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Rent-seeking, spillovers and the benefits of decentralization

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Abstract

In the presence of spillovers, decentralized provision of local public goods may lead to a higher surplus than centralized provision even though localities have identical preferences. Indeed, free-riding costs associated to decentralization can be lower than the costs of rent-seeking and influence activities under centralization. Actually, centralization yields a higher level of regional surplus only if both the spillover effect from local public spending is sufficiently large *and* the elasticity of the influence function is sufficiently small.

JEL classification: H11; H41

Keywords: (De)centralization; Local public goods; Rent-seeking; Spillovers

1. Introduction

The existing literature on fiscal decentralization can be divided into three branches. The first branch, pioneered by Tiebout [22], emphasizes the benefits of competition among local jurisdictions. The basic idea is that, under a head tax-regime, competition for mobile citizens should match bundles of public goods to citizens' preferences more accurately. Tiebout further argued that in a system with many jurisdictions, competition among them would ensure an efficient outcome both in the production of local public goods and in the distribution of total population over

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communities.[1] The Tiebout sorting equilibrium, however, crucially depends on a number of unrealistic assumptions one of them being the absence of spillovers among localities. The second branch of the literature on fiscal decentralization focuses precisely on the spillovers among jurisdictions resulting from the mobility of the tax base. The standard analysis assumes immobile citizens but mobile capital that is taxed by local governments to finance public good provision. Mobility of capital across borders raises the marginal cost of public funds perceived by each jurisdiction since it reduces the available tax base. As a result, suboptimal levels of tax rates and of local public goods emerge in a decentralized equilibrium.[2] In general, however, this literature abstracts from any heterogeneity between consumers. Brueckner [6,7] was the first to attempt to reconcile these two branches of the literature by analyzing a tax-competition model where consumers are heterogeneous and can move from one jurisdiction to the other. One of his main conclusions is that the dispersion of preferences is a critical factor to evaluate the relative performance of fiscal or political decentralization.

The third branch of the literature concentrates on the optimal allocation of powers between the central and local governments. It emphasizes that fiscal decentralization may be inefficient even though the tax base is immobile and there is no heterogeneity in preferences within local jurisdictions. This is the case if citizens can benefit from public goods provided in other jurisdictions or if there exists economies of scale in the production of public goods. The drawback with a centralized system, however, is that it produces a uniform policy that does not reflect local preferences. Hence, when different localities have different preferences over public policies, the choice of a centralized system over a decentralized system depends on the size of the benefits of internalizing externalities relative to the costs of policy uniformity. This result is usually known as the Oates' [17] decentralization theorem. The present paper belongs to this strand of literature since we focus on the relative performance of centralized and decentralized structures when both consumers and the tax base are immobile and in presence of cross-boundary externalities stemming from locally provided public goods. However, in contrast with most previous analysis, we argue that even though localities have identical tastes and value public spending to the same extent, centralized decision-making may not be the most efficient system. This is because, under centralization, sharing the costs of local public spending gives rise to a distributive conflict, as each region wishes to push the central government for an expansion of its own public sector level and for a decrease of that level in the other region so as reduce tax burden. Thus, from a political economy perspective, the relative performance of centralized and decentralized systems depends upon the costs of this distributive conflict, which is reflected in a competition for political influence, relative to the cost of non-cooperative behavior between localities.

While much of the recent literature in political economy analyzes lobbying as a common agency game (see Grossman and Helpman [12]), we adopt, in this study, the public choice school paradigm of modeling the competition for political influence which was proposed by Tullock [24, 25]. This approach is not micro-founded, and therefore is not suitable to study important theoretical topics such as the role of asymmetric information in politics. However, the central focus of our work is the importance of the distributive conflict between regions and the resulting waste of resources on lobbying that fiscal centralization may imply. The analysis of the harmful competition for political influence can then be conveniently based on the complementing, reduced-form

[1] See Scotchmer [21] for a recent discussion of the Tiebout literature.

[2] See Wilson [27] for a recent survey of the tax-competition literature.