further, technical objections to the idea of regional stabilization policy based on the assumption of substantial interregional leakages have been found not to apply in practice (Rabeau 1986).

Finally, stabilization policy may be another illustration of the fact that the relevant "domain for concern," to use McLure's phrase, may occur below the national level, because regional swings in the business cycle can be very disparate, and frequent demand disturbances of regional origin are well documented. To offset such shocks, it may well be economically costly and politically difficult to differentiate central government budgets on the scale required, and a good case can be made for some participation by larger subnational governments in stabilization policy (Fortin 1982a, 1982b).

## Decentralization and Efficiency

The case for decentralization is fundamentally based on efficiency considerations, and Prud'homme offers several qualifications to this case. The classic argument is that in a democratic society decentralization results in a better match of supply and demand for local public goods. Although one may agree with Prud'homme that this argument need not hold in the less-than-democratic circumstances that apply in some developing countries, there is no reason to expect that a central government's performance will be better in this respect, and it may be a great deal worse (Sewell and Wallich 1995). Prud'homme does not think economies of scale are important for local government functions, and much additional survey evidence can be adduced in support of this point (Bird and Hartle 1972; Eden and McMillan 1991; McMillan 1995). Finally, while Prud'homme postulates that central governments may attract more able local officials because they can offer better career prospects than can local governments, well-functioning *national* markets for local officials exist in many countries.

Nothing in Prud'homme's arguments suggests that it is necessary to qualify the case for decentralization on grounds of efficiency, and it may be worth emphasizing how important this case is. The principle of user cost recovery for local infrastructure and utility services is central to the efficiency rationale of local governments; subsidies for such infrastructure services often have regressive effects and are not recommended as a means of attaining distributional goals (World Bank 1994). Local governments the world over provide such infrastructure and utility services in areas including transportation (roads, public transport) and environmental services (water, sewers, trash collection). Among the member countries of the Organization for Economic Cooperation and Development (OECD), local governments alone are responsible for about half of all government capital formation, although this is often achieved with the aid of substantial transfers from higher levels of government (McMillan 1995). All subnational governments are responsible for even greater levels of public investment. In a survey of the nineteen OECD countries for the latest year in which data are available (1989–90), Austria recorded the median percentage of public investment by subnational governments, with a share of 71 percent (Sewell 1994).

## Conclusion

Decentralization may entail other difficulties; it is more inconvenient for those involved in lending operations to deal with a host of subnational governments rather than with a central government. Decentralization may also cause difficulties for international financial institutions, whose charters oblige them to lend only to their sovereign member governments. A great deal of attention is currently focused on the resulting "on-lending" problem of getting these funds to subnational governments. These problems are inevitable, however, where important functions for which lending takes place, such as the provision of infrastructure, are principally the concern of subnational, rather than national, governments. They may pose difficulties for international financial institutions, but they should not be thought of as "Dangers of Decentralization."

## Note

David O. Sewell is a member of the Technical Department of the World Bank's Europe/Central Asia and Middle East/North Africa Regions.

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