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Second generation fiscal federalism: The implications of fiscal incentives

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ABSTRACT

First generation fiscal federalism (FGFF) studies the performance of decentralized systems under the assumption of benevolent social planners. Second generation fiscal federalism (SGFF) studies performance based on the fiscal and political incentives facing subnational officials. The paper focuses on three aspects of SGFF. First, it considers the design of intergovernmental transfers. While FGFF emphasizes correcting vertical and horizontal equity, SGFF emphasizes the importance of fiscal incentives for producing local economic prosperity. SGFF extends FGFF approaches by showing how non-linear transfer systems can produce both equalization and high marginal fiscal incentives to produce local economic growth. Second, the paper raises the fiscal incentive approach, showing how different tax systems produce different fiscal incentives for political officials to choose policies. Third, the paper discusses the interaction of democracy and fiscal federalism.

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> [Second generation fiscal federalism represents] a new literature on fiscal federalism that examines the workings of different political and fiscal institutions in a setting of imperfect information and control with a basic focus on the incentives that these institutions embody and the result behavior they induce from utility-maximizing participants (Oates, 2005, p. 356).

> Much fiscal analysis of developing countries is on the following pattern: the academic literature is drawn on to construct a model fiscal system; the existing situation in a particular country is examined to determine how it diverges from the model; and a fiscal reform is then proposed to transform what *is* into what *ought to be*.... In contrast, my approach is first to study in detail exactly *how* the existing system works, and *why* it works that way, in order to have a firm basis for understanding what changes may be both desirable and feasible. My emphasis has thus always been more on what *can* be done than on what *should* be done (Bird, 1992, x, emphasis in original).

1. Introduction

Why do federal nations exhibit such widely different economic performance? Some are rich (Switzerland and the United States) while some are poorer (Argentina and Brazil); some exhibit fast-paced growth (modern China) while others little growth (Mexico). In this essay, I explore this issue by surveying the new literature on second generation fiscal federalism (SGFF), which complements first generation fiscal federalism (FGFF). The distinction between FGFF and SGFF parallels that made by Musgrave (1959, p. 4):

> [Theories of Public Economy] can be approached in two ways. First, we attempt to state the rules and principles that make for an efficient conduct of the public economy.... In the second approach, we attempt to develop a theory that permits us to explain why existing policies are pursued and to predict which policies will be pursued in the future.

FGFF is largely normative and assumes that public decision-makers are benevolent maximizers of the social welfare (Musgrave, 1959; Oates, 1972; Rubinfeld, 1987). SGFF builds on FGFF but assumes that public officials have goals induced by political institutions that often diverge from maximizing citizen welfare (Oates, 2005; Garzarelli, 2004; Qian and Weingast, 1997; see also Brennan and Buchanan, 1980; Salmon, 1986; and Wicksell, 1967). As Hatfield (2006) puts it, "Economic policy is not decided by benevolent social planners, but by government officials, usually with at least one eye to their reelection prospects."

The distinction should not be overdrawn – no clean demarcation exists between the generations, and many first generation works develop considerable positive implications. Nonetheless, the

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distinction is important because it emphasizes the extension of normative fiscal federalism to take systematic account of public official incentives.

SGFF models provide a range of new insights into fiscal federalism (Oates, 2005). This approach also provides new normative prescriptions for the design of federal systems, including how many of the prescriptions of FGFF should be adapted given more realistic political choice environments. SGFF explores how various institutions align – or fail to align – the incentives of political officials with those of citizens. This approach is central to understanding differential federal performance.

In this essay, I survey a range of SGFF ideas and explore their implications for developing countries in the context of decentralization and democratic governance. I begin with the perspective of market-preserving federalism. By studying the conditions and incentives of subnational government authority and policymaking, this perspective provides a comparative theory of federal performance: federal systems that satisfy different combinations of the market-preserving federalism conditions differ in predictable ways. The comparative analysis helps explain why decentralized systems exhibit so much variance in behavior. This analysis allows us to study a range of "pathologies of federalism" – fiscal institutions that produce perverse or market-distorting outcomes.

I next discuss SGFF implications for intergovernmental transfer systems. FGFF models emphasize the importance of transfers for mitigating vertical and horizontal imbalances. The SGFF approach emphasizes the importance of incentives generated by local tax generation for fostering local economic prosperity. Subnational and urban governments are more likely to provide market-enhancing public goods when they capture a large portion of the increased tax revenue generated by greater economic activity. SGFF approaches have significant implications for the design of transfer systems so that equalization goals can be achieved while providing public officials with incentives to foster thriving local economies.

Next, I turn to the fiscal incentives approach with long roots in the study of fiscal federalism.[2] The idea is that, whatever their goals, public officials favor policies that relax their budget constraint. Different systems of taxation and intergovernmental transfers therefore directly affect local governmental behavior and policy choice. I study several types of fiscal incentives associated with intergovernmental transfer systems, including the design of markets and corruption.

I also discuss the role of democracy. Democracy is a source of freedom and expression for citizens, and when it works well, it provides citizens a means to express choices and to hold public officials accountable. But democracy often fails in practice for developing countries. I show how the fiscal system affects the performance of democracy by investigating one source of failure of democracy called "tragic brilliance," the idea that voting can create political dependence (Diaz-Cayeros et al., 2008). By making fiscal transfers to finance local public goods and services – such as water, road maintenance or schools – depend on whether voters in a locality support it, the incumbent regime can force then to support it. Elections in the presence of fiscal dependence and opportunism become a means of political control rather than of citizen expression. Local government fiscal independence mitigates this perverse effect. I end with a brief discussion of the differences between FGFF and SGFF approaches.

Before beginning, let me observe that SGFF encompasses a large and varied literature. At the most general level is Inman and Rubinfeld's call for a new political economy of federalism (Inman, 1988; Inman and Rubinfeld, 1997b).[3] Others working in the context of developing countries, follow Bird's (1992) point noted in the paper's headnote.[4] A large body of work studies various forms of common pool problems, of which three stand out: the so-called "race to the bottom"[5]; problems with a soft budget constraints for subnational governments[6]; and common pool problems associated with centralized provision of local public goods.[7] Still other scholars call for understanding differences among federal systems in order to learn what institutions support market-preserving (Weingast, 1995).[8] Beginning with Riker (1964), another strand in the literature emphasizes the political aspects of federal performance, particularly political parties.[9] Relatedly, scholars investigate the self-enforcing rules necessary maintain federal stability.[10]

2. Market-preserving federalism and the comparative theory of decentralized governance

Local governments exist within a complex set of institutional arrangements, with political, legal-constitutional, and economic aspects. This section develops a framework for analyzing how different institutional arrangements affect the performance of local governments.

Federalism, and decentralization more generally, encompasses a wide range of different political–economic systems, not one, whose political and economic properties vary widely (Shah, 1997b; Watts, 1999). As Litvak et al. (1998, p. vii) observe, "decentralization is neither good nor bad for efficiency, equity, or macroeconomic stability; but rather that its effects depend on institution-specific design." We therefore cannot speak of the tendencies of federalism per se. Some federal systems promote macroeconomic stability and economic growth while others just the opposite.

Consider: For the last three centuries, the richest nation in the world has almost always been federal. The Dutch Republic from the late sixteenth through mid-seventeenth centuries; England from the late seventeenth or early eighteenth and mid-nineteenth centuries (a de facto though not de jure federal system); and the United States from the late nineteenth to the present. Similarly, modern China, a de facto federal state, has experienced sustained rapid growth. India, having grown slowly for several decades, has experienced high growth in the last. In contrast, the large Latin America federal states of Argentina, Brazil, and Mexico, have all fared much more poorly. How do we account for such large differences in economic performance?

In this section, I summarize a comparative theory of decentralized governance that explains the differential economic performance of various types of decentralization. This framework helps understand some of the institutions necessary to support decentralization that provides political officials with incentives to improve social welfare.

[2] Including Buchanan (1960), Brennan and Buchanan (1980), Glaeser (1996), Oates (1972), Salmon (1986), Tiebout (1956), and Wallis et al. (1994).

[3] Rodden (2005), Weingast (2005), and Winer and Hettich (2006) provide partial surveys.

[4] See also Bardhan (2002) and Litvack et al. (1998).

[5] Zodrow and Mieszkowski (1986), Wildasin (1991), and Wilson (1991). Revesz (1997) provides a survey and critique. A closely related literature studies tax competition, e.g. Wilson (1999) and Wilson and Wildasin (2004).

[6] Rodden et al. (2001) survey this large literature.

[7] Besley and Coate (2003), Inman and Rubinfeld (1997a), Knight (2004), Lockwood (2002), Sanguinetti (1994), Stein (1998), Weingast et al. (1981), and Winer (1980). A large empirical literature provides evidence for this proposition, including Cohen and Noll (1998), Dillinger and Webb (1999), Inman (1988), and Poterba and von Hagen (1999).

[8] See also Montinola et al. (1995), Jin et al. (2005), McKinnon (1997), and Slider (1997).

[9] See Blanchard and Shleifer (2000), Chhibber and Kollman (2004), Filippov et al. (2003), Garman et al. (2000), and Jones et al. (2000).

[10] Bednar (2006), de Figueiredo and Weingast (2005) Filippov et al. (2003), Inman and Rubinfeld (2008), Stepan (2004b), and Treisman (1999).

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