1. Decentralisation in a globalised world: Consequences and opportunities

by

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Globalisation accompanied by the growing importance of information technology and knowledge-based production pose challenging problems for federations. The chapter summarises the difficulties that traditional decentralised federations face in addressing problems of competitiveness, innovation and inequality brought on by globalisation. Adapting to these challenges involves rethinking the roles of various levels of government and rebalancing them appropriately. On the one hand, responding to inequality enhances the policy role of the federal government. On the other hand, state and local governments must respond to the imperative of providing education and business services to equip citizens and firms to compete in the knowledge economy. Perhaps most important, large urban governments are best placed to provide the physical and social capital to support innovation hubs. A key challenge for fiscal federalism is to facilitate the decentralisation of responsibilities to urban governments. This entails new thinking about revenue decentralisation, policy harmonisation and the structure of intergovernmental transfers so that cities can implement their policies effectively and accountably.

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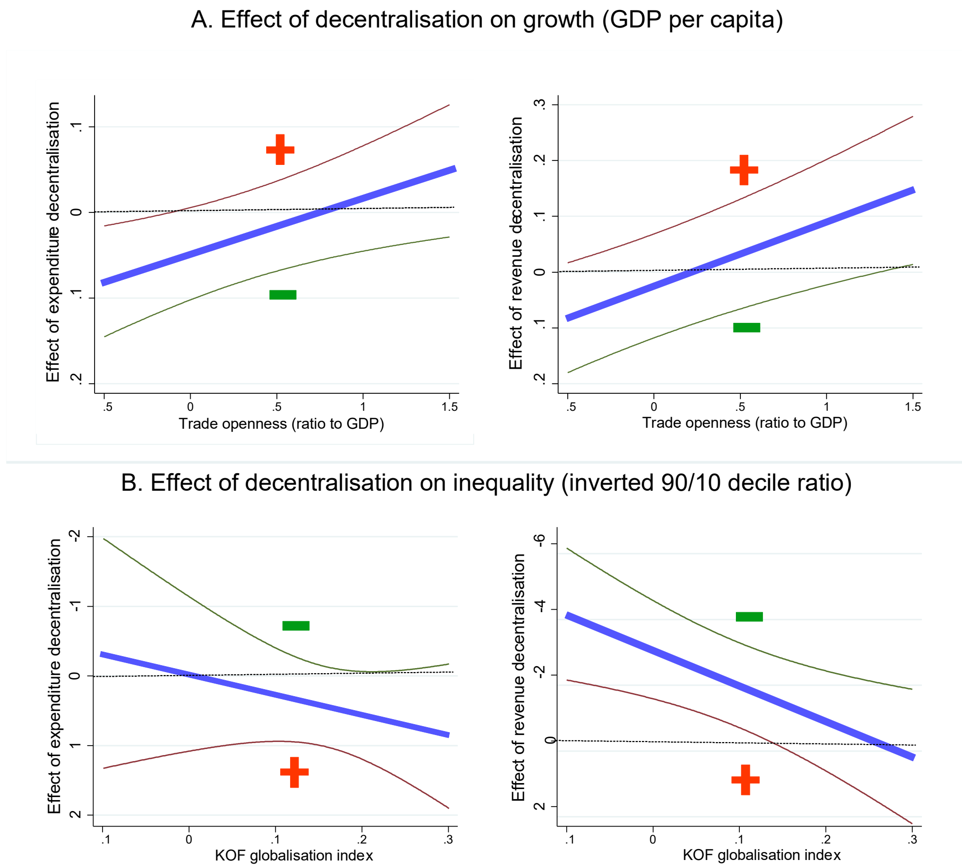
1.1. Introduction

Modern nation-states face a globalised world characterised by challenging features. Globalisation implies that markets for capital and skilled persons are international, and that much of production is organised on a transnational supply-chain basis. Advances in information technology mean that a growing proportion of production is knowledge-intensive and "footloose". International patterns of specialisation and the mobility of skills result in growing inequality within nations, as the gains from growth accrue to top income groups, although international inequality becomes moderated as workers in developing economies are lifted out of poverty. OECD economies are becoming more urbanised, and technological innovation is especially concentrated in urban innovation hubs. Nation-states are prone to economic shocks transmitted from abroad, often regionally specific in the case of heterogeneous nations, and the nature of employment itself becomes increasingly precarious. National governments are constrained by globalised markets, as well as by the instantaneous flow of information to citizens to whom they must account (see Boadway and Shah, 2009).

Our objective is to explore the consequences of these developments for decentralised nations. Globalisation and decentralisation may influence each other (Alesina et al., 2005). Decentralisation can help or hinder the challenges posed by globalisation, while the extent and nature of decentralisation should adjust with globalisation, urbanisation and information innovation. Our discussion is in terms of federations with federal, state and local governments, though similar considerations apply in unitary nations with active local and regional governments. Our approach complements that of Sean Dougherty (in OECD/KIPF, 2018) who finds that fiscal decentralisation—especially both expenditure and revenue decentralisation combined—encourages economic growth in highly open economies, but that it also can induce economic inequality (see Figure 1.1).

Figure 1.1. Growth and inequality effects of decentralisation, conditional on globalisation



Note: Growth elasticities are based on a time series regression framework, with government size fixed; inequality effects are analogous, but based on an inverted 90/10 decile ratio, also with government size fixed. Red and green lines are 95% confidence intervals around the estimated elasticity (in blue).

Source: Adapted from Dougherty and Akgun (2018).

Federations are both economic unions in which factors of production and producers flow freely across internal borders and social unions with common citizenship rights and some degree of solidarity. The extent and form of decentralisation vary from country to country, but some common features can be noted. The level of combined state and local expenditures in most federations tends to be comparable with that of the central/federal government (Watts, 1999). The proportion of expenditures consisting of transfers is much higher at the federal level, including transfers to lower levels of government. State and local expenditures are dominated by goods and services, and local governments are especially important in the provision of infrastructure. The extent of decentralisation of revenue-raising varies greatly among federations, and this is reflected in the extent to which sub-national governments rely on transfers from higher levels of government. In many federations, states have access to at least one broad-based tax, such as income or consumption taxation, and they have significant discretion to borrow from capital markets. Local governments are generally more reliant on states for their finances, and have only limited discretion to borrow. In addition, localities face significant oversight from state governments.

Relations among governments are typically hierarchical, with the federal government engaging fiscally with the states, and the states in turn with localities. Vertical fiscal gaps exist between levels of government and are the outcomes of interdependent tax and fiscal transfer choices. Despite what the fiscal federalism literature would suggest, there is considerable institutional co-operation between the federal government and the states, albeit with the federal government exercising leadership and with both levels of government enjoying legislative autonomy. The federal government can influence state decisions by a variety of means that vary by federation, such as conditional transfers, mandates, the disallowance of state legislation, and moral suasion. Sub-national governments with more revenue-raising ability are better able to deal with adverse fiscal shocks, although this will depend upon how federal-state transfers respond to shocks. There are no fail-safe mechanisms to guarantee that higher governments will not bail out lower ones who fall into fiscal distress. The design of formula-based transfer systems, however, offers some protection.

1.2. Decentralisation in heterogeneous federations

It is useful to summarize briefly some standard arguments from the fiscal federalism literature on the pros and cons of decentralisation. By decentralisation we mean the devolving of responsibilities to state and local governments. This includes especially legislative responsibilities, but can also include state governments administering or designing programs legislated by the federal government. We consider mainly fiscal responsibilities: raising revenues through taxes, user fees and borrowing; spending on goods and services, infrastructure and transfers to individuals and firms; social insurance; and intergovernmental transfers. State responsibilities may be exclusive to the state, or they may be subject to oversight by federal legislation or regulation. Moreover, federal and state governments may share some fiscal responsibilities, with paramountcy given to one level. And, governments may enter into bilateral or multilateral agreements, for example, to harmonize taxation or spending programs, or to facilitate internal free trade. Dispute settlement mechanisms necessarily accompany such agreements, although sometimes the federal government is the final authority.

Decentralisation contributes to the efficient delivery of public services to residents, including those that are important for competitiveness, growth and fairness. Indeed, state spending programs are critical components of government policies for redistributive equity and equality of opportunity. State programme responsibilities typically include: important public services delivered to individuals, such as education and health; targeted transfers such as welfare; in-kind transfers like childcare and elderly care; and employment and training services. State governments, along with local governments, undertake the bulk of infrastructure spending. Local governments also provide some social programs like low-income housing and transportation, and care programs for children and the elderly. States generally have access to discretionary revenue sources, although they rely in varying amounts on federal transfers. Local governments have less buoyant revenue sources and enjoy limited discretion for spending on infrastructure programs.

The arguments for decentralisation anticipate its consequences. Beneficial consequences of decentralisation include the following:

1. good governance by locating decisions at a level close to those being served;
2. respect for local preferences and for diversity of needs, while abiding by national standards;

3. holding governments to account via exit (migration) and voice (local participation by citizens, community leaders and politicians);
4. innovation and experimentation in service delivery (laboratory federalism); and
5. beneficial fiscal competition with other jurisdictions including through yardstick competition and mimicking best practices.

The responsiveness and accountability of state and local programs to citizens' needs and preferences varies with the amount of legislative and financial discretion these governments enjoy. State governments enjoy more discretion than local governments.

Decentralisation also has some potentially adverse consequences. It creates horizontal imbalances such that states and localities differ in their ability to provide public services at comparable levels of taxation. To the extent that this causes fiscally-induced migration, labour and business will be inefficiently allocated among jurisdictions. Horizontal imbalances also lead to horizontal inequities in the federation, that is, with otherwise identical persons being treated differently depending on their state of residence. Whether this is a serious issue depends on the weight society puts on solidarity or social citizenship. On the other hand, horizontal imbalances may reflect agglomeration and scale economies, in which case undoing them can be counter-productive. Also, while decentralisation allows states to differentiate their policies in accordance with local preferences and needs, it may also detract from national standards of fairness and distort inter-provincial movements of products and factors of production. In particular, fiscal competition can lead to a race-to-the-bottom in redistributive policies and in sub-optimal tax rates and levels of public services, due to mobility of capital and labour, especially skilled labour. As well, the decentralisation of broad tax bases and major public services to the states can lead to distortions in the internal economic union simply because policies are not harmonised among states. Finally, decentralisation of spending responsibilities that is not accompanied by sufficient revenue-raising discretion can leave state and local finances without adequate ability to respond to fiscal shocks and face the federal government with deciding whether to come to their aid. The expectation that the federal government will bail out state and/or local governments that are in financial trouble can encourage behaviour by the latter that is not fiscally sustainable.

A variety of measures can be taken to address the adverse consequences of decentralisation without sacrificing its advantages. Fiscal equalisation transfers from the federal government can undo the horizontal imbalances created by decentralisation without unduly influencing state behaviour provided they are well-designed. This requires that the transfers to a state not be too responsive to its fiscal decisions. Block transfers with broad but non-intrusive conditions can be used to close whatever gap remains between sub-national spending responsibilities and their revenue-raising abilities as well as to encourage states to abide by minimum national standards in the design of their public service programs. Detrimental effects of decentralised decision-making on the internal economic and social union can be ameliorated by fiscal harmonisation agreements between the federal and state governments. Institutional arrangements such as fiscal rules and fiscal councils can be used to encourage governments to be fiscally responsible and to minimise the chances of bailouts. In some federations, more decentralisation of revenue-raising to the states can induce greater fiscal accountability and responsiveness to local needs and shocks.

Enhancing the effectiveness of local governments, especially in larger urban areas, is more challenging but crucially important. The demands on urban government for infrastructure and other public services are substantial, but getting fiscal tools to them is difficult. Cities vary greatly in size, and within states one or two cities can dominate the populations. The case for asymmetric treatment is strong, for example, giving only larger cities access to selected revenue sources. Local equalisation systems that are based on need and that distinguish among cities by population size are relatively straightforward to design. An open question is the extent to which the federal government should have direct fiscal relations with larger cities, especially since their policies can have national implications.

1.3. Challenges of globalisation for decentralisation

Globalisation accompanied by the movement of populations to large urban areas and the growing importance of knowledge-based production poses an enormous challenge for national economies and national governments. Competitive pressure puts a premium on innovation, entrepreneurship and investment in physical, intangible and human capital. Governments at all levels are constrained by the openness of markets for capital, products and highly skilled labour. They increasingly compete with one another to attract economic activity, and this limits their control over tax bases and tax rates. Moreover, open economies are vulnerable to economic shocks, both aggregate and sector-specific, and this affects the fiscal fortunes of all levels of government. Advances in information technology increase the rapidity with which change occurs and propagates, and result in more disruptive and precarious labour markets facing workers. This is on top of the tendencies for inequality to increase as wages of low-income workers face increasing competition from abroad, and the fruits of information-based innovation and transnational production accrue to the already better off.

New forms of information technology also serve to empower citizens by enhancing their ability to hold governments to account and by enabling novel forms of citizen activism. This bottom-up accountability has the potential to induce more responsive and efficient service delivery and reduce the costs of citizens transacting with their governments, particularly local government. Information technology also improves the voice of non-government entities and offers the possibility of enlisting them in local service delivery. There is also greater awareness of neighbouring jurisdictions leading to more competition and innovation since local performance can be judged by benchmarks established elsewhere (so-called yardstick competition). The upshot is an enhancement of the role of local governments at the expense of state governments, especially as the federal government takes on some of the responsibilities of the latter in response to globalisation pressures.

Policy responses to these challenges involve all levels of government, and especially call for reinvigorating the role of local governments. The federal government has a prime role to play in responding to the challenges of inequality. It dominates the personal tax-transfer system, which is the first line of attack on income and wealth inequality. It can also use the corporate tax system to both encourage innovative investment and to tax economic rents at source, albeit constrained by corporate profit shifting using tax avoidance devices. Though profit shifting is often not illegal, it nonetheless exploits tax loopholes that exist unintentionally. The federal government also controls the main elements of social insurance, especially the unemployment insurance system.

At the same time, state and local government policies complement federal redistributive equity policies. To the extent that public expenditures are used to address redistribution—and arguably they are at least as important as taxes and transfers—sub-national governments are largely responsible for them. Such policies include education and training, health, social services, childcare and housing.

Pursuing economic growth involves policies to enhance productivity, innovation and entrepreneurship. Federal tax policy can partly address this by making both business and personal taxes friendly to investment and innovation. However, a growth agenda will also involve investments in human capital, in public capital and in information technology, and sub-national governments have a role to play. State governments influence human capital investment through the universities and colleges that they typically operate. They also control much of the transportation facilities and communications technology. As previously mentioned, local governments are responsible for the bulk of infrastructure spending. Most important, cities are home to innovation hubs and to the high-tech sector and the highly skilled persons it employs. Cities are also home to capital markets, including those for venture capital. More generally, urban areas are where agglomeration economies and technology networks are found, and local governments provide the public infrastructure that supports them.

For state and local governments to play their part in complementing the redistributive policies of the federal government, and in providing infrastructure and other public investments that support innovation and growth, discretion in revenue-raising is important. The ability to decentralise revenue-raising effectively and efficiently to the states has been well established in many federations. Systems of federal-state tax harmonisation can achieve that. Income and sales tax bases and rate structures can be harmonised, while giving discretion to the states for the level of state tax rates. Provided this is accompanied by an effective revenue equalisation system, states will have comparable fiscal capacities with which to pursue fiscal programs that best suit their needs and preferences, while at the same time abiding by national norms of efficiency and equity.

It is rather more difficult to decentralise revenue-raising to local governments in a way that enables them sufficient discretion to choose their tax rates while at the same time retaining balance in the fiscal capacities of what are highly heterogeneous jurisdictions. Given the crucial role that large cities play in growth and innovation, a high priority must be given to establishing financing mechanisms that leave them with the ability and the discretion to implement the important infrastructure programs and local services in support of knowledge-intensive economic activity. Devolving income or sales taxes to local governments is one possibility, although it poses administrative and economic challenges. Alternatively, block-grant programs or revenue-sharing mechanisms could be devised to ensure that local governments have sufficient discretionary funds to fulfil their growing responsibilities. As mentioned, asymmetric solutions are important to consider.

The discussion so far reinforces the importance of decentralised decision-making combined with inter-governmental co-operation as organising features of multi-level government in a globalised world. Decentralisation poses two further challenges for policy design. The first is that economic shocks will apply asymmetrically to different regions, leaving some states with difficulties in meeting their fiscal obligations. In a decentralised federation, there are various mechanisms for addressing these shocks. An important one is the fiscal equalisation system, which automatically boosts the revenues of states facing an adverse fiscal shock. The more decentralised the system, the more important is a well-functioning equalisation system. Yet there are many challenges involved in designing an effective equalisation system, including that the system is bound to operate with lags and this cannot be avoided. In addition, as local governments take on greater responsibilities, devising an equalisation system to include them becomes harder.

The second challenge for policy in a decentralised federation, in which sub-national governments rely on federal transfers to some extent, is to avoid soft-budget constraints (see Herold, 2018). There is no easy answer to this problem since in principle it involves the federal government being able to commit not to bail out a state or local government that faces a funding crisis. At best, the possibility of a soft-budget constraint can be mitigated. Decentralisation of revenue-raising responsibility is one element of this. Sub-national governments that have such discretion can be expected to respond to fiscal crises on their own at least to some extent. Fiscal councils can also be set up whose role is to enhance the transparency and sustainability of sub-national budgets. They can also help to provide early warning of fiscal problems, or of the risk of such problems.

Ideally, fiscal councils ought to encompass both federal and state government fiscal behaviour. Fiscal shocks and fiscal profligacy are sometimes difficult to distinguish. Both can lead to fiscal crises in particular states as well as imbalances between federal and state finances. Fiscal councils, like parliamentary or congressional budget offices, can forestall unexpected difficulties by recording fiscal sustainability measures for both levels of government.

1.4. Future reforms and research

The above discussion emphasises that globalisation, combined with the growing importance of information and knowledge-based technology, poses challenges for traditional structures of authority in multi-level governments. While national governments cede decision-making ability to supra-national bodies and to international and global markets, they are expected to deal with the inequality induced by globalisation and the imperative of enhancing the skills needed to thrive in a knowledge-based economy. This requires assuming greater responsibility for improving the social safety net, for educating and training citizens and for encouraging innovation. This entails federal leadership as well as co-operation with sub-national governments, given that many of these policies are best delivered by levels of government that are closer to their citizens. These strengthened federal responsibilities will come especially at the expense of state governments, which have traditionally taken responsibility for social program design and delivery and for education. At the same time, the responsibilities of local governments grow in importance as urban areas expand and densify, especially in larger urban areas. Local governments will be called upon to provide the infrastructure and social capital—possibly in collaboration with non-government institutions—to support this growth as well as to serve as hubs where innovation and human capital development is most likely to occur. Overall, this represents a fundamental shift in government responsibilities from state governments, both upwards to central governments and downward to local governments, a phenomenon referred to as “hourglass” federalism (see Allain-Dupré, 2018).

Responding to the need for re-alignment of responsibilities will be challenging. It will require a fundamental shift in state-level responsibilities from primary providers of public services to overseers of services that are delivered by local governments. States will be called upon to co-operate with both the federal government and with the localities, and possibly to act as a conduit between them. States can assume a coordinating role with local governments in the provision of infrastructure, transportation and education where spillovers are important. Similarly, the roles of local governments will be enhanced considerably, both as providers of essential services and as builders and maintainers of infrastructure.

Means will have to be found to establish mechanisms of financing local governments in ways that foster local autonomy. This will inevitably involve a role for state-local transfers that will not only provide sufficient finance to localities in a way that recognises their varying fiscal needs, but will also encourage efficient and results-based accountability (see Phillips, 2018). Moreover, care must be taken to avoid as much as possible soft-budget constraints. In principle, giving enough revenue-raising ability to local governments so that they are held responsible for any budget shortfalls would be ideal. This can include piggy-backing on state taxes. Other sources of local finance should be sought, such as revenue-sharing and fiscal transfers. In the case of infrastructure finance, private financing can be enhanced, possibly through infrastructure banks or direct access to pension funds. To the extent that localities rely on state-local transfers for their financing, measures such as fiscal rules or fiscal councils are desirable to maintain transparency and anticipate fiscal problems. In addition, such transfers should be formula-based rather than discretionary so that state governments are not tempted to pass their fiscal problems onto localities and local governments can engage in long-term planning.

These realignments of responsibilities and the imperative of responding to the joint challenges of globalisation-induced inequality and the need to compete in knowledge-based economies requires re-thinking federal decision-making structures and evaluating their performance. This suggests a forward-looking research strategy that focusses on how best to reform fiscal structures. Some combination of qualitative research and empirical analysis would be useful.

A qualitative approach would be useful to explore options for realigning fiscal responsibilities in ways that:

1. recognise the importance of the federal government role in addressing inequality, innovation and human capital investment,
2. recognise the need for local governments to have the ability to provide infrastructure and innovative hubs possibly in collaboration with non-government actors; and
3. foster appropriate levels of cooperation among levels of government and explore especially the relationship between the federal government and local governments.

Importantly, options for revenue-raising and intergovernmental transfers would be considered, as well as mechanisms for inter-governmental agreements, either bilaterally or multilaterally. What might come out of such research would be a menu of "best practices", including some that may not have been tested in practice. It will be important to recognise that one size does not fit all, and that history, diversity, political institutions and culture will influence what is right for any country or autonomous region.

It is more difficult to suggest empirical analyses. One might want to investigate the role of decentralisation to local governments and particularly local infrastructure on growth, inequality and other dimensions of inclusive growth (see OECD, 2015). One could also look at how urbanisation has influenced the design of local government finances, both revenue-raising and grants. It would also be useful to study the performance record of institutions like private-public partnerships, infrastructure banks, and fiscal councils, among others.

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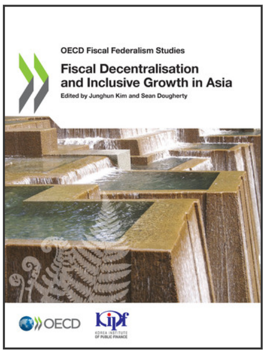

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