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Why Federalism Matters: Implications for Tax Policy

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Why Federalism Matters: Implications for Tax Policy

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1. Introduction

Many of the world's nation states are Federal systems in which there is a sharing of powers, including the power to tax, between a central government and lower-tier, provincial or state governments. However, other nations are unitary with most or all power at the center. Does the allocation of taxing powers matter for economic growth, for the ability to achieve the desired level of redistribution, or for the efficient allocation of public services? If so, is a Federal system to be preferred?

Many scholars who would almost certainly say yes; they include economists Wallace Oates (1972), James Buchanan (1995), and Roger Myerson (2006), as well as political theorist Barry Weingast (1995 and 2006). However, others might well disagree; they include Malcolm Feeley and Edward Rubin (1994 and 2007), William Riker (1964) and Alberto Alesina and Enrico Spolaore (2005).

In this brief note, we highlight a number of our views on this fundamental political economy question and its implications for tax policy.[2] We begin with a brief description of the federalism dilemma wherein a nation's choice of a constitutional framework depends on the extent of its economic development. We then define four distinct federal structures that characterize the world's nation states. The presentation moves to our empirical study, which involves a panel study of 73 countries over a 35-year time period. Our preliminary findings support the view that decentralization does bring with it a number of substantial social benefits.

2. The Federalism Dilemma

As nation states evolve and new nations are born, it is natural to ask three fundamental design questions. First, how many local and state governments should there be? Second, how will they be represented in the central government? Third, how should taxing and spending responsibilities be allocated among the central and lower tiers?

With respect to taxation in particular, our answer depends crucially on whether the nation is a mature or a developing economy. Within the confines of a mature nation state, the constitutional planner has greater flexibility in the choice of feasible policy instruments and in many cases fewer fundamental objectives (e.g., macroeconomic goals may have been achieved or will be seen as manageable). However, in a developing economy, redistribution is likely to be at least as important as efficiency in taxing and spending. Moreover, local units of government may not have the training or sophistication to manage substantial tax revenues and to organize the provision of locally-provided public goods.

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[2] The note relies heavily on a chapter of our planned volume on the political economy of federalism.

Our studies of federalism in the United States and throughout the world have convinced us of the advantages that lie in an economy that has a federalist structure. Federalism allows one to achieve a range of social goals, relating to redistribution, political participation, and various efficiencies, including the achievement of scale economies, the matching of benefits to costs, and the innovation flowing from competition among subnational governmental units. Furthermore, within a federal system subnational governments can check central government abuses and promote individual rights and liberties. We are comfortable, therefore, with the principle of s*ubsidiarity*. Subsidiarity requires that one allocate spending and taxing responsibilities to the smallest geographical and/or population jurisdictions that can raise taxes most efficiently and in the process provide the desired level of service quality at the lowest cost per citizen.

Within mature economies, the now standard economists' prescriptions for efficiency are eminently sensible. One should level broad-based taxes at the center, which should take primary responsibility for the redistributive function. Subnational provincial governments, especially local governments, should focus on efficiency. They should levy benefits taxes (including user fees) whenever possible. Some redistributive functions – those that benefit from direct ties between service providers and recipients – are best provided locally. However, those local functions should be limited in scope.

Even a quick survey of the world's nation states tells us that the use of decentralized tax revenues varies substantially among both mature and developing countries. But, does this really matter? We suggest that the answer is yes, especially for developing nations.[3]

3. Governance Structures

To begin, we find it useful to distinguish among four forms of federal governance. These are as follows:

> 1) *Constitutionally Federal*. Under this regime, there are two or more constitutionally created provinces, there is constitutionally required representation for those provinces in the central legislature, and there are significant policy responsibilities for the states or provinces that operate at the subnational level.
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> 2) *De Facto Federal.* Under this regime, there are two or more constitutionally created provinces and significant policy responsibilities at the subnational level (usually among only a few provinces). However, there is no constitutionally guaranteed representation for the provinces in the central legislature and consequently little or no political or economy power for the subnational units.

[3] For a developing economy such as South Africa, we have supported a gradual move to a decentralized system. As Inman and Rubinfeld (2005) describe, in the South African federal system, provinces have substantial power over spending, but most tax revenues are raised at the center. Central taxation allows for substantial redistribution, while provincial control over spending serves to protect the white minority from exploitation by the non-white majority.

3) *Administrative Federalism*. Under this regime, there is significant policy decentralization of taxation and spending functions to regional and large local governments, but there are no constitutionally created provinces and, by definition, no representation of provinces in the central legislature.

4) *Unitary.*: Under this regime, there is a single nation state and significant policy centralization. There are no provinces, and by definition no provincial representation to the central legislature.

Examples of *constitutionally federal* countries are the United States, Canada, Germany, Mexico, Nigeria, and Pakistan, of *de facto* federal countries are China, Italy, Japan, and the Netherlands, and of *administrative federal* countries are Denmark, France, Norway, Sweden, and Uruguay. *Unitary governments* have a single state, no provincial representation, and centralized policy-making. Examples include Chile, Peru, New Zealand, the United Kingdom, Korea, Thailand, Sierra Leone, and Zimbabwe.

4. The Empirical Evidence

To evaluate the question of whether federal systems with substantial decentralization of taxing and spending authorities do generate preferred outcomes to unitary and other more centralized systems, we have undertaken a substantial empirical study. We are motivated by William Riker's proposal to find many matched pairs of countries, one federal and one unitary, and to compute the average difference in their performance for a variety of valued country outcomes. The key, of course, is to define the relevant dimensions on which the countries should be matched and then to find enough matched pairs of federal and unitary countries so that we can be confident that the average differences in performance are real.

Riker's empirical evidence was limited; he drew his conclusions from a comparison of six, reasonably chosen pairs and found no real differences in country performance between federal and unitary countries. Our sample contains within it over thirty pairs of federal and unitary countries, including all the world's federalist nations, and we are able to match more precisely than could Riker.

In total, our sample consists of data for 73 countries, including all of the world's federalist countries, with outcomes measured over the period from 1965 through 2000.[4] A key variable in the analysis is the degree of policy decentralization. We use the share of lower-tier revenues as our measure of policy decentralization under the belief that own local government revenues carry with them greater local policy discretion.[5]

[4] There is relatively little change in governance structures over time; most of the relevant variation is cross-sectional.

[5] The share of all government spending which is done locally might also be used, but this share includes central-to-local intergovernmental aid and such assistance is often closely monitored by the central government. In any case, local revenue shares and local expenditure shares are highly correlated (r = .81) and a ranking of countries by expenditure shares gives the same federal classifications as revenue shares are used.

Ours is still a work in progress. However, our preliminary finding is that federal institutions do matter. On average, federal systems have higher worker productivity and improved protections for property, civil, and political rights of residents.[6] What is particularly interesting, however, is that the benefits associated with a federal system (relative to a unitary system) are greatest when the system is democratic. The potential performance gains of adding federal institutions to a unitary democracy are a substantial increase in national income per capita, in worker productivity, a reduction in income inequality, an improvement in relative property rights performance, and an improvement in relative political and civil rights performance.[7]

If federal systems do perform better, at least on some dimensions, why do they do so? Our view is that policy decentralization is key and that the formal institutions of federalism, particularly politically independent provincial governments, have important roles to play as promoters for, and safeguards of, assigned local and provincial policy responsibilities.

Moving beyond these cross-country comparisons to a deeper understanding of exactly *how* the institutions of federalism might lead to these favorable outcomes, and how the institutions might be improved, remains our extensive research agenda.

[6] For prior evidence on worker productivity, see Hall and Jones (1999).

[7] For a related study from a different perspective, see Thornton (2007).

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