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Further evidence on revenue decentralization and inflation ☆

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Abstract

Results from a panel regression study of 19 OECD member countries suggest that when the measure of revenue decentralization is limited to the revenues over which sub-national governments have full autonomy, its impact on inflation is not statistically significant.

Keywords: Fiscal decentralization; Sub-national governments; Own-revenues; Central bank independence; Inflation

JEL classification: E58; E62; H29; H71

1. Introduction

Recent papers by King and Ma (2001) and Neyapti (2004) found that revenue decentralization, measured as the proportion of tax revenues accruing to sub-national governments, have a significant negative effect on inflation and that this effect is accentuated by central bank legal independence. Their results are potentially important in that they contrast with much of the literature on fiscal decentralization and macroeconomic stability, which tends to stress the possible problems for macroeconomic policy coordination (e.g., Tanzi, 1995; Ter-Minassian, 1997).[1] The King-Ma-Neyapti results would suggest that

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[1] Empirical evidence on the actual impact of fiscal decentralization on macroeconomic variables is scarce, though Part III of Ter-Minassian (1997) has several interesting descriptive event studies of destabilizing fiscal decentralizations.

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fiscal decentralization, even if it complicates policy coordination, ultimately leads to a more conservative fiscal policy at the level of the consolidated government.[2] However, a potentially serious problem with their estimates is that the measure of revenue decentralization used makes no distinction between revenues from tax sharing that involve little real autonomy on the part of sub-national governments, and these governments' 'own-source' tax revenues, where they exercise some degree of control over the tax rate, the tax base, or both. In this regard, recent surveys of fiscal relations by Joumard and Kongsrud (2003) and Darby, Muscatelli, and Roy (2003) show that limits on the discretion of sub-national governments to determine tax rates and tax bases significantly reduce local fiscal autonomy. In addition, tax sharing arrangements sometimes leave sub-national governments with little or no power to influence the revenues accruing to them individually, and even when they have such powers they are sometimes reluctant to use them. As such, I examine the issue of revenue decentralization and inflation focusing on the share of the revenues of sub-national governments over which they have full autonomy. Results from panel least squares regressions suggest that, when measured in this way, the impact of revenue decentralization on inflation is not statistically significant.

2. Data and methodology

In a recent study, the OECD (1999) showed the degree of revenue autonomy of sub-national governments in 19 OECD member countries in 1995 by calculating the amount of their revenue stemming from the tax rates and the tax base over which they had full discretion.[3] Of the 19 countries, sub-national governments had full discretion over own-revenues revenues in only four of them, in a further nine countries they had full discretion over less than two-thirds of their revenues, and in a further five countries they had full discretion over less than 15% of own-tax revenues. A reasonable annual time series proxy for the own-revenues over which sub-national governments have full discretion can be constructed by weighting annual data on total tax revenues received by sub-national governments (in percent of national and sub-national revenues) by the 1995 share of discretionary revenue. Fig. 1 relates the total tax revenues of sub-national governments to their discretionary revenues calculated in this way for the period 1980–2000.[4] The vertical axis shows the tax revenue received by sub-national governments relative to total taxes and the horizontal axis plots the revenue over which they have full discretion relative to total taxes. The great majority of countries are located in the southwest corner of the figure and are those in which the sub-national governments have the least degree of autonomy. This makes it clear that the King-Ma-Neyapti studies substantially overstate the degree of fiscal decentralization. Against this background, I

[2] These authors do not specify the mechanism by which revenue decentralization impacts upon inflation, which presumably is related to whether it promotes or subdues fiscal dominance.

[3] Specifically, the OECD used a classification of sub-national tax revenues ranging from (a) where the sub-national government can set both the tax rate and the tax base, to (e) where the central government sets both the base and the tax rate. Tax sharing schemes are divided into four categories from (d.1) where the sub-national government can determine the revenue split, to (d.4) where the national government can decide the revenue split. The countries included in the study were Austria, Belgium, Czech Republic, Denmark, Finland, Germany, Hungary, Iceland, Japan, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Spain, Sweden, Switzerland, and the United Kingdom.

[4] The sample period was ended in 2000 because of fiscal reforms in the late 1990s that changed the degree of autonomy over revenues in several of the countries, increasing it in some and reducing it in others (see Joumard and Kongsrud, 2003).