

Fiscal decentralization and centralization under a majority rule: A normative analysis

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Received 1 March 2005; received in revised form 20 July 2005; accepted 16 August 2005

Abstract

In his seminal work on fiscal federalism, Oates [Oates, W., 1972. *Fiscal Federalism*. Harcourt Brace Jovanovich, New York, NY] addressed the so-called Decentralization Theorem, which states that, if such factors as scale economies and spillovers are left out of consideration, a decentralized system is always more efficient than a centralized system for supplying local public goods. Based on his analytical framework, we show that a decentralized system may at times be inferior in efficiency to a centralized system under a democratic decision rule (Proposition 2). An intuition for this result is that, under majority rule, a majority may choose an extreme policy in a local district that best matches its own preference but ignores the interests of minorities. In some cases, such disregard of minority taste may result in a considerable loss of efficiency. If instead some moderate policies are chosen through voting in an integrated constituency, then the interests of minorities could be better served to some extent. As a result, centralization would improve social welfare. © 2006 Published by Elsevier B.V.

JEL classification: D72; H70

Keywords: Fiscal (de)centralization; Local public services; Majority rule; Minorities' interests

1. Introduction

In this paper, we construct a model of two-tier constituencies with intra- and interdistrict heterogeneity, and examine comparative efficiency between decentralized and centralized systems for the supply of a public service under majority rule. We pay special attention to the

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interests of minorities in each local district, which a decentralized system may ignore but a centralized system may take into account rather better.

Comparative efficiency between decentralization and centralization in the supply of local public goods has long been examined in the literature of fiscal federalism. Conventionally, goods and services supplied by a public enterprise are assumed uniform in the constituency. In particular, it is assumed that residents in different local districts are provided with the same level of local public goods by the central government.¹ Based on the assumptions of uniformity and benevolent governments, Oates (1972) addressed the well-known Decentralization Theorem. For the supply of local public goods, the theorem states that local governments, which respectively choose the amount of public goods for their own local districts, are always more efficient than the central government, which provides a uniform amount of public goods to all local districts.

Since the Decentralization Theorem, the study of fiscal federalism has been developed by adding to the model some extra factors that are balanced with the effects of uniformity. For example, Oates (1972) himself introduced into his model scale economies in the provision of local public goods. He also examined a tradeoff between uniformity under centralization and spillovers of the benefit from local public goods. Other sorts of tradeoffs include scale economies under centralization against the district-tailored supply of public goods under decentralization (Alesina and Spalore, 1997), exogenously given benefit of centralization against an income tax schedule that is appropriately chosen according to the income inequality of the local district under decentralization (Bolton and Roland, 1997), internalization of spillovers under centralization against the interests of small districts which are saved under decentralization (Ellingsen, 1998), and internalization of spillovers under centralization against adaptation to heterogeneous tastes for public goods by decentralization (Besley and Coate, 2003).

Contrary to such trends in any extension of the model, this paper retains the original setting of Oates with the uniformity assumption, leaving out of consideration such factors as scale economies, spillovers, and any other exogenously given benefit from centralization. Rather, we consider a normative implication of democracy to the efficiency of decentralized and centralized systems.² We find from the study that, despite the Decentralization Theorem, a decentralized system, which can apply different levels of a public service to distinct local districts, is at times less efficient than a centralized system, which is restricted to apply a uniform level of the public service to all local districts (Section 3, Proposition 2).

The intuitive logic behind this result is as follows. In a local district, majority rule may ignore the interests of minorities. In particular, when there is a wide divergence of taste for a public service among residents in a local district, an extreme policy can be chosen that is preferred by a

¹ A critique of the uniformity assumption claims that the level of local public goods need not be uniform across local districts under centralization (e.g., Besley and Coate, 2003). On some occasions, however, the uniformity assumption seems quite reasonable. First, in reality, many public services are supplied uniformly across local districts by the central government because of limited information on individual tastes, abilities and physical constitutions, of administrative costs, and of the ethics of equality. Examples in some European nations and Japan include primary and secondary education, immunization for children, and basic sanitation programs, although the kinds and intensity of schooling or medical care may differ across children living in distinct local communities. Second, in a sense, it is theoretically biased to assume that the central government is able to supply different levels of local public goods to the residents in its own constituency, but that a local government is not able to do so in its district.

² In the related literature, Panizza (1999) empirically suggested that the level of democracy is inversely correlated with fiscal centralization. See Section 5 for implications of his research to our results.

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