GOVERNMENT DECENTRALIZATION AND ECONOMIC FREEDOM

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Introduction

The model of government employed by Brennan and Buchanan (1980) suggests that a revenue-maximizing "Leviathan" government will be larger if there are fewer nearby governments. If a Leviathan government raises taxes too high, then it may see diminishing revenue as taxpayers begin to avoid the taxes by moving to other jurisdictions. This paper expands the revenue-maximizing assumption to a more general power-maximizing assumption, and empirically examines the relationship between intergovernmental competition and the governmental power.

The Basic Theory

If we assume that government has an innate predisposition to grow in power and size as the Leviathan hypothesis does, then more governmental units should result in less overall government. A single monopolistic government would face minimal constraints on its ability to grow. Since human and physical capital would have no alternatives to choose from, the government would be free to raise taxes and other intrusions significantly. The only constraint to this process would the inevitable decrease in work effort associated with higher taxes and regulations.

If the number of governments to choose from increases, the those governments may engage in a competitive process of lowering taxes and regulations in an effort to encourage resources to locate in their jurisdiction. Such competition will yield less government intrusion into the economy.[1]

There are a number of complications to this basic theory to consider. First is transportation costs. Obviously, it is costly to move; this creates a wedge in this competitive process-allowing each government a certain amount of monopoly power. We should note that immigration and emigration controls of both human and physical

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capital work to increase the cost of relocating and thus contribute to the government's monopoly power. Another complication is the possibility of intergovernmental collusion. Governments, like firms, may enter into collusive compacts to keep taxes and regulations high. For example, intergovernmental grants are a way to even out taxes and spending across jurisdictions, thus reducing real competition. Finally, the decision to locate in a particular jurisdiction is not only a function of government taxes and regulations. A variety of locational rents create an opportunity for government to grow so long as the excess government cost does not exceed the value of the locational rents.

Within a nation, federalism may be a way to create intergovernmental competition. Federalism is a constitutionally designed system of government in which the powers to tax, spend, and regulate are partitioned among a large number of smaller sub-national jurisdictions. True federalism is not merely an administrative decentralization, but is a system where local units have a large amount of autonomy over their activities. This provides us with an empirically testable hypothesis: nations with a more federal system will have less total governmental intrusion than more centralized nations, ceteris paribus.[2]

Measuring Intergovernmental Competition

One way to measure the degree of intergovernmental competition within a nation is government revenue collected by the central government as a share of total government revenue — a measure of fiscal centralism. If there is only one central government in a nation, then the share would by one. Most nations, however, have many governmental units that compete internally for tax base, and would have central government shares less than one.[3]

Another method is to simply count up the number of governmental jurisdictions within a country—a measure of fiscal fragmentation.[4] All other things equal, more jurisdictions mean more competition, which should mean smaller government size.

Oates (1985) found no support for the hypothesis that fiscal centralism is positively correlated with government size across nations. Though Lawson (1992) found that fiscally fragmented nations — nations with more jurisdictions — had smaller governments than more unified governments.

Measuring Governmental Power

The standard way to measure the size of the government has been to use total government fiscal size (either revenues or expenditures) divided by gross national product. This measure certainly fits in with the revenue-maximizing model of Leviathan most often considered.

However, a broader power-maximizing model should be employed.[5] If tax revenue is assumed to be an objective of Leviathan, then the general power to control resources could also be an objective. But resources can be controlled through a variety of non-tax means. As Stigler (1971) has noted, regulations have tax-like effects. Also, government-created inflation acts like a tax on dollar-denominated assets.

In order to get a more complete measure of governmental power, this paper employs an Index of Economic Freedom constructed by Gwartney, Block and Lawson (1993). The index is designed to measure the amount of governmental infringements on the economic freedom of property owners' control over their resources. We believe the Index of Economic Freedom to be a more accurate indicator of governmental power than simply government spending.[6]

The Index of Economic Freedom measures the degree of economic freedom in five different categories : (1) money and inflation, (2) government operations and regulations, (3) takings and discriminatory taxation, (4) international trade, and (5) capital markets and interest rates. Three component variables were collected in each category; thus, fifteen variables are used to create the final index. Exhibit 1 lists the component variables used in the five categories. In all, 100 countries were rated with the Index of Economic Freedom.

Each country received a zero to ten rating based on their performance in each component. A category rating was calculated as the average of the three variables. A summary rating was then calculated based on the category ratings. Exhibit 2 shows the 1990 ratings in each of the five major areas and the overall summary index for each country.

Gwartney, Block and Lawson have found the Index of Economic Freedom to be highly correlated with economic growth during the 1970s and 1980s.