The implementation of Fiscal Policy: monitoring local governments.

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One of the more contentious issues in macroeconomic policy is the role of fiscal policy in promoting prosperity. Nowhere is that more relevant to people's welfare than in the expenditure of local governments. After all, most people in the world are moving to cities, and their quality of life is impacted directly by the quality and availability of basic public services. In poor and middle-income countries, it is difficult to find local governments that would deliver reliable public services. People migrate to large cities not only to look for jobs, but also because the provision of public services there is usually better than in rural areas.

Expansionary fiscal policy is about increasing public spending to generate economic growth. But details matter. Public spending may result in crowding in or crowding out. Perhaps nowhere is that more evident than in the spending by municipalities across the world.

The world is becoming urban. In the mid 2000s, for the first time in modern history there were more urban than rural dwellers – in 2016, 54% of the world's population already lived in cities and by 2050, that number is projected to rise to 66 per cent (United Nations, 2016). In the Americas, more than 80% of the population inhabit cities, while in Africa almost 60% of the population still are in rural areas.

Local governments are responsible for providing basic services, planning for growth, and making sure cities are livable. The quality of local governments is a major source of divergence between rich and poor countries. Corrupt and incompetent officials destroy social welfare, while good governance is a boon to the local citizens. One important issue is the societal arrangement that creates incentives for local officials to perform well.

Every kind of production, public or private, results in some kind of waste – no company performs efficiently all the time. Afonso and Fernandes (2008) analyze the performance of public officials in Portugal, assessing the extent of municipal spending that seems to be "wasted" relative to the "best-practice" frontier. Their results suggest that most municipalities could achieve, on average, the same level of output using fewer resources, improving performance without necessarily increasing municipal spending.

In order to deal with the inefficiency of mayors and other municipal officials, most countries moved away from decentralization and merged small regions into larger cities. There has been a global movement to restructure local governments on almost all continents. Authors such as Blom-Hansen et al (2016) and Allers and Geertsema (2016) have investigated the effects of the increased size of municipalities. Economies of scale from larger regions should decrease administrative costs and make local governments more efficient. But there is no evidence for this. As Blom-Hansen et al (2016) observe, cost savings in some areas were offset by deterioration in others, while for most public services jurisdiction size did not matter at all. It seems that local government efficiency is not related to region size.

China is unique in its system of monitoring local officials. The country has a long tradition of strong bureaucratic hierarchy, with the imperial exam dating back to the beginning of the 7th century. The imperial exam was a civil service examination that selected the best candidates to serve as administrative officials. Throughout the centuries, as dynasties came and went, the imperial exam remained a steady supplier of government officials. The Chinese system, in fact, was praised and motivated some of the recommendations of the Northcote–Trevelyan Report of 1854, the cornerstone of the modern civil servant system in the United Kingdom.

Having survived many upheavals in the turbulent 20th century, the rigid Chinese bureaucracy continues to be a cornerstone of the political system in the country. The many layers of hierarchy provide a monitoring mechanism to local officials, whose incentives are tied to China's 5-year plans. Officials who do not deliver local economic growth rarely climb the bureaucratic ladder. More importantly, in the case of China, the number of layers actually matters when it comes to effectively monitoring of local officials. Li and Wang (2016) provide quantitative evidence about how a government's productivity measured by per capita GDP varies with the number of vertical layers in its hierarchy. They analyzed the effect of China's province-managing-county (PMC) reform since 2003. After the reform, a provincial government could by-pass the prefecture level and directly administer county governments with respect to fiscal matters in the same way it manages prefectural governments. Improving the economic development of counties has become a priority for policy makers in China because of its large county-level population and the concerns about rural poverty and inequality. On 72% of the Chinese territory, counties directly administer 70% of the total population and yet generate only 37% of the national gross domestic product (GDP). Their results are striking: delayering has led to increases in revenue and inter-governmental transfers for county governments, but the associated enlarged span of control makes it difficult for upper-level governments to coordinate and monitor local ones. This has led to a reduction in county governments' total public expenditure and pro-growth expenditure, as well as an increase in land corruption. Overall, the flattening of the government hierarchy has had a negative effect on economic performance.

The Chinese case shows how enacting fiscal policy, when filtered to local communities, is much harder than monetary policy. While Central Banks can simply intervene in credit markets by buying or selling government bonds, when governments expand spending the economic and social effect will depend on many variables, from agents' expectations to the quality and monitoring of local officials. It is much harder to achieve prosperity if fiscal spending is wasted on corruption or useless projects. In a world in which income inequality and climate change are two of the main obstacles to sustained prosperity, governments should strive to be careful with their expenditures.

Questions for discussion.

1) Compare the level of infrastructure and public services in your town to other major cities in your country and on the continent. To what do you attribute the differences within and among countries? What are the conditions for expansionary fiscal policy to help the citizens in your municipality?

2) For a long time, China's main benchmark for promoting local officials has been delivering significant economic growth in their administrative regions. Explain the risks associated with a GDP-focused incentive for local officials.

3) Blinder and Zandi (2015) estimate the following fiscal multipliers for projects started in the US soon after the great financial crisis.

Table 1 - Fiscal Multipliers for Various Spending Changes. Estimates of the one-year change in GDP for increases in government spending.

	As of 2009 01	As of 2015 01
Temporary increase in SNAP (formerly food stamps)	1.74	1.22
Temporary federal financing of work-share programs	1.69	1.13
Extension of unemployment insurance benefits	1.61	1.01
Increase in defense spending	1.53	0.87
Increase in infrastructure spending	1.57	0.86
General aid to state governments	1.41	0.58
Low Income Home Energy Assistance Program (LIHEAP)	1.13	0.55

Source: Blinder, A., & Zandi, M. (2015). The Financial Crisis: Lessons for the Next One. Report by the Center on Budget and Policy Priorities, Table 4.

The table shows that these programs had a larger fiscal multiplier in 2009 when compared with 2015. Analyze how fiscal multipliers can change over time and provide an explanation for the differences found in table one – note that in 2009 the American economy was contracting rapidly due to the financial crisis, but was growing steadily in the 2013-2017 period.

4) The United States went through the Great Depression in the 1930s. The New Deal program in the US in the 1930s aimed to help the economy recover. The New Deal had two phases. The first was the NIRA, which limited competition and allowed labor to capture some of the extra rents by exempting industry from antitrust prosecution if it immediately raised wages and accepted collective bargaining with the labor unions. The NIRA was ruled unconstitutional in 1935. After this ruling, The Roosevelt administration passed the National Labor Relations Act (NLRA), which strengthened several of the NIRA's labor provisions, despite the threat of being ruled unconstitutional (Cole and Ohanian, 2004). More than just direct spending by the government, the New Deal was about trying to increase wages and investments by restricting competition temporarily. The table below displays the pattern of wage growth from the depths of the Depression.

TABLE 2 – Monthly wages relative to the GDP (GNP) Deflator (February 1933 = 100)

Industry	April, 1933	December, 1933	June, 1934	May, 1935	December, 1935	June, 1936
Leather tanning	96.6	124.0	122.2	121.9	123.0	124.9
Boots and shoes	104.7	145.9	138.1	139.0	139.7	137.0
Cotton	96.7	142.0	133.2	135.2	133.4	134.3
Iron/steel	100.2	123.1	122.7	124.6	125.0	127.0

Foundaries and machine shops	99.4	112.6	111.9	113.4	113.6	115.9
Autos	98.9	115.5	121.3	121.0	123.1	125.8
Chemicals	102.8	117.6	118.2	121.5	123.1	124.1
Pulp/paper	100.7	117.5	111.4	115.3	116.4	117.9
Rubber manufacturing	100.7	121.3	125.9	134.1	137.0	128.6
Furniture	102.3	118.9	125.9	129.2	129.0	130.3
Farm implements	96.5	107.1	105.6	115.3	116.9	113.7

Source: Cole, H. L., & Ohanian, L. E. (2004). New Deal policies and the persistence of the Great Depression: A general equilibrium analysis. Journal of Political Economy, 112(4), 779-816.

Do you think a program like this is viable in the US today? Explain your reasoning.

5) Poland grew significantly in 2017, with real GDP increasing by more than 4%. Its prospects for 2018 are of lower but still robust economic growth. Nevertheless, the central government has planned for the budget deficit in 2018 to be lower than into 2017 (41.5 vs. 59.3 billion zloty, according to Reuters). Explain the costs and benefits of lowering the deficit during an economic expansion. Is this an example of a countercyclical fiscal policy?

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