How decentralization improves efficiency and protects future generations

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True federalism works

• True federalism = decentralization and budgetary autonomy
  • True bottom-up procedure

• Better decisions through expenditure & revenue decentralization + local autonomy
  • True federalism strengthens incentives for good politics

• Mechanisms
  • Exit & voice ⇒ competition
  • Laboratory for ideas ⇒ escape competition
  • Institutional congruence ⇒ increase efficiency
Institutional Congruence = Fiscal Equivalence
The relevance of institutional congruence can be understood through the relationship between decision makers, contributors, and beneficiaries. Institutional incongruence occurs when these roles are not aligned, whereas institutional congruence occurs when they are. The diagram illustrates the interplay between these roles, emphasizing the importance of alignment for effective outcomes.
Too little public expenditure & neglect of needs

Too high expenditure & exaggeration of needs

Relevance of institutional congruence
Heterogeneity and comparisons
## International success of Swiss system

<table>
<thead>
<tr>
<th></th>
<th>Switzerland</th>
<th>Germany</th>
<th>France</th>
<th>Belgium</th>
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</thead>
<tbody>
<tr>
<td><strong>Gross domestic product per capita</strong> (PPP adjusted, 2016, Int-$)</td>
<td>53'969</td>
<td>42'765</td>
<td>37'272</td>
<td>41'249</td>
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<tr>
<td><strong>Budget balance in % (forecast 2017)</strong></td>
<td>+0.2</td>
<td>+0.5</td>
<td>-3.1</td>
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<td><strong>Unemployment rate (harmonized, current)</strong></td>
<td>3.2</td>
<td>3.9</td>
<td>10.1</td>
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<td><strong>Competitiveness index (various years)</strong></td>
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<tr>
<td><strong>Perceived health status &quot;good&quot; or &quot;very good&quot; in % (2016)</strong></td>
<td>77.1</td>
<td>63.5</td>
<td>65.5</td>
<td>72.9</td>
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<td><strong>Life satisfaction (latest, [1-10 scale])</strong></td>
<td>7.6</td>
<td>7.0</td>
<td>6.4</td>
<td>6.9</td>
</tr>
</tbody>
</table>

Switzerland always ahead of Germany and France (often #1)

Sources: own calculations based on Economist Intelligence Unit, International Monetary Fund, World Economic Forum, OECD, World Value Survey
What makes Switzerland different?

• Competition induced through effective decentralization
  • Tax decentralization: ≈ 25% local jurisdictions, ≈ 40% cantons
  • Strict no-bailout rule, limited vertical and horizontal transfers
  • Constitutional setting according to Swiss Constitution
    • Art. 3: „Les cantons sont souverains […] et exercent tous les droits qui ne sont pas délégués à la Confédération.”
    • Principle of subsidiarity (Art. 5a)
    • Federalism = decentralization (irrelevance of terms “federalism” and “con-federalism”)

• Voice through direct citizen participation
  • E.g. fiscal referenda, debt brakes, etc.

⇒ Strong institutional congruence
Enormous heterogeneity inside Switzerland

- Enormous **regional diversity** in Switzerland regarding
  - Language
  - Religion
  - Topography
  - Etc.

⇒ Need for **regional solutions**
⇒ Need for **flexibility**
Heterogeneity regarding industrial structure

1st sector: 16,651 employees
2nd sector: 1,099,446 employees
3rd sector: 3,778,411 employees

Sources: Swiss Federal Statistical Office
Banks are not everywhere & only banks are marginally relevant.

Sources: Swiss Federal Statistical Office
Heterogeneity regarding policy preferences
(Referendum for “Buying Defense Airplanes”)

Sources: Swiss Federal Statistical Office
Heterogeneity regarding where foreigners live

Sources: Swiss Federal Statistical Office
Taxation and outcomes of Swiss cantons
True federalism works

• Large heterogeneity $\Rightarrow$ decentralization even more relevant
  • Decentralization theorem (Oates 1972, p. 32): “For a public good - the consumption of which is defined over geographical subsets [...] it will always be more efficient (or at least as efficient) for local governments to provide the Pareto-efficient levels of output [...].”

• BUT? Differences in outcomes?

• Yes, of course!
  • But: Relatively small outcome differences
  • But: Output generally better than in (large) centralized states
Heterogeneity induces differences in taxation

Sources: Swiss Federal Statistical Office
Small differences in outcomes & impressive outcome levels

Sources: Swiss Federal Statistical Office
Thalwil mit kleinerem Defizit

Limited fiscal equalization
National fiscal equalization in Switzerland

• Reform of fiscal equalization in 2004
  • Introduced through referendum
  • 64% yes votes

• Aim: Limited equalization of fiscal capabilities (≈ 5bn Swiss Francs) & extension of fiscal autonomy

• Mechanisms:
  • Resource based equalization
  • Burden based equalization
  • Hardship compensation (decreases 5% every year)
National fiscal equalization in Switzerland

Federalism as a laboratory & protector of future generations
Interaction of federalism with cantonal self-imposed expenditure & revenue rules

The non-bailout of bankrupt Leukerbad
The riddle of low Swiss municipal debts

• **Common wisdom:** Debts = **burden** for future generations

• **Ricardian equivalence:** Debts = **no burden** for future generation if ...

• **Common belief:** Ricardian conditions not met in reality
  • Particularly not at local/regional level

• **Common wisdom:** Debts = **burden** for future generations
(cont’d...) The riddle of low Swiss municipal debts

• **Moralist view:** Debts = **bad**

• **Homo oeconomicus:** Debts = **cool**

• **Politicians:** Debts = **coolest thing in world**
  • (Just pretend that debts are a bad)

• **The riddle:** Why do most **Swiss local** jurisdictions and **Cantons** have comparatively low public debts?

• **Solution:** “We owe it to ourselves”
  • ... due to debt capitalization
Solution to the riddle

Debt capitalization:
Property prices in Leuk **higher than** in Leukerbad
Local public debts affect property prices

Local public debts affect property prices

Local public debts affect property prices

• Capitalization of net debts
  • 60-100% debt capitalization

• Public debts no struggle between generations
  • Public debts struggle between today’s property owners and tenants

• Federalism with real autonomy of local jurisdictions protects future generations from public debts
Insights generalize
Insights from Switzerland generalize
(e.g. in Denmark)

Sources: Nielsen (2015), Fraud and Capitalization of Municipal Debt, mimeo, Copenhagen Business School, Denmark.
Insights from Switzerland generalize (e.g. in Scandinavia in general)
Insights from Switzerland generalize
(e.g. in Ancient Greece)

Conclusions
Conclusions

• Federalism with **true regional and local autonomy works**
  • Fosters institutional congruence
  • Leads to competition
  • Induces comparisons

• In federalist systems ⇒ **jurisdictions generate new ideas**
  • Innovation and flexibility central in globalizing world

• Federalism = **protector for future generations**

• Insights generalize
Thank you!

Find my research papers on:
  •  http://bit.ly/StadelM
  •  ... or search on Google:

  “David Stadelmann” Bayreuth
  @davidstadelmann
If grants were given to local governments without supervision, there would be some instances of gross neglect or venality and more variety in the quality of the performance of public functions. We should also expect to find that much of this variety was eminently sensible, and that many types of experimentation would constantly be embarked upon by the more venturesome and the more foolish communities – with large social benefits from both the successes and the failures.

— George J. Stigler (1957: 219)

Conditional grants can be equivalent to a centralization of constitutional powers.

— Albert Breton (1996: 258)
Commuting in Switzerland as a form of exit

### Finanzen der Kantone und lokalen Verwaltungen

#### Finanzierungsrechnung im FS-Modell

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¹ inkl. Sonderrechnungen
² In Anlehnung an die Definition von Maastricht

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**Sources:** Eidgenössische Finanzenverwaltung (EFV) (2016), Finanzstatistik der Schweiz 2014, Jahresbericht, Bundesamt für Statistik, Neuchâtel.
Consequences of debt capitalization

Further strengths of federalism

- Increase of efficiency through „Voting by Feet“ (Tiebout 1965, Banzhaf & Walsh 2008)
- Higher quality of education with financial autonomy of jurisdictions (Barankay & Lockwood 2007, Adam et al. 2014)
- Decentralization protects from exploitation by leviathan (Brülhart & Jametti 2007, Eichenberger & Schelker 2007)
- Smaller shadow economy and higher tax morale in decentral systems (Buehn et al. 2013, Torgler et al. 2010)
- More stable public finances (Baskaran 2010)
- Higher life satisfaction (Frey & Stutzer 2000)