A NOTE ON FISCAL DECENTRALIZATION

Tadamichi ITOH

1. INTRODUCTION

Recently fiscal decentralization has become an important problem in public finance. Now in Japan fiscal operations are carried out by the three-tier level of government and may be conducted in centralized fashion. Though a centralized fiscal system has some merits, a excessive centralization also has some demerits. So far, a number of studies have been made on decentralization issues. In this note I try to review principles of decentralization and intergovernmental relationships under multi-level fiscal system. It offers the key to a consideration of how the fiscal system should be.

2. FISCAL FUNCTIONS AND MULTI-LEVEL FISCAL SYSTEM

Here I would like to focus attention on fiscal functions and fiscal systems. Fiscal operations may be conducted in centralized or decentralized fashion, with different functions being more or less appropriate at various levels of governments. Musgrave describes there are three basic fiscal functions—allocation, distribution and stabilization.

Multi-level fiscal system would be necessary to let these function work effective. Basically under multi-level fiscal system there are some economic reasons why distribution and stabilization function should be appropriated to central government while allocation function should be operated by local government. Distribution function must be performed by the central government on nationwide basis. Excessive regional differentials in distributed incomes among individuals may be undesirable. Stabilization function cannot be successfully carried out by the local government because of its limited ability to realize stabilization purposes. Allocation function is divided among various levels of governments. Some public goods are provided for nationally while most of public goods are provided by local governments. This function, therefore, mainly belongs to the local government.

Benefits of local public goods are limited to the residents of a particular geographic region. Such public goods should be supplied in line with the preference of the residents in the benefit region because of an allocative efficiency. Thus a decentralized multi-level fiscal structure constructed with higher-level and lower-level government is desirable for the provision of public goods.
3. DECENTRALIZATION AND INTERGOVERNMENTAL FISCAL RELATIONS

As mentioned above, a realization of allocative efficiency in public sector calls for a decentralized multi-level fiscal system. In this system each government would carry out its appropriate allocative function without relation to the fiscal activities of others. A decentralization, however, needs an appropriate allocation of revenue sources among different levels of government through the tax system and the grant system.

The intergovernmental fiscal relations is directly related to the fiscal function to be performed by each level of governments. On the tax side, it is desirable for the decentralization that tax assignments by the level of government meet with its needs of revenue. Under the idea of decentralization local services should be financed by local taxes burden of which remains local, but actual tax systems are not likely to comply with this condition. On the other hand a well-designed intergovernmental transfer system is essential in any decentralization strategy. Equalization in the fiscal position of lower-level of governments would be achieved by the grant system. Grants for equilization are divided into two types. One is general, another is selective. The general grant is a vertical arrangement that corrects fiscal differentials among lower-level of governments under the initiative of higher-level of government. This has a merit which can make a intergovernmental transfer without damaging the autonomy of local governments.

4. CONCLUSION

Opinions are divergent on decentralization issues. Decentralization however has an efficiency cost of its own which is avoided in a centralized fiscal system. From the point of view that it is important to make fiscal functions, especially allocation function, work effective, the multi-level fiscal structure is essential under a decentralized fashion. Then what has to be noticed is the decentralized multi-level fiscal system should be supported by a well-designed intergovernmental transfer system. It may keep an autonomy of the local government.

It should be stressed that decentralized multi-level fiscal system can promote more accountability and responsiveness in the provision of local services. There may be acceptance of the notion that lower-level of governments should be given the authority to determine their own activities. Finally we didn’t treat in this note, we should draw attention to the optimal size and the executive ability of local governments under the decentralized fiscal system.

REFERENCES


