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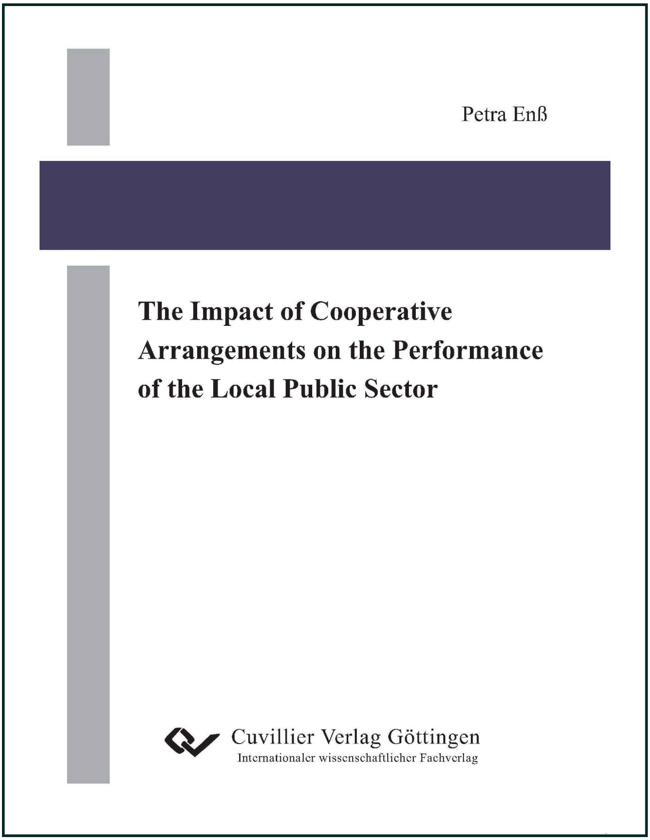
The Impact of Cooperative Arrangements on the Performance of the Local Public Sector



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1 Introduction

This book contributes to the discussion on fiscal federalism by analyzing the impact of institutional arrangements on the performance of the public sector. For a long time public finance has set a focus on the efficiency consequences of competition between subordinate jurisdictions in federations. The competition for mobile resources and the accompanying inefficiencies in public spending have been subject to an outpouring of literature. But the welfare loss can be reduced by institutional arrangements. Over the past years research has identified a number of these institutional arrangements that can enhance welfare in competitive environments. Whether they are actually effective in reducing the welfare loss depends on the objectives of the implementing government. The traditional approaches assume that social planners organize the public sector to the best of their ability. Equalization systems are then able to internalize the externalities arising from the competition for mobile resources.

Welfare maximizing governments are clearly a strong assumption, which was doubted by the growing importance of the political economy approach. This development has been reflected in fiscal federalism. As the policy outcome depends on the institutional structure and the behavior of both politicians and bureaucrats, the decision on public spending and taxation might not only regard residents' utility, but also other objectives. Within the last decades many approaches have been taken to explain the influence of decision mechanisms and institutional arrangements on the public sector. These models show how political decisions differ from the way a welfare maximizing planner organizes the public sector. There is a broadening choice of literature devoted to representative parliaments and voting and their impact on the performance of the public sector. Surprisingly, one type of governmental institution has rarely been investigated: cooperative arrangements. Cooperative arrangements are built up by lower-level governments, states or even countries and influence their competitive behavior. The purpose of this book is to identify the specific welfare consequences of this institutional arrangement.

Cooperative arrangements are chosen for several reasons. Regions and countries might expect economic advantages like the integration into foreign capital and labor markets. The reasons for cooperation, however, do not only have to refer to economic issues. Unions can be formed in order to foster political peace and freedom of individuals. The European Union, for example, ensures freedom of movement for residents of European countries and political peace between its member states. Concentrating more on local cooperative arrangements, the concern might also be on the organization of the public sector. Jurisdictions involved expect to improve efficiency in public spending. Local administration unions are built up by municipalities or cities for a common public goods provision, e.g., a public transfer system. Providing public goods for larger units may have several advantages. Economies of scale can decrease costs per capita, so that providing public goods becomes favorable. Furthermore, cooperation can internalize spillovers of regional public goods and therefore prevent an inefficient supply of public services. I bring up an additional reason for cooperative arrangements. Thinking of integrated capital markets, the cost of raising revenues may decrease within cooperation since contributions to such arrangements are frequently dependent on the local tax base and therefore mitigate the tax competition. This effect has been applied to equalization systems within federations, but to my knowledge it has not been adopted to cooperative arrangements yet.

Cooperation fundamentally differs from other forms of governments at least in two aspects. First of all, it is normally built up voluntarily. Since it is not forced by any upper-level government, each affiliated jurisdiction needs to achieve improvement by the arrangement. Even though in cooperative arrangements a common decision process takes place, all partners involved have to accept the decision autonomously. Secondly, one can generally expect the number of players involved in cooperation to be small. Literature argues that larger unions tend to have a greater mismatch of preferences, so that costs of agreements rise with the number of cooperating parties. In contrast to a decision process with a large number of participants, a small number enables each government to ensure a certain impact on the policy outcome. Both features of cooperative arrangements imply a decision process, which is more a bargaining between affiliated jurisdictions rather than social welfare maximization within a region. This must be considered in the analysis.

The concern of my contribution is to compare in a formal model the decision in a bargaining process with the one of a central planner. The analysis will show that even if both settings have the same instruments to improve the welfare by coordination, the allocation of a central planner dominates cooperation at least weakly. The need of acceptance of a bargaining solution requires not only a simple Pareto improvement for both participants of cooperation, it also defines a certain share of improvement. Therefore more instruments are needed to achieve efficiency. If they are restricted, inefficiencies can arise not only in the public, but also in the private sector.

This book investigates the impact of cooperative governments on the efficiency of public spending in competitive environments. I first ask a positive question: *What impact does a cooperative arrangement have on the supply of public goods?* Regarding the large number of cooperative arrangements not only on the local level of federations, but also between states and countries, it seems quite important to consider welfare consequences of this political institution. At the same time the results of the theoretical analysis may provide an advice for the constitutional framework for cooperative arrangements. Hence the second and normative question to answer is: *Which constitutional framework should be provided for cooperation?* As we will see, a superordinate government can promote efficiency by its choice of institutional framework. However, then it disregards equity, which has normally a high priority in governmental decisions. While former research emphasizes that both, equity and efficiency, can be achieved by equalization, I show that this cannot hold if equalization is organized locally or local players gain influence on central decisions concerning fiscal relations.

This book is structured as follows. The first chapter reviews related literature, where I mainly refer to two different strands: 'tax competition and equalization' and 'bargaining in public finance'. The following chapters 3 and 4 provide two theoretical models dealing with cooperation of local governments. The first approach assumes a closed capital market, while the second one examines the impact of cooperative arrangements when the regions' capital market is integrated. The local governments then face tax competition in addition to their cooperation. The case study in chapter 5 takes a closer look at an example of local cooperation in Germany. Implications from the theoretical analysis are applied to the performance of counties, in which municipalities bundle local tasks for an efficient supply. The last chapter summarizes the main results and offers some suggestions for further research.