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# ***Can (limited) fiscal autonomy curb government deficits at the local level?***

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# Motivation

The paper aims to answer:

- What is the impact of „potential” or „de jure” fiscal autonomy (decentralisation) on fiscal discipline at the local level?
  - Fiscal autonomy = „potential” own revenues / total revenues
- What is the impact of tax exemptions (i.e. what happens when local authorities „use” their autonomy)
- Does political competition change the picture?

# Sample

- Whole sample of over 2400 Polish municipalities in years 2002-2014
- Detailed data on the revenue structure & political variables

The share of different revenue sources in total revenues of Polish municipalities, in years 2003-2015 ( in %)

	2012	2013	2014	2015
<b>Own revenues</b>	<b>30,2</b>	<b>31,2</b>	<b>32</b>	<b>31,4</b>
Shared taxes (PIT&CIT)	16,4	16,9	17,4	18,3
Conditional grants	22	20,9	21,6	21,3
Unconditional grants	31,4	31	29,1	29

# Contribution of the paper

- Single country – uniform institutions, culture, etc.
- Detailed data, allowing to precisely measure the fiscal (revenue) autonomy
- We utilise a measure of
  - „potential” (de jure) own revenues and tax exemptions that to some extent alleviates the problem of endogeneity
  - Tax exemptions
- Inclusion of the variables related to the political environment

# Relation to the literature

- The effects of decentralisation depend on the revenue structure of the local governments (Eyraud and Lusinyan, 2013)
- Higher reliance on fiscal transfers from the central government matters for fiscal imbalances. Higher share of transfers (i.e. lower fiscal autonomy) may lead to higher fiscal deficits due to:
  - fiscal illusion (Wibbels, 2000)
  - common pool problem (Plekhanov and Singh, 2006)
  - Lower accountability (Baskaran, 2012)
  - lower fiscal flexibility in face of unexpected fiscal shocks (Asatryan et al., 2015)
  - soft budget constraints (Baskaran, 2012; Foremny, 2014; Goodspeed, 2002; Neyapti, 2013; Rodden, 2002)
  - Leviathan Hypothesis (Besley and Case, 1995)

## Relation to the literature

- On the other hand, higher fiscal autonomy might lead to higher fiscal imbalances, due to:
  - competition between local units for the mobile capital and a “race to the bottom” in taxation (Edwards and Keen, 1996; Wilson and Wildasin, 2004)
  - diseconomies of scale and coordination problems may increase the costs of supplying public goods (Neyapti, 2010)
  - higher corruption (Neyapti, 2010)

# Empirical Strategy

$$fb_{i,t} = \alpha + \beta * fb_{i,t-1} + \gamma RD_{i,t} + \gamma TE_{i,t} + \vartheta * Z_{i,t} + \mu * Pol_{i,t} + \omega * time_i + e_{i,t}$$

- fb stands for current fiscal balance (current revenues - current spending/ current revenues) and total fiscal balance (total revenues - total spending/ total revenues)
- RD is the share of „de jure” own revenues (measure of fiscal autonomy);
- TE\_1 is the share of tax exemptions granted by each municipality of total revenues of the municipality
- TE\_2 is the share of tax exemptions granted by each municipality of own revenues of the municipality
- Z is a set of control variables

# Empirical Strategy

- Yearly data: FE, the GMM dynamic panel data estimation (Arellano & Bond, 1991; Arellano & Bover, 1995).
- Four-year averages: fixed effects estimation (FE with Driscoll-Kraay standard errors)
- Estimation for the whole sample of all municipalities, as well as the subsamples of only urban and only rural municipalities

# Data

- We use annual data, for years 2002-2014; collected for all municipalities in Poland.
- Local revenues and expenditures: Polish Ministry of Finance;
- Demographic & other structural characteristics: the Local Database of Central Statistical Office
- Political variables: National Electoral Commission

# Results

	(total fb) Whole sample	(total fb) Whole sample	(5) Urban	(6) Rural
<b>Potential RD</b>	<b>0.221***</b> <b>(0.0117)</b>	<b>0.221***</b> <b>(0.0297)</b>	<b>0.0787**</b> <b>(0.0265)</b>	<b>0.192***</b> <b>(0.0187)</b>
<b>Tax exemptions</b>	<b>-0.203***</b> <b>(0.0317)</b>	<b>-0.203**</b> <b>(0.0865)</b>	<b>-0.161*</b> <b>(0.0879)</b>	<b>-0.361***</b> <b>(0.0517)</b>
Driscoll_Kray Controls	no yes	yes yes	yes yes	yes yes

# Empirical strategy – the political scene

- To measure political competition (fragmentation) at the elections - we calculate a Herfindahl index (from 0 to 1)
  - Higher values corresponding to higher level of political competition, i.e. many political candidates & almost equal share of votes; no candidate strictly dominates over the others.
- We also control for:
  - party fragmentation of the municipal or town council
  - educational attainment of the mayor, mayor party

Variables	current fb	currrent fb
potential RD	<b>0.190***</b>	<b>0.222***</b>
	<b>(0.0199)</b>	<b>(0.0231)</b>
tax_exemptions	<b>-0.502***</b>	<b>-0.525***</b>
	<b>(0.0509)</b>	<b>(0.0690)</b>
mayor_fragm	-0.00879***	-0.0105***
	(0.00291)	(0.00173)
council_fragm	0.00154	-0.000813
	(0.00386)	(0.00305)
mayor_edu	0.000755	0.00266**
	(0.00194)	(0.000633)
mayor_party	-0.000703*	-0.000419
	(0.000413)	(0.000221)
Controls	yes	yes
Driscoll-Kraay	no	yes

# Conclusions

- Higher „potential” level of fiscal autonomy is associated with more fiscal prudence
- When the local governments choose to actively shape their tax policy and decrease the local tax burden, this is associated with lower fiscal balances.
- The need to join fiscal autonomy with fiscal rules?
- The results remain robust also when we limit the sample to just rural or just urban municipalities.

# Conclusions – the impact of the political scene

- Political competition index has a significant and negative impact, indicating that tighter elections lead to deterioration of fiscal balances.
- The findings are consistent with the hypothesis that a fragmented political arena has a negative effect on local fiscal balance.