

10 **Fiscal federalism: a survey of the literature**

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1. Theoretical aspects of multi-level government action

1.1 Allocation and federalism

There seems to be wide agreement among economists that macroeconomic stabilisation should be left to the central government - whether this be of a state or a supranational federation - while distribution and allocation functions may be exercised at lower levels. The strongest case for decentralisation is made for the allocation function. If there are various forms of public goods which can only be consumed jointly and provided uniformly, then these goods should be supplied at the level at which consumer preferences are relatively homogeneous. This is the essence of Oates' (1972) decentralisation theorem. Where regional preferences differ, the decentralised provision of public goods brings efficiency gains. Decentralisation would also make it possible to apply the benefit-pricing rule for public services, which is difficult to implement at the highest levels since regional tax discrimination is usually prohibited by federal constitutions. Although the efficient provision of regional public goods could eventually be effected at the central level, this would normally imply information requirements that are difficult to meet, and it would entail costs deriving from uncertainties (Tresch 1981).

The decentralised provision of government services also facilitates political decision-making, as it enhances the cost-effectiveness of supplying such services: political representation closer to voters and taxpayers can be expected to be both more responsive to demand and more accountable for policy actions (Cornes and Sandler 1986). This can also bring welfare

improvements for regional polities, mobilising political resources through the greater involvement of taxpayers. Organisational diversity, institutional competition, and experimentation all contribute to stimulating innovation and creativity at the regional level.

The decentralisation theorem put on its head would recommend centralisation only for public goods the benefits of which are general and supraregional in nature. Defence would be the typical candidate. For the EC, it is not defence which has been the driving force behind regional integration, but the improvement of economic welfare through the creation of a single market and economic co-operation. Specific supraregional benefits can be expected in the fields of energy (common carriers), transport and telecommunications, environmental protection, research and technology policies (and to some extent higher education), as well as from foreign trade policy.

Apart from public goods, there are at least two further arguments in favour of a more centralised provision of public services: (i) increasing returns to scale in producing such services; and (ii) spill-over effects between lower-level jurisdictions of the federation. Although these arguments are often used in the literature, they are open to challenge. Increasing returns to scale were overstressed by communist rulers in Eastern Europe, with disastrous results. While such cost-reducing effects cannot be denied in principle, decentralisation has greater dynamic cost-reducing potential, through competition and process innovation. This may be true even with a degree of co-ordination at a higher level. After all, it is typical for modern industrial organisations to decentralise and to contract-out in order to reduce costs. Why should such principles not apply to government?

Moreover, neither increasing returns to scale - where they exist - nor regional spill-over effects preclude regional governments from co-operating with each other, and there is empirical evidence that this happens on a voluntary basis. Co-operation does, however, entail co-ordination costs, and these may be sufficiently high to open up the way for central government intervention.

These arguments do not, however, substantially support the concentration of expenditure functions within a federation. All they indicate is some scope for regulatory action and a catalytic role for central government. An optimal institutional design would seek to minimise organisational and co-ordination costs for such a framework.

Co-ordination costs in federal government have attracted little attention in the literature. Breton and Scott (1978) analysed the impact of organisational costs on the allocation of functions to different levels of government. While they were unable to derive firm conclusions on the problem of assigning expenditure functions, they emphasised the political elements embedded in such costs.

From an economic point of view, co-ordination costs - including political and organisational aspects - are the clue to the centralisation problem, and there is much scope for further research in that area. Whereas there is a general presumption in favour of a decentralised provision of public services, and not