FEDERALISM AND ECONOMIC EFFICIENCY

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ABSTRACT

Through decentralization a government decides to give up parts of its authorities and power within the framework dictated by the law to local governments. Decentralization, as a phenomenon, must be implemented in different countries relative to their unique political and sovereignty system. Adopting a specific type of decentralization over others and the way it is implemented are directly related to administration structure. There are different concepts and interpretations extractable from decentralization and when it comes to practice and plan, a country needs to take into account financial, managerial, and service provision structure of the country. Failure in doing so and negligence of the infrastructures, standards, government-citizen relationship, regulations, institutionalization, and so one, not only means failure of the government’s plan in this regard but also destruction of infrastructures, economy, efficiency, economic growth, and consequently inefficient public services.


INTRODUCTION

The last decade has been featured with general acceptance of decentralization policies, in different forms, by the developed countries. The cause of increasing attention to decentralization lies with:

- Decentralization is proved to be an effective tool for higher efficiency of public sector; although there are drawbacks including lack of horizontal balance between the local governments and threats to macro economy of the country. Thus, one of the main reasons of recent acceptance of decentralization is the policies that seek increase in welfare, efficiency, and economic growth.

- The root of acceptance of decentralization in the developed and developing countries is in the unsuccessful experience of centralized power model in the last two decades.

- Decentralization can be effective, through up-down power transfer, on stopping the monopoly of the central government on the national economy.
More tendency toward democracy in the developing countries help expansion of
decentralization policies.

These reasons explain the recent wave of decentralization among different countries. Depending
on the goals sought after by decentralization, the policies take different forms.

World Bank Group defines decentralization as handing over the power and responsibility of
doing public affairs by the central government to local governments or semi-state/private
organizations (Tajgardoun, 2009). Along advantages there are costs to care about in
decentralization. The present article focuses on one of the key advantages of decentralization (i.e.
higher economic efficiency). The relation between decentralization and efficiency was first
introduced by Tiebout (1956). In a statement known as “Voting with feet” he stated that local
government are more successful than the central government in meeting the expectations of the
people and spending resources. He further argued that when free choice is possible for the
people, they will find the best place for living based on the expenditure-tax combination, along
with preferences and interests. To put in another way, flexibility of families means that the
demander (family) is free to purchase their needs from the best supplier (migrating to regions

1- DECENTRALIZATION EXPERIENCES

The expenditure decentralization index of the developing countries for the recent years has been
19.7% and 32% for the developed countries. Average of the index is 28.5; and different countries
experience different decentralization processes. In the 1980s, the US states contributed in 8% of
the federal government expenditure, while this figure for Mexico, Canada, Australia, and India
reached up to 40%. Contribution of the states in total expenditure varies between 2% (Mexico)
and 50% (Denmark). Currently, countries are considerably different regarding share of local
government in the national expenditures. (Jing and Zou, 2002)

These differences are explained, to some extent, by the different tasks assigned to the local
government. In many cases, national defense, foreign affairs, and migration affairs remain in the
hand of central government, while domestic security and order, fire department, transportation,
health care, and other public services are handed over to the local governments.

Regarding other tasks, no specific pattern can be found nor a universal the legal framework as
there are differences regarding codification of policies, financing, and budgeting.

The idea of decentralized system was seeded in early days of Mashroutit in Iran and among
liberal activists as they made great effort to make it legal. Four supplements of the constitution of
Iran, which was approved by the representatives of national council, as proof of such activities are:

Rule 90: state and regional federations, with definite article of associate, must be established in
the territory.
Rule 91: members of state and regional federations must be elected directly by the local residents.

Rule 92: the state federations are fully authorized for conducting reforms toward public interest and observance of the law.

Rule 93: the budget of the states and the regions, on any nature, must be prepared and approved by the federations.

Clearly, Iranian legislators were concerned about decentralization since the early days of Mashroutiat and emphasized on rule of local federations – elected directly by the public – within the legal boundaries. Doubtlessly, the purpose of establishing the federations was nothing but participating the public in local affairs and their fate. However, the law was not implemented even as a pilot. After the World War II the government once again emphasized on decentralized system and tried to put into action the idea by enacting the municipalities law. Unfortunately, this measure was another failure.

By virtue of the municipalities law (1965), two local bodies were predicted to undertake management of local affairs; one was municipalities with relatively limited authorities, and another was councils with relatively wider authorities. It is noticeable that the law was not put into practice.

FOUNDATIONS OF FEDERALISM

Federalism is a set of thoughts, values, and ideologies that represent the philosophy of preserving diversity along with unity and integrity. (Khobroui Pak, 25)

Emanuel Kant, the German Philosopher, argued that federalism is crucial for peace and by “peace” he meant prevention of war outbreak. He found a direct relationship between peace, law, and establishment of world federation. (The same, 18)

Different performances of federalism have one common point from the eyes of different authors, which is: a balance between freedom, independency, local autonomy and national/international administration.

There were four federalism schools of thought in Europe of 19th century. One was by Alexis de Tocqueville, the French politics theoretician, who tried to explain successes and failures of the USA government. Another school of thought was mainly about federalism in German countries. The French tradition was the third school of thought, which supported wider federalism to build a world with more cooperative relationship between the countries. A fourth group which was originated from the UK represented the empire’s federalism and aimed to convert the empire into a universal system. (Lipest, 1991)

One definition of federalism is a policy that tries to reach unity while guaranties independence; in other words, the policy of independent groups that have independency as their shared goal.
Thus, federalism is an answer to sovereignty of the central government on different communities (Khobroui Pack 21). From other perspectives, federalism is a pragmatist pioneer, and because of this, there are different form and ideology of federalism.

2- ADVANTAGES OF DECENTRALISM

A. HIGHER EFFICIENCY

One of the main advantages of decentralization, based on diversification hypothesis and decentralization is increase of efficiency. Equal production of goods and services is not possible by different producers (Oates, 1972) as different groups of people have different preferences for a specific product or service. Hence, local governments have better performance comparing with central government as they have closer contact with the public and better in finding tastes and demands of the consumers. This also means more efficient utilization of resources. (Martinez Vazquez and McNab, 2003)

B. LOWER X-INEFFICIENCY

From another viewpoint, decentralization can be defined as limitation on the budget-maximizing government (Brennan and Buchanan 1980). Although the government’s action lead to maximization of budget, the horizontal and vertical competition between different sections of the government over the budget leads to limitation in total size of budget. Thus, decentralization may prevent provision of goods and services more than the requirements and reduction of budget.

C. HIGHER PERFORMANCE

In the view that decentralization puts emphasis on handing over responsibilities by the central government to the local government, not only the local governments have more motivations to meet the expectation of their citizens, but there is more room for the local talents and potential to take part in supplying products and services. In other words, decentralization makes it possible to use local knowledge and skills. With utilization of local capacities and talents, the products and services will be more affordable comparing with those in centralized system (where a uniform method is used for production and provision public services).

D. LOWER COSTS

Decentralization lessens bureaucratic hierarchy. Financially speaking, each region is governed based on the available facilities and in observance of local specifications, while plans are set based on the facilities available. This means great reduction in budget expenditure and increase in economic growth.

E. REDUCTION IN CORRUPTION

There are different viewpoints regarding the relationship between decentralization and corruption and possibility to lessen bureaucratic corruption. The jest of all these viewpoints is that centralized power and monopoly leads to corruption, while more responsive authorities means
less rate of corruption. Thus, decentralization may lead to reduction in financial corruption and bribery.

3- COSTS OF DECENTRALIZATION

Along with advantages, there are disadvantages regarding implementation of decentralized policies. In this way, two different approaches to the costs of decentralization are notable; first, the costs incurred by decentralization by failing to determine the level and extension of decentralization. The second is the structural costs of decentralization, which are incurred due to inconformity of decentralization structure and political, economic, and cultural structures of a society.

3-1- COSTS PERTINENT TO THE LEVEL OF DECENTRALIZATION

A. WIDER INCOME GAP

Studies have shown that handing over the task of sharing incomes to local governments is not free of problems as poverty in poorer regions is much easier to fight against comparing with more wealthy regions. That is, fighting social gaps does not need equal treatment and thus handing over the responsibility to fight the challenges is not defendable. In addition, redistribution of incomes by local government is doomed to fail as adopting proper wealth distribution policies in underdeveloped regions entails with heavier taxes on more wealthy classes. This means migration of wealth from the wealthier to the poor and also migration of the poor of other regions to one region. This, per se, means wider social gap and failure of income distribution policies usually adopted by the local governments.

B. THREAT TO ECONOMIC STABILITY

Handing over the responsibility to keep the economy stability is also doomed to fail. Above all, local governments do not have influence over the whole economy, while macro economy policies are usually beyond the power of local governments and they have to bear heavy costs if they deal with such issues. In addition, partial transfer of authorities in this regard may also end up with failure of the policies of the federal government as there is a possibility of controversy between economic policies of local governments and the federal government.

C. MARKET FAILURE

In general, handing over the power to the local authorities, within decentralization policies, results in failure. Factors such as positive/negative effects of foreign actors, provision of pure public goods, more economic expenditures thanks to the scale, inability of the private sector to finance large economic projects, and risky activities are some of the cases that might lead to market failure. (Prud’ home, 300)
3-2- COSTS OF DECENTRALIZATION STRUCTURE

A. INEFFECTIVENESS OF ASSIGNMENT

Generally, one of the advantages assumed for decentralization is better resources assignment. However, this assumption, within the theory of financial federalism, is based on the assumptions which are barely found in developing countries. In some cases, the main problem is not recognition of the priority of the public but rather it is poor economic structures that make, even the local governments, inefficient in dealing with the crystal clear needs of the people of their region. In addition, not all the voters have the chance to express their priorities through elections.

B. LIMITATIONS OF HUMAN FORCES

When the local governments lack human forces, successful decentralization program is not expectable. Having enough workforces as the key to success of the decentralization approach explains this. That is, the federal government has more job opportunities and higher salaries to offer comparing with the local government and thus wins the valuable workforces. (Prud’ home, 303)

4- DECENTRALIZATION AND EFFICIENCY

As mentioned earlier, local authorities have deeper insight into the specific needs of their regions than those in the federal government. Thus, they are better in finding more key needs to be met and in planning. On the other hand, the federal government is poorly performed in drawing the customers’ indifference curves in different regions. This is pictured in figure 1; clearly, point A represents the consumption mixture between two consumers (N and M), which maximizes satisfaction of using specific amount of goods (X and Y). In this way, welfare curve of the diagram is represented by U so that choosing a point on this line means highest welfare for the society and realization of to efficiency.

Therefore, taking into account the function of social welfare, S on the curve W is taken as the max. point of society welfare under Pareto efficiency condition. It is assumed that all the local governments can achieve the point A in an efficient national economy. The only thing needed is that one local government is doing efficiently and then horizontal competition between the local governments is triggered and reaching the efficiency is guaranteed for all of them. On the other hand, when the federal government fails to spot the customers’ indifference curves, the point B is the optimum mixture of consumption. This point is located on another transaction border (the hashed line). False customers’ indifference line leads to adoption of wrong welfare line (curve U), which is surely below actual welfare line of the society (in specific parts the two lime by be tangent). Thus, based on the welfare line, the federal government tries to maximize welfare of the society and consequently (according to social welfare functions) point S’ on social welfare curve W’ is taken as the maximum welfare of the society and basis of further plans. By meeting the planned point – in the best scenario - welfare of the society is degraded equal with the difference of W and W’.
Thus, assuming that the local government enjoys the knowledge of preferences of the consumers (indifference curves), it has more chance for better performance than the federal government. Therefore, even in its most efficient form, the federal government brings in lower welfare than that can be achieved by the local government as it fails to recognize actual tastes of the society. This is to say that development of decentralization policies, by ensuring higher efficiency (efficiency of the consumers) guarantees higher welfare for the society.

Without reducing the level of welfare of the consumers, thus, costs of social services can be saved. In other words, with decentralization, Pareto efficiency increases.

There are several studies on the relationship between decentralization and efficiency. Ebel and Yilaz (2001) utilized the theorem of decentralization and divided the benefits of higher efficiency of decentralization into two groups of assigned and managerial benefits. Decentralization leads to more efficient assignment of resources as the local governments enjoy more detailed information regarding needs of the people and, thus, do better in realization of public’s demands. In addition, when the public products are financed from the source of local taxpayers, people adopt regions that best fit with their preferences. Decentralization, in this way, results in competition between the regional government for better utilization of public resources and higher economic performance consequently.
Wred and Leviathan (1998) surveyed flexibility of families, efficiency of the government and decentralization. They argued that flexibility of the families force the government to provided better public products. They also investigated if efficiency is achievable in locally provision of public goods when families have complete flexibility. Two regions were adopted and it was assumed that the consumers in the both regions are satisfied with the public and private products they receive. Then, preference function for one of the consumers was maximized based on the limitations adopted. The results of Lagrange equation showed that with complete flexibility of families, local politicians tend to use policies to meet inter/intra-region efficiency.

Iregui (2005) focused on semi-private goods such as health care and education and studied if provision of such goods by local government results in higher welfare among Colombian people. By semi-private goods the researcher meant the goods that are separable and that the consumer enjoys benefits by spending more on the products which are still provided by the public section. The region under study was divided into several regions and two CGE scenarios of public goods supply balance by the federal government and local government were compared. The model was calculated using Colombia model. The results revealed that supply of not-fully public goods such as health care and education, when supplied by local government, increased welfare of the Colombian up to 1.3% of GDP.

Akai and Mikami (2006) surveyed “financial decentralization and centralization under the Majority Rule” and to this end used the Majority Rule model. They compared efficiency of a decentralized and a centralized system. The results showed that, in some cases, a decentralized system is outperformed by a centralized system as under the former, the interests of the minority might be neglected. Thus, although the policies are based on the majority’s interests, there are cases that minorities have to sustain losses. They acknowledged that priorities of the federal government in a decentralized system might be met through indirect manipulation to support the minorities. The results of the study were also based on a simple rule of majority and by adopting other rules the negative effects of decentralization can be avoided.

CONCLUSION

Handing over authorities to the local government, in fact, might be a reliable approach to higher efficiency and higher satisfaction with public products. It is noticeable, though, the results are mainly based on two main assumptions and neglecting each of which may be greatly effective on the results. The assumptions are:

Democracy: a basic assumption under decentralization approach is guarantee of democracy and efficiency of it. Political solidarity of minorities, competition between the states, interruption by powerful groups, guarantee for rights of ownership, transparent public interaction - all of which lead to development of the market - are more evident and tangible in a democratic system compared with a dictatorship. Thus, the results of the present study must be taken with precautious if they are to be applied for countries without a strong democratic system and developing countries in particular. In fact, such societies are first need to improve and develop their democratic systems.
Another assumption is that with all other factors fixed, clearly along with advantages, decentralization also has costs. So that, it is possible to encounter with considerable costs that may overcome the expected benefits.

Thus, the mere fact that decentralization brings in more efficiency cannot be the basis of further actions. What is needed is to take into account the costs of decentralization along with the advantages. Indeed, an optimum level of decentralization must be adopted when the final costs and advantages of decentralization are equal. At this level the society can enjoy the highest level of welfare. At any rate, realization of this level of decentralization demands simultaneous survey of all the costs and advantages of decentralization for a specific region. Having the two assumptions granted, increase in decentralization index is coincident with increase in efficiency and welfare of the society.

REFERENCES


