

Can decentralization be beneficial?

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Abstract

A conventional justification for government hierarchy in the fiscal federalism literature is based upon asymmetry in policy tools or in information access that is available to different levels of government. This paper demonstrates that even if these asymmetries are eliminated, addition of local (regional) governments to a one-tier central government can be strictly welfare improving.

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1. Introduction

Hierarchical governments, either federations or confederations, are widely spread across the world and are persistent across time. This suggests that they may outperform unitary governments. However, according to a textbook economic argument, a central authority can internalize the externalities, hence, it has an advantage over a set of local governments, in which politicians, representing their constituents, are motivated solely by local interests. So in a world, in which both levels of government have access to the same information, the role for local governments is unclear. Nevertheless, even in such a world, maintaining a multi-leveled government may be worthwhile as opposed to a potentially cheaper unitary one. This paper provides an explanation.

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Let me briefly describe the set up. Legislators at the “original position”¹, have to write a constitution for their country. “Constitution” in this model is just a set of rules governing acceptance of public projects. As in Harsanyi (1992), the legislators are rational and it is common knowledge that each one of them may occupy any position (represent any locality with equal chance) after the “veil of ignorance” is lifted. Assume their beliefs are consistent, so that there is a common prior, F , with respect to the appearance of public projects, and this prior is shared behind the veil of ignorance. The benefits and costs of a project are expressed in the same (monetary) terms. Thus, by Harsanyi (1992), the social objective is to maximize the expected (net) value of a public project, or simply, the welfare. All the ex-ante identical individuals should agree on this objective, and so they can be thought of as a single (fictitious) individual, named ‘constitutional designer.’

The designer will decide to add local governments only if by doing so he can increase the expected welfare. The role of local governments here is reduced to accepting public projects that can be fully financed by one of the regions. In the absence of negative externalities, which is true in this model, an addition of local governments cannot decrease welfare. In these circumstances, the hierarchy is justified only if it generates a strictly positive social benefit that can cover the costs of running another tier of government (either explicit or implicit), these costs being omitted here for simplicity. That is why decentralization is called beneficial in this model only if it is *strictly* welfare improving.

Clearly, the decision of whether or not to decentralize depends on the rules according to which the central legislature operates. If the designer is unconstrained, he can condition the constitution on the benefits and costs that become known to the legislators once a project appears on the agenda, and attain the ex-post optimum as in Laffont and Maskin (1982). Then there would be no need for local governments. This result, however, rests on the assumption that the realization of the payoffs is truly exogenous, in other words, it is not subject to strategic manipulations. Unfortunately, in many practical cases, the assumption is violated, as estimating benefits and costs of a public project requires specific knowledge, or expertise, that politicians often lack. For example, in the US, the evaluation of water projects is performed by the US Army Corps of Engineers. Clearly, once it is done, predicted benefits and costs become common knowledge among the legislators.² In this case, conditioning the cost sharing arrangements on benefits would be equivalent to delegating *the formulation of the rules* to the “experts,” who conduct the evaluation study. As their objectives may not coincide with those of the elected representatives, and, especially, those of the general electorate,³ this can result in additional informational rents

¹ or behind Rawlsian/Harsanyi’s “veil of ignorance.”

² Similar procedures are applied in the other areas of public policy.

³ Large scale water projects in the US have been evaluated and constructed (if approved by the Congress) by the US Army Corps of Engineers for over a century. From Washington Post, May 14, 2002; Page A2, “150 Water Projects Halted For Army Corps Review” by Michael Grunwald: “. . . In 2000, the Post series detailed how the Corps has justified many projects with skewed assumptions and overly optimistic predictions of barge and ship traffic. E-mails from high-ranking Corps officials revealed that they had manipulated an economic study in order to justify a billion-dollar lock expansion project on the Mississippi River. An internal Pentagon investigation concluded that Corps studies were tainted by an institutional bias toward large-scale construction.”

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