

THE MICRO STRUCTURE OF THE PUBLIC SECTOR

– On the Role of Local Authorities for Macroeconomic Stability

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1. "Who Governs Local Governments?"

Two notions about local governments - contrary but both simplistic - are common in traditional economic literature.

According to the *first* notion, local governments can be viewed as simply an extension of central government. Public consumption and investment can be treated in total as policy instruments for the central executive power. This is in fact the treatment still accorded local authorities - in e.g. the government's medium term economic plan in Sweden. The same is true in most other industrialized countries. This official fiction of a centralized control of public money is often also accepted and integrated in textbooks in economic theory, even in some of the books and papers explicitly dealing with fiscal policy and public finance. The contrast between this theoretical idea of centralized control and the real picture of decision-making in local authorities is perhaps nowhere more apparent than in Sweden, where 308 independent local governments are responsible for the major part, both of household taxes and of public real resource use and has tended to expand much faster than any other sector in the economy.

According to the *second* popular notion, local government choices are merely an indirect expression of consumers' preferences for social services, within an extended budget restriction, including all disposable income left after central government taxes. The local councillors are merely executing the wishes and the willingness to pay of a club of voters. This is not merely the idealized standard for local democracy but also the starting-point for many econometric attempts to determine local government expenditure.

By now, we all know that neither control from above – central government steering - nor control from below – voter determination – is complete or indeed easily identified. We know many areas, where responsibilities overlap, and where sluggishness or rigidity in local government planning and execution often makes it hard to distinguish the decisive influences *ex post*. With the slow-down in economic growth during the second part of the 70s and the consequent pressure exerted on public finance the question of controlling local expenditure became a focal political problem in many countries.

In June 9–10, 1981, IUI hosted a meeting of experts from the U.S., the U.K. and Sweden. The aim was to discuss and evaluate experiences from the respective countries on the control of local expenditures. The three countries

exemplify rather different aspects of the contrived problem. In the U.S. of tax revolts and tax limit proposals, the emphasis in public debate has been on voter control. The question has been raised whether there is a danger of local government expenditure outrunning voters' intentions – or running in the wrong directions. In Sweden with a much larger local government sector there seems to be less suspicion from below – but more anxiety from the central government level concerning the possibly destabilizing effects of a too fast expansion of local governments. In the U.K. finally, the pessimists would say they have the worst of both worries - inefficient central control over local expenditures and a very weak voter control over local taxing. These differences were spelled out clearly by the participants in the IUI Conference.

2. Controlling Local Government Expansion

USA

In the United States – where local government expenditures account for less than 10 percent of GNP and where the share decreased slightly during the 70s – politicians want to make sure that local expenditures do not grow more than voters are willing to pay for. Professor Edward Gramlich, University of Michigan, has studied how, and why, local government expenditures have sometimes become "too large" from a voter's point of view. He concludes that, with the exception of the rapidly growing welfare payments, the expenditure growth per se is, as yet, not in conflict with the desire of voters. Hence, there must be other reasons behind the decisions to put a ceiling on tax rates and expenditure growth in a number of American states. (Gramlich, 1983.)

Professor Wallace Oates, University of Maryland, who has studied the American tax revolts, interprets the tax limitations as consequences of income distribution problems, associated with local real estate taxes. In addition, he contends, there is a general suspicion of a widespread wastefulness within the public sector. (Oates, 1983.)

One possible way of checking local government expansion could be to privatize some of the services offered. Dr. George Peterson, Urban Institute in Washington D.C., has examined the attempts made in this direction in the U.S. In some East Coast states, worn-down public dwellings have been transferred to private ownership. This led, in many instances, to improved neighborhood services and a face-lift of the local area. Experiences from garbage collection service show, however, that the most efficient way is to place contracts with private companies. (Peterson, 1983.)

England

In Great Britain, where the share of local government expenditures in GNP has been slightly larger than 10 percent since the early 70s, a main concern

has been that the growing public sector would crowd-out the private industry from the labor and capital markets. There has also been much talk of "financial irresponsibility", associated with the fact – according to professor Peter Jackson from Leicester – that those local residents, who vote for more expenditures, only contribute one-sixth of the real estate taxes - the main source of tax income – while the rest are paid by business companies. (Jackson, 1983.)

According to Mr. Noel Hepworth, the attempts of the British central government to control local government expansion by way of tightened state subsidy regulations and cash limits have not had the intended effects. They have in many instances led to a political confrontation between local authorities and the central government. Mr. Hepworth contends that the main fault with the control attempts up till now has been that the subsidy system (1) is too detailed and too complex, (2) has been changed too often, and (3) leaves too much room for political arbitrariness. A continued escalation of the conflict between local and central authorities could lead to a strong centralization of expenditure control and put an end to local economic autonomy in Great Britain. (Hepworth, 1983.)

Sweden

In Sweden, both the proportions and the character of the problems are different. The share of local government expenditures in GNP has doubled in the last 20 years. It now amounts to approximately one-third. Local governments, including their business enterprises, now employ more people than the entire Swedish industry. Domestic consumption growth has to be checked in order to handle the imbalances in state budget and current accounts, and part of this restraint must be born by the local governments. We need to know more about what determines local government growth and what means the central authorities really have to control development.

Bengt-Christer Ysander and Tomas Nordström, IUI, have simulated local government growth in the 80s. (Nordström, Ysander, 1981.) They assert that several of the determinants of the rapid local public sector expansion during the 70s will change over the next decade. Population changes will to a lesser degree give rise to "automatic" increases in expenditures. Also, relatively moderate wage increases could lead to a more favorable cost development for local governments. They also stress the fact that the local government sector may, to a greater extent than before, give rise to, or reinforce, "domestic business cycles". Finally, as regards the instruments of the central policy authorities, cut-backs in state subsidies may have the same restraining effects on total domestic consumption as raised payroll taxes, but do not significantly change the public versus private share. The desired reallocation between private and public consumption is best achieved through limitations of local taxes.

The effectiveness of the present system of central control of local governments has been studied by Richard Murray. (Murray, 1981.) The immediate cost increasing effects of new regulations are often counteracted by a lower rate of growth of the expenditure area in question. There are, however, significant differences between regions as regards the effects of changes in state subsidies. Concerning state control of total, local government outlays, there is some doubt whether the voluntary agreements on limitations in local tax increases, which were tried in the 70s, had any effects whatsoever on the actual expenditure growth.

3. The IUI Research Program on Local Governments

The international conference was part of a broad research program at IUI which is now concluded, and the results being successively finalized and published.

The first phase of this program consisted in the collection and analysis of statistics for local government development in Sweden during the 70s (cf. Ysander, 1979, and for a summary account, Ysander, 1980).

In second phase local government behavior was studied econometrically. The determination of local government expenditure was analyzed from cross-section data by Murray (1981a) while a model of aggregate spending and taxing was estimated from timeseries data by Mellander and Ysander (cf. Ysander, 1979, and Nordström-Ysander, 1981). Supporting studies were also made of public budgeting matters with particular attention to ways of meeting the increased need for flexibility (cf. Ysander, 1982, and Robinson-Ysander, 1982).

In the third and final phase an attempt was made to relate local government behavior to the rest of the economy focusing in particular on its role for macroeconomic stability. We have already mentioned the international conference whose discussions centered around these issues. In the work of Nordström and Ysander (1981) the local government model was incorporated into the institute's macro model to enable simulation studies of the interaction between local authorities and the private sector. A survey and analysis of Swedish post-war experiences of central control of local authorities has also been carried out as part of a cooperative Nordic research effort initiated by the Nordic Economic Research Council (Murray-Ysander, 1983). One result of that study is to stress the change of business cycle impact in the stagflation of the 70s. From having on the whole contributed to a stabilization of total demand in the first post-war decades, the local governments in the 70s seem to have had rather a destabilizing impact on total demand fluctuations.

Although earlier research plans have now been carried out, there is at IUI a continuing interest and research activity directed towards the microeco-

nomics of local governments. Within the Nordic research program, already mentioned above, an attempt at a more ambitious econometric modeling of local government behavior will be started this summer at the institute. We hope that the insight provided by this work will enable us later to get a better understanding of the intricate network of interactions between different local authorities, between different levels of government and between private and public resource use.

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