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Fiscal decentralization, ideology, and the size of the public sector

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ABSTRACT

No consensus has yet emerged on whether fiscal decentralization facilitates or impedes the growth of the public sector. One explanation for this ambiguity in the literature is that the effect of fiscal decentralization on public sector size depends on the government's ideology. This paper therefore develops a simple model to study theoretically how interactions between fiscal decentralization and the ideology of the government may influence the size of the public sector. Thereafter, the implications of the model are tested empirically with panel data from 18 OECD countries over the 1980–2000 period.

1. Introduction

Whether fiscal decentralization leads to a reduction or an increase in the size of the public sector is a well researched question within the field of fiscal federalism. The starting point of this literature is Brennan and Buchanan's famous conjecture which states that government intrusion into the economy will be smaller when the public sector is decentralized (Brennan and Buchanan, 1980). Several authors have attempted to test this Leviathan Hypothesis empirically, partly because Brennan and Buchanan explicitly invited researchers to do so,[1] and partly because the validity of the hypothesis is based on a controversial view of government. Indeed, Oates (1985) already offers a number of arguments for the opposite relationship between decentralization and public sector size, for example that citizens' willingness to delegate responsibility to the government might increase when the public sector is decentralized.

Facing two competing theoretical predictions, Oates (1985) explores the relationship between decentralization and public sector size empirically. He runs two sets of cross-section regressions, first with data on US States and then with international data, using three measures of (de)centralization, and several different specifications. These regressions suggest neither a robust nor a significant relationship between fiscal decentralization and public sector size.

The overarching aim of the articles which build upon Oates' influential contribution is to explore the robustness of the finding of no significant relationship by using different data, an improved specification, considering alternative sets of countries, or other measures of decentralization.

For example, one issue that is ignored in Oates' study is whether the federal and subnational governments are able to limit the competitive pressures due to decentralization by colluding with each other. Grossman and West (1994) address this possibility in

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[1] "There are, then, clear empirical implications here that could be tested to determine the extent to which this explanation of revenue sharing and the structure of grants is an acceptable one" (Brennan and Buchanan, 1980, p.182).

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a study on the Canadian Provinces with time-series data. They indeed find that collusion between tiers of government increases the size of the public sector.

Another characteristic of Oates' study is that he conducts cross-section regressions at the US state level. In contrast, Marlow (1988) explores the link between decentralization and public sector size for the United States at the national level by using time-series data. He measures the aggregate size of the public sector with the ratio of total government expenditures to GNP, and regresses this variable on a measure of decentralization and two other controls. The results indicate, unlike in Oates' study, that decentralization in the US is negatively related to aggregate public sector size.

Other studies emphasize the importance of the underlying fiscal constitution for the effect of decentralization on public sector size. In these studies, it is argued that granting certain types of intergovernmental transfers to subnational governments will increase the size of the public sector when the federation is characterized by soft budget constraints and horizontal equalization schemes. For example, Grossman (1989) finds that while decentralization has indeed led to a smaller public sector in the US, intergovernmental grants have contributed to the growth of government.[2] Jin and Zou (2002) obtain similar results in a panel data study on 32 industrial and developing countries. They find that expenditure decentralization leads to a larger aggregate government, whereas revenue decentralization seems to have the opposite effect. Vertical fiscal imbalances created by vertical transfers are found to expand the public sector. Overall, their results support the Leviathan Hypothesis for revenue but reject it for expenditure decentralization. Stein (1998) confirms these results for South American countries. He concludes that decentralization, when financed through central transfers, leads to an expansion of the public sector.

A related literature studies the impact of fiscal decentralization on public borrowing. However, this literature, too, is inconclusive. For example, while Neyapti (2010) finds that fiscal decentralization reduces deficits, De Mello (2000) reaches the opposite conclusion.

Compared to these studies, the scope of analysis is broadened in Rodden (2003). While his main concern continues to be the impact of the intergovernmental transfer scheme on the relationship between decentralization and size of the public sector, he also considers a number of political and institutional variables. He finds that fiscal decentralization tends to decrease the size of the public sector, but that public sectors grow faster when subnational expenditures are financed through intergovernmental grants. However, his key theoretical insight is that the overall impact of decentralization could be determined by how different tax bases are allocated to the various tiers of government. That is, fiscal decentralization might lead to a smaller public sector size particularly in such regimes where the fiscal constitution allocates those bases that are mobile to the subnational tier. This argument suggests the possibility that the suppliers of different production factors are locked in a battle to pass the financial burden of national and regional public goods onto each other by structuring the fiscal constitution appropriately.

Even though Rodden's argument is enlightening, it is made informally and its implications are not fully explored. Therefore, we attempt in this paper to elaborate on it by constructing a formal model that links the degree of mobility of factors of production to the fiscal preferences of their suppliers. In this model, we take the fiscal constitution (that is, the allocation of taxing powers over different tax bases between the tiers of government) as given, and endogenize tax rates and thus the size of the public sector.

While there are some contributions that analyze the political dimensions of decentralization, e.g. Sengupta (2010) and Hindriks and Lockwood (2009), an explicit connection between ideology and decentralization and their joint impact on the size of government is rarely made in the literature. Sengupta (2010), for example, studies partisan effects in the allocation of federal transfers to subnational governments, while Hindriks and Lockwood (2009) analyze the impact of decentralization on electoral discipline.

We derive in the theoretical part of the paper that a decentralized public sector leads to a larger public sector size than a centralized one when the federal government is formed by a left-wing party, but that with a right-wing federal government, decentralization results in a smaller public sector size. In the empirical part of this paper, we test this hypothesis. We primarily use data from 18 OECD countries for this test, but also conduct a robustness check with a larger set of countries.

The remainder of this paper is organized as follows. In Section 2.1, we describe the general framework of the model and introduce the notation, in Sections 2.2 and 2.3 we derive the optimal size of the public sector with a benevolent government under centralized and decentralized regimes. These results will serve as our benchmark in evaluating the public sector size under "political" governments in Section 3. Based on the theoretical results, we start our empirical investigation in Section 4. In Section 4.1 we formulate our empirical hypothesis and describe the data. The results are presented in Section 4.2. In Section 5, we conclude.

2. The basic model

2.1. General framework

Assume a federation consisting of a continuum of jurisdictions whose measure is normalized to 1. The population in each jurisdiction is also normalized to have a measure of 1. Then, the number of inhabitants in the federation is unity.

In each jurisdiction, there are two types of inhabitants who are distinguished by the factor of production they supply to the production process. There are (i) "capitalists" who each supply inelastically 1 unit of capital and zero labor, and (ii) "laborers" who each supply inelastically 1 unit of labor and zero capital. We assume that capital is mobile between subnational jurisdictions, but

[2] Corresponding to this, Schaltegger and Feld (2009) find for Switzerland that decentralization increases the probability of successful fiscal consolidations, while federal transfers reduce this probability.