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Porto, Alberto and Tortarolo, Natalia Porto y Darío

National University of La Plata, Argentina

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# **“Glocalization” and decentralization: The role of local governments in the new international context\***

Alberto Porto, Natalia Porto y Darío Tortarolo \*\*

Globalization, technological changes and the information revolution are phenomena that affect the ways in which different levels of government allocate their public resources and expenditures. This paper examines one aspect of the problem: the decentralization of the subnational public sector and its relation to economic integration. The study focuses on Argentina and Brazil with a panel data for each country separately, for the period 1985-2005. The results show no relationship between the vertical structure of the subnational public sector and economic openness. There may be two explanations for this: factors working in opposite directions compensate their effects; or interferences from higher levels of government prevent modifications. The control variables have the signs suggested by the theory of fiscal federalism.

JEL Classification: F15, H77

Keywords: globalization, information revolution, glocalization, local governments

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\*\* National University of La Plata (Argentina). Corresponding author: Alberto Porto. Calle 28 N<sup>a</sup> 235. La Plata (1900) Argentina. E-mail: [porto.alb@gmail.com](mailto:porto.alb@gmail.com)

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## INTRODUCTION

In the new international context that has characterized economies in the last decades, globalization, technological changes and the information revolution are phenomena that are affecting the way in which different levels of government allocate their public resources and expenditures, both within a country and among countries. The expected impacts are summarized in Bell's quotation (1987): "the nation-state is becoming too small for the big problems of life, and too big for the small problems of life". This change was called "glocalization"<sup>1</sup> (Courchene, 1993), which involves an increased role for global governments (and institutions) and local governments, and a secondary role for national and provincial levels of governments. In the new "glocalization" context an important question is how the vertical structure of the public sector has been modified since there have been tendencies against and for decentralization (Garrett and Rodden, 2003; Stegarescu, 2009; Ermini and Santolini, 2010, 2011). This paper examines one aspect of the problem: the decentralization of the subnational public sector and its relation to economic integration. The study is performed for Argentina and Brazil, the quantitatively most important countries in MERCOSUR,<sup>2</sup> with a panel data for each country separately, for the period 1985-2005. Our main question is if the (local) municipal participation has increased or decreased within the subnational public sector (municipalities plus provinces/states) due to economic openness. The determinants of decentralization identified in the theories of fiscal federalism are used as control variables. The paper is organized as follows. In Section II, the main arguments for and against fiscal decentralization within a country, which result from normative and positive theories of fiscal federalism, are presented. Most theoretical and empirical studies are developed for closed economies and for decentralization measured by the relationship between subnational and total expenditures and revenues. The novelty in this work lies in considering the subnational dimension of fiscal decentralization in open economies. In Section III, empirical analysis -data, model, variables and estimates- is addressed. Section IV shows the conclusions. The results show no relationship between the vertical structure of the subnational public sector and economic openness, which may be only valid for the short term. As phenomena linked to modernity are, as they seem, irreversible, their forces will join to the other variables leading to greater participation of local governments. The challenge is to modernize and strengthen them for this new scenario. Two obstacles appear in the way: on the one hand, the resistance of provincial governments to lose fiscal powers in favor of lower levels of government; on the other hand, the interference of the national government in the life of the local governments. These obstacles are present both in Argentina and Brazil.

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<sup>1</sup> According to Sharma (2008), the expression "glocalization" had its origin in studies of Japanese economists and it is referred to the adaptation of agricultural techniques to local conditions. The sociologist Robertson (1992) used the term to refer to the universalization of the particular and the particularization of the universal; that is, the "conjunction of universality and singularity" (Sebrelli, 2012, pp. 406-407).

<sup>2</sup> The Common Market of the Southern Cone (MERCOSUR) was created in 1991 by Argentina, Brazil, Paraguay and Uruguay.

## THEORY AND EMPIRICAL EVIDENCE

### THEORY

The main question of this paper is if the (local) municipal participation has increased or decreased within the subnational public sector (municipalities plus provinces/states) due to the new integration processes that have been affecting economies during the last years. Trade agreements proliferation and trade easiness, financial integration and the revolution in production technologies, communications and services, among other aspects, are part of a scenario of a globalized world in which it is interesting to investigate how decentralization, both of revenues and expenditures, responds. To carry out this work, there are certain difficulties not only in defining conceptually but also in quantifying a variable that reflects all the aspects that integration involves. As a proxy, we use one dimension of economic openness: the relationship between level of exports and gross domestic product (GDP). The arguments for and against fiscal decentralization, both in a closed and in an open economy, are considered below. In a closed economy, there are arguments for and against fiscal decentralization that come from the normative and positive theories of fiscal federalism. In the normative theory, the degree of decentralization results from the trade-off between benefits –the better adaptation of the offer of uper20.indd 65 25/11/14 14:42:52 Urban Public Economics Review | Revista de Economía Pública Urbana the local public goods to the demand in each locality (preference matching)- and costs –due to the loss of economies of scale and the presence of interjurisdictional externalities. In the positive theory, the trade-off results from the benefits of greater control of politicians and bureaucrats by the citizenry (accountability) and the costs due to perverse incentives for fiscal responsibility that intergovernmental transfers can generate. Most theoretical and empirical studies are developed for closed economies, and the degree of decentralization -measured by the relationship between subnational and total expenditures and revenue- is the variable to be explained. In few of these papers, the degree of decentralization within the subnational sector (municipal in relation to subnational expenditures and revenues) is studied (Wallis and Oates, 1988). In the new international context there are new factors which can also explain fiscal decentralization. From an initial closed economy scenario, the international context generates movements in both directions, strengthening or weakening decentralization. On the one hand, due to the improvement in transport and communications, free trade enables to obtain goods at lower prices without the need of great extension, which weakens the argument of economies of scale in favor of centralization. Additionally, if there are differences in the preferences of the jurisdictions, the centralized government, in the new context, will have greater availability of information, which may also lead to reduce the heterogeneity of preferences and the advantages of decentralization. Moreover, information dissemination generates higher pressure for decision making at the local level since it increases the power of decision of the citizens against central governments. On the other hand, the common market (openness) generates incentives for subnational governments to invest their revenues efficiently, which enables their jurisdictions to improve their competitive position (Quian and Weingast, 1997; Weingast, 1995, 2009).

Globalization generates greater productive specialization of regions, non-coordinated business cycles among regions, and winner and loser jurisdictions and persons, which will demand national compensatory policies –insurance role (Rodrik, 1998). Two obstacles arise for local government decentralization: on the one hand, the resistance of provincial governments to lose fiscal powers in favor of lower levels of government; on the other hand, direct interference from the national government on local governments. Some literature (de Figueiredo and Weingast, 2005; Oates, 2005) considers that within society and uper20.indd 66 25/11/14 14:42:52 66 67 the public sector there are forces that may weaken the structure and functioning of the federal system: 1) the intrusion of upper level of governments, which reduce the power of decentralized governments and can lead to the destruction of the federal system; 2) the opportunistic behavior of lower levels of government which seek to obtain benefits for their jurisdictions from transferring costs to the rest of the country. The stability and governance of the federal system is a delicate balance between these two forces. Specifically for Brazil and Argentina, it is possible to find concrete examples of the facts previously mentioned. In Brazil the Constitution of 1988 recognizes three level of government –the Union, the States and the Municipalities. In contrast with other federal countries, the relationship between the three levels of government is between principals. The Constitution considers Municipalities as members of the Federation with broad autonomy. This autonomy is reflected at the state level by a lower vertical imbalance, but when full account of national regulations is introduced, it is clear that autonomy in decision making by subnational governments is considerably reduced. Something similar happens at the municipal level. Gomes (2012) documents that due to national regulations the index of autonomy of the states reduces from 77.1 percent to 48.6 percent, and the one corresponding to subnational governments (states plus municipalities) from 61.7 percent to 33 percent (year 2004). In Argentina, at least in the Constitution, the relationship between the nation and the provinces is between principals, but it looks distorted in practice by the interference of the central government. This intrusion is possible by the important vertical imbalance due to revenue centralization and expenditure decentralization. Provinces have weak and distortionary tax bases and poor access to credit. Moreover, the relationship between the provinces and their municipalities is of principal-agent type, that is, the political power of the provinces is strong in comparison with the one of the municipalities.<sup>3</sup> Provinces regulate the functions and resources of the municipal governments and dictate the regulations of transfers. In Argentina there is great national interference in subnational finances. Not only the total revenue is highly centralized (almost three quarters at the head of the national government), but also national regulations reduce the total amount and the power of decision making by subnational governments in relation to the destination of the transfers. The intricate mechanism for the distribution of the national revenue between the Nation and the Provinces, and among provinces is a clear example (Bertea, 2012). The intrusion of the central government, which has concentrated on provincial governments for a long time, is now extended to municipal governments. One proof is the growing share of direct

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<sup>3</sup> An example is the failure of several of the provinces in fulfilling the mandate of the 1994 Constitution granting autonomy to the municipal level of government.

transferences to municipalities,<sup>4</sup> designed apparently to improve the local decision process and to strengthen decentralization but actually, it is a mean of political control of the municipalities.<sup>5</sup> The net result of various forces -economic, political and social- which operate in opposite directions is an empirical issue that is discussed in the next section. The previous arguments are similar for resources, but there is an additional tension between centralization and decentralization. On one hand, the second generation theories of fiscal federalism recommend to decentralize revenues *pari passu* with expenditures to maintain fiscal discipline in the subnational sector. On the other hand, recent progress in communications and transports, which made possible high mobility of financial flows, goods and people, provide a stage for tax competition between countries within an economic union and between regions within a country, resulting in the need of coordination and harmonization. The problems of coordination and harmonization become more complex when the vertical structure of public sector is taken into account. If all the countries/regions have their revenue tax system centralized, the difficulty of harmonization will be lower. <sup>6</sup>

## CONCLUSIONS

In international literature, there are very few papers that investigate the determinants of subnational public sector decentralization; instead, they deal with it in contexts of closed economies. A novelty of this paper is to extend the study to open economies. The main question is if the (local) municipal participation has increased or decreased within the subnational public sector (municipalities plus provinces/states) due to economic openness (ratio between exports and GDP). The results show no relationship between subnational decentralization and economic openness since the estimated coefficients are only significant (positive) for revenues in Brazil. The control variables have signs compatible with the theory of fiscal federalism; in particular, population (positive and significant in all cases), GDP per capita (positive and significant for expenditures and revenues in Argentina, and for expenditures in Brazil) and provincial/state fiscal correspondence (positive for expenditures and/or negative for revenues). The expected broader role for local governments is not confirmed in the estimates, which reveal rigidity in the vertical structure of the subnational public sector, both at the aggregate level and at the subnational level, to changes in the economic openness. The bids and tensions between the levels of government can explain this rigidity (de Figueiredo and Weingast, 2005; Oates, 2005; Boadway and Shah, 2009). National and provincial governments have constitutional

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<sup>4</sup> Direct transfers from the national government to the municipalities in Argentina have increased suddenly in the recent times

<sup>5</sup> Another recent example in Argentina is that due to the increase in agricultural prices, the price of rural land, which is taxed by the province and municipalities, also increases. The national government imposed taxes on the exports and captured the largest fraction of the increase on land rent, limiting the possibility of raising revenues of the municipalities. Provinces had a behavior similar to the nation. Municipalities, with less constitutional and political power, could not take advantage of the increasing value of this tax base.

<sup>6</sup> There is vast literature about fiscal coordination and harmonization in a common market, such as González-Páramo (1999), Sorensen (2004) and Rezende (2006).

and political roles stronger than those of local governments and they pose obstacles in the path of decentralization at least in the short and medium term. Two obstacles are in the way: on the one hand, the resistance of provincial governments to lose fiscal powers in favor of lower levels of government; on the other hand, direct interference from the national government to local governments.

To the extent that the mentioned phenomena linked to modernity are, as they are, irreversible phenomena, their forces will join to the other variables that lead to greater relative participation of local governments. The challenge is to modernize and strengthen them so that they can face the new stage. To achieve this, they must overcome the barriers from higher levels of government. <sup>23</sup> These interferences generate opportunistic behavior of subnational governments seeking to obtain benefits for their jurisdictions by transferring costs to the rest of the country.

In summary, there is not a clear result in the scarce literature which studies decentralization measured by the relationship between subnational expenditures (revenues) as a percentage of the public total expenditures (revenues). When the relationship between subnational sector decentralization and economic openness for Argentina and Brazil is estimated, the results, again, are not conclusive. The variety of results -which may be due, among other factors, either to the various definitions of the dependent and independent variables, to the different econometric methods, or to the countries and periods covered- invite to keep the topic on the agenda of research

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