COMMENT ON “THE DANGERS OF DECENTRALIZATION” BY PRUD’HOMME

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As an advocate of decentralization, I find it difficult to respond to Rémy Prud’homme’s arguments against decentralization. It is undoubtedly true that decentralization, done badly, can cause problems. But the article is not devoted primarily to demonstrating that proposition; for the most part it argues that decentralization, per se, is wrongheaded.

Prud’homme (p. 201) sets up a straw man that he calls the “pure decentralization of fiscal federalism.” He then argues that relying on this theory would lead to a variety of problems, including a tolerance of interjurisdictional disparities, an inability to conduct macroeconomic stabilization policy, and a loss of productive efficiency in the public sector. In a section entitled “Beyond the Centralization-Decentralization Dichotomy,” he presents his antidote to this approach.

The “centralization-decentralization dichotomy” is a false one. Prud’homme cites no literature advocating the “pure” theory of decentralization, and the antidote that he prescribes is little more than the conventional wisdom in this area. (The reference list contains only one item that pre-dates 1985; thus it omits many classics in the literature, which present a more balanced theory.)

First, Prud’homme states that according to the “pure” theory of decentralization, interjurisdictional disparities are “abnormal phenomena . . . that will be reduced and eliminated automatically by the movement of goods, capital, and labor” (p. 202). The implication that there are no transfers in the decentralized theory can be true only if one ignores literature that does not conform to the author’s Procrustean bed of “pure” theory. Academic literature on fiscal disparities and intergovernmental grants goes back at least to Buchanan (1950), which evoked the response by Musgrave (1961). Oates (1972) devotes one of six chapters to “The Theory and Use of Intergovernmental Grants,” and Break (1980) contains a fifty-page chapter on “The Economics of Intergovernmental Grants.”

The study of such grants has not been confined to academic research. Although the use of grants is relatively limited in the United States, that is not the case in other federations. In Australia the very title of the official history of the
Grants Commission, *Equality in Diversity: Fifty Years of the Commonwealth Grants Commission* (Australian Government Publication Service 1983)—as well as the voluminous output of the Centre for Research on Federal Financial Relations, Mathews (1980), invalidates the assertion that such issues are hardly recognized (see Boadway and Hobson 1993 for a discussion on the same question in Canada).

Nor has the World Bank ignored fiscal disparities and intergovernmental grants. Bahl and Linn (1992) contains a long chapter entitled “Flows and Effects of Intergovernmental Transfers,” and Shah (1991) includes a section entitled “Intergovernmental Transfers: Theory and Practice.” The introductory chapter to Bird, Ebel, and Wallich (1995: 8) states: “The level, design, and effects of intergovernmental fiscal transfers constitute key elements of the emerging intergovernmental and local finance systems of the transition economies.” A substantial portion of Wallich (1994), including Bahl (1994) and McLure (1994), addresses the question of intergovernmental fiscal disparities in Russia. Far from considering such disparities to be “'abnormal' phenomena . . . that will not last” (p. 202), it was assumed that such disparities would be part of the fiscal landscape of Russia for the foreseeable future. (As in many countries, some of these disparities reflect geographic concentration of important natural resources, such as oil.)

Prud'homme states that “the reasons for decentralizing expenditures are completely independent from those in favor of decentralizing taxes. There is no reason why the two processes should lead to similar results” (p. 213). It is true enough that the determinants of tax and expenditure assignment are, for the most part, different and that tendencies to vertical fiscal imbalance are pervasive. It is also true that expenditure assignment logically precedes tax assignment, which is often an exercise in filling the fiscal gap at the subnational level of government. But to say that the two questions are independent overstates the case. The literature on decentralization commonly holds that the activities of subnational governments should be financed—to the extent possible—by fees, charges, and taxes related to the benefits received. (See, for example, Bahl and Linn 1992, ch. 9.)

I would disagree that “most discussions of decentralization . . . ignore geography” (p. 214). I suspect that virtually everyone who has ever studied intergovernmental fiscal relations in New York City (to take but one obvious example) has noticed that interstate externalities are rampant, in large part because the metropolitan area covers parts of three states. This is an inevitable result of drawing political boundaries down the middle of rivers, instead of along mountain ridges. (Interstate externalities are much less important in cities such as Denver and Omaha, which are located in the interior of the states.) I—and, I presume, others—have a very different reaction when decentralization is discussed in the context of small Central European countries, such as Bulgaria and Hungary, than when it is considered for a large country such as the Russian Federation.
As Prud'homme points out, “decentralization in India is discussed with the same concepts and words as decentralization in Tunisia” (p. 214). Although true, this statement is not an indictment of the analytical method used to study decentralization; it describes the nature of conceptual analysis. Whether “one size fits all” depends on whether one is talking about concepts and theory (in which case perhaps it does) or about policy prescriptions, based on the judicious application of those concepts in different contexts (in which case one size generally does not fit all). Criticism is appropriate only if the analyst fails to take due account of the differences among countries that should affect the application of the concepts and thus the policy prescriptions.

Prud'homme remarks that “Public services exhibit different characteristics” (p. 215). The placement of this sentence and his citation of a 1992 analysis on the potential for privatization suggest that he views this statement as a new insight—and one that the “pure” theory of decentralization might deny in a head-long rush to decentralize. But it has been commonplace for many years in the literature on expenditure assignment to characterize various public services as appropriate for one or another level of government, according to the extent of economies of scale and spillovers between jurisdictions. Thus, “technicity” may have some bearing on the assignment of services (and may give rise to economies of scale). By comparison, “chargeability” is more relevant to the decision to provide a service publicly or privately than it is to the decision about which level of government should provide it.

This raises a related issue: whether budgetary finance (“provision”) of a public service means governmental production. This identification is invalid; most governments utilize armaments, but they do not produce them, and they may not need to produce many “public” services, either. Government procurement of services on a competitive basis can be cost-effective, by limiting the growth of bureaucracy, inefficiency, and costs. The risk that the politicians and bureaucrats who award contracts to private providers will be corrupt argues for the use of vouchers for services that can be provided by the private sector in a competitive environment.

Prud'homme confirms the conventional wisdom that it is difficult for subnational governments to engage in policies intended to redistribute income. But surely this difficulty is a function of the small size and openness of the jurisdictions rather than of their representing subnational units. Small countries may have as much difficulty as large subnational governments in redistributing income. Leaving these practical problems aside, Prud'homme appears to be inconsistent. He takes as given that the distributional policies of the national government should prevail over those of local governments. Yet in discussing the need for intergovernmental transfers he writes that, “each region is a social and political entity that exists beyond the individuals who reside there. In assessing their well-being, the citizens in a region consider not only their own income but also the income of their fellow citizens much more than the income of inhabitants of other regions” (p. 203). These
words could easily be interpreted as supporting subnational policies to redistribute income. In McLure (1995: 212–13), I ask, “Which level of government should be responsible for implementing tax policies that are intended to reduce inequality in the distribution of income? At a philosophical level, the answer can go either way, depending on whether the ‘domain of concern’ about inequality is nationwide or more limited.”

What about the assertion that the budget of the central government must be large (and that of the subnational government small) if the central government is to engage in stabilization policy. Suppose there are two kinds of public goods, “national” and “subnational,” each of which is financed by taxes that are not cyclically sensitive. Any attempt to use variations in public spending (except for transfer payments) as a tool of countercyclical stabilization is likely to result in considerable inefficiency, given the lead time in most projects and the difficulty of forecasting macroeconomic conditions. Most stabilization is likely to come from two sources: the built-in stabilizing effects of certain taxes and transfer payments, and autonomous changes in taxes and transfers. As Prud’homme recognizes (following Musgrave), these policy instruments should be assigned to the central government. (Variations in grants to subnational governments are ruled out by the latter’s need for fiscal certainty.) Because most of the budget is, by assumption, off-limits for the pursuit of stabilization policy, the same stabilization can occur, regardless of the relative size of the national and subnational budgets.

Prud’homme cites examples of the macroeconomic dangers of decentralization such as the federal underwriting of irresponsible fiscal activity by Argentina and the bottom-up financing of the central government of the Federal Republic of Yugoslavia. But decentralization is not the root cause of these problems. The macroeconomic stability of Switzerland—a very decentralized country—provides a useful counterexample.

The benefits commonly ascribed to decentralization involve the degree of control that citizens have over decisions that affect them; local governments are better able to recognize differences in tastes between subnational jurisdictions and to respond to asymmetries in information at the local and national levels. Differences in tastes, however, are only part of the story. At least as important are discrepancies between the tastes of local communities and the tastes of their national governments—governments that do not necessarily represent their citizens. Suppose that households would like government to provide basic needs, while the central government prefers to spend money on the military or palaces (or anything else of low priority to the populace). In such a case it is clearly possible that decentralized decision-making would be more likely to address the satisfaction of basic needs, even if all jurisdictions have identical tastes. It takes a great deal of production efficiency, which Prud’homme says is an advantage of centralization, to offset a central government choice to waste resources on activities that are harmful to the populace.

Subnational governments may not always strive to satisfy the desires of local households; such behavior is often sustainable because subnational governments
are not forced to compete with each other. Decentralization tends to increase healthy competition among jurisdictions (Brennan and Buchanan 1980; Breton 1989; on the risk of excessive competition, see Bird 1993). At the same time, decentralization is no panacea and must be accompanied by measures to increase popular control over subnational activities. Moreover, few limits should be imposed on the ability of citizens to form nongovernmental organizations to engage in quasi-governmental activities, including providing services that formal governments fail to provide. Self-seeking subnational politicians and bureaucrats should not be able to stymie the legitimate wishes of people to band together to meet their needs. In many cases this will involve serious political reforms. Thus structural adjustment may require a political component as well as an economic one.

There are many real-world examples of bad decentralization policies, and warnings against such policies are probably needed. But it is neither fair nor useful to suggest, as Prud'homme's article does, that the conventional wisdom resembles the straw man depicted in his article, that it has failed, and that good policies would flow from some new, radically different, rational, and coherent theory of decentralization. Properly applied, the conventional theory of decentralization can help improve the enactment and execution of government policy.

Notes

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References

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