ON THE EFFECTS OF INTERGOVERNMENTAL GRANTS: A SURVEY

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Outline

1. Brief review of taxonomy of grants
2. Effects of grants on fiscal choices
3. Effects on procyclicality, incentives, fiscal discipline, and spillover effects
4. Effects on autonomy and accountability
5. Moving forward

1.1. Taxonomy of Grants: Relevance

- Grants are a **key financial instrument** for funding subnational governments:

    1. *Helping finance ongoing subnational public services and infrastructure investments.*

    2. *Equalization of subnational horizontal fiscal disparities.*

    3. *Subsidization of certain subnational desirable activities.*

- Transfers are also a **policy tool** in the hands of central or federal governments to effectively address various forms of shocks and crises.

- **Intended** and **unintended effects** of grants are highly dependent on their **design** and **implementation**.

- Different **types of grants** have different observed effects.

1.2. Taxonomy of Grants: Classification

- Intergovernmental grants can be classified according to their **purpose** and to **how funds are allocated:**

Purpose	Allocation
• **Conditional/Earmarked**: Specific forms of spending: ❖ Ex-ante conditionality ❖ Ex-post conditionality (performance-based) ❑ Matching ❑ Non-matching • **Unconditional:** No restriction in the use of funds	• **Formula-based**: Pre-defined criteria. • **Discretionary:** Ad hoc manner.

- Each type can trigger a **substitution effect** (cost of the subsidized public spending), an **income effect** (pool of resources available), or **both**.

1.3. Taxonomy of Grants: Is there an optimal practice?

- *1) Are some transfers superior instruments than others?*
  - **Simple answer: NO**
  - Grants vary in suitability based on objective needs. Different grants support various objectives, and balancing trade-offs is key in transfer design.
- *2) What is the optimal design?*
  - Optimal transfer design can vary depending on a country's goals and context.
- *3)* Using a **single** grant instrument for multiple goals is a **common mistake** that can cause lack of transparency, confusion, and inefficiencies.
- 4) Over time, transfers have shifted from **ad-hoc** to **formula-based** approaches, and from **earmarked/specific** grants to **block** grants. And although formula-based is general preferred for predictability and stability, having more autonomy in the use of funds can be trumped by the need for effectiveness.

2. Effects of grants on fiscal choices

- Transfers can have **extensive** effects on subnational revenue autonomy, spending, and budget balance behavior.
- Changes in the amount of grants impact the **budget constraint**, which links **spending**, **taxes**, **grants**, and **borrowing.**
- Potential effects on **subnational tax effort**:
    - *Crowding-out and crowding-in effects*
    - *Tax competition*
    - *Asymmetric responses of subnational governments*
- Potential effects on the **expenditure side**:
    - *Size of the public sector*
    - *Fly-paper effect*

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2.1. Tax effort and crowding-out effects

- Grants are believed to induce a **crowding-out** effect **==> negative incentives** of subnational governments to **raise** their own revenues (tax effort).
- Results vary depending on how grants are **designed, the country's context** and **institutional capacity,** and the **methodology used in each paper.** Subnational tax effort may **increase** (**crowding-in**) when **tax capacity** or potential tax revenues are used instead of **actual revenues**.
- The empirical evidence is somewhat **mixed.** Most of the studies for high income countries suggest a **negative** impact. Crowding out effect is more pronounced in developing countries.

2.2. Tax competition

- Tax competition when subnational governments **lower their taxes** to **inefficiently** low levels to attract or retain mobile tax bases.
- Theoretical findings suggest that: ↑grants volume ➔ ↓tax rates.
- Empirical evidence, mostly centered on **OECD countries**, including Canada, Germany, Switzerland, and the US, confirm these predictions (for example, Smart, 2007; Widmer and Zweifel, 2012 and Buettner and Krause, 2020).
- However, these studies observe **divergent** results in the degree **of tax reductions** (possibly due to differences in datasets employed or systematic institutional contexts).
- Some recent studies indicate that subnational governments may rather **increase** rates when receiving additional grants (Holm-Hadulla, 2020).

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2.3. Asymmetries in the effects of changes in the level of transfers

- Gramlich (1987) suggested that program spending **cuts** following **decreases** in transfers are much smaller than program **expansions** following **increases**.
- Empirical research indicates that there is a higher tendency to **increase spending** when government grants rise compared to the **reduction in spending** when grants decrease (Lago-Peñas, 2008)
- Asymmetrical effects may vary by transfer type (**lower** for **conditional block** grants than for **unconditional** grants).
- Notably, political factors, like left-leaning administrations, and institutional factors, such as weaker tax enforcement, also seem to influence these asymmetrical effects.

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2.4. Effects on government size

- Brennan and Buchanan's (1980) Leviathan hypothesis argued that decentralization increases competition among government units, **limiting the size** of the government.
- When that financing is based on intergovernmental transfers, that story tends to change radically (Rodden, 2003).
- Subnational governments funded with intergovernmental grants tend to **increase in size**, while those funded with own tax revenues tend to **decrease** in size.
- This positive impact on government size holds for subnational units funded through **revenues sharing** or centrally regulated subnational **taxation**, instruments more akin to transfers (Makreshanska-Mladenovska and Petrevski, 2019).

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2.5. Fly-paper effect

- Subnational governments **increase public spending** by more than in response to an increase in **local income** of equivalent size (Hines & Thaler, 1995; Inman, 2008).
- Various theoretical explanations:
  - **Fiscal illusion** of taxpayers, as the main driver of this behavior, has been confirmed in many studies.
  - Other explanations: Citizens' inability to establish "political contracts" with elected officials, **dynamic interactions** between politicians and interest groups, or the **relative political strength** of local governments.
  - Building upon Hamilton (1986), recent studies see it as a rational response in situations where subnational governments use **distortionary taxes** to finance at least a part of their expenditures.
- Research mainly focused on high-income countries. However, recent papers confirm the fly-paper in countries like Nigeria, South Africa, Honduras, and Indonesia.

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3. Effects on procyclicality, incentives, fiscal discipline and spillover effects

- Transfers can either dampen or amplify **subnational spending behavior**. Many studies, especially for the U.S. and other OECD countries, show that grants are often **pro-cyclical** with respect to subnational output shocks (Behera et al., 2020)
- Poorly designed transfers can encourage perverse fiscal behaviors. According to the **soft budget constraint** hypothesis, a heavy reliance on grants can **weaken budget discipline** and lead to **excessive borrowing**.
- Subnational policies and programs can exert **positive** and **negative spillovers** beyond their jurisdictions, thus complicating the determination of appropriate grant sizes (Bird & Smart, 2002).

4. Effects on autonomy and accountability

- Subnational governments need **autonomy** in their spending and taxing decisions, and so public officials are **accountable** to their voters. Grant financing can affect **revenue** and **expenditure** autonomy, reducing subnational officials' accountability.

- **Non-earmarked** or **unconditional** grants are generally interpreted to be more beneficial to **autonomy**, and among **earmarked** grants, **block** grants are preferred to specific grants (Martinez-Vazquez & Searle, 2006; Ladner et al., 2016).

- Grants can lead to subnational governments **losing accountability and autonomy**, as shown in studies from OECD countries (Zhuravskaya, 2000; Psycharis et al., 2016) and developing countries (Azis et al., 2001; Mogues and Benin, 2012; Bongo, 2019).

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5. Moving Forward

- Our understanding is still limited, although empirical studies are constantly using more sophisticated approaches.
- The overall quality and quantity of subnational government data have been also a significant handicap.
- Better balance in cross-country analyses with single-case country studies still needed.
- Some areas remain **unexplored**: constitutional design, separation of powers, disciplining of political actors, or the role of judicial authorities

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