FISCAL AUTONOMY, CIVIC ENGAGEMENT AND LOCAL GOVERNMENT EFFICIENCY

Benny Geys
Department of Economics,
Norwegian Business School BI,

Civic engagement is often argued to foster political awareness, and to increase the public's monitoring ability. Still, weak fiscal autonomy – by separating spending from revenue decisions – can undermine voters' interest in and demand for an efficient production of public services. Using a broad panel of German municipalities, we show that voter involvement indeed has a positive impact on local governments' cost efficiency, but, crucially, this efficiency-enhancing effect is strongly affected by local governments' fiscal autonomy.

The UK Conservative Party's election manifesto during the most recent 2010 elections included the aim to have *each* citizen over 18 become a member of a voluntary association. This objective was also voiced in David Cameron's first speech as Prime Minister by stating that the restoration of the UK's social fabric and citizen involvement was a 'top priority'. Actually, former UK Prime Minister Tony Blair had already made similar commitments when first taking office in 1997. US presidents Bill Clinton and Barack Obama as well as former German Chancellor Gerhard Schröder are likewise known to be outspoken proponents of a stronger civic community and many national governments contemplate modifying the institutional environment in which voluntary associations work so as to encourage them to assume a more active role in public provision at the local level. Even the European Union has in recent years shown increasing interest in replacing the state-market and private-public dichotomies in favour of a greater 'partnership' between state authorities, private partners and voluntary

organisations to identify common interests, work on societal development and decide how to address societal changes.

One issue where citizens' social and/or political involvement is said to be especially fruitful, concerns public sector performance. This, indeed, was a central contention of Robert Putnam's (1995) book '*Making Democracy Work*'. In this work, he shows how regional governments in the more trusting, civic-minded northern and central parts of Italy provide public services more effectively than those in the less trusting, less civic south. Later studies on a myriad of other countries (and using a diverse set of government performance indicators) generally provide support for Putnam's Hypothesis.

Clearly, however, two crucial assumptions have to be met for this argument to hold. Firstly, civic engagement should foster political awareness and interest. Secondly, this increased interest and involvement should improve government performance. While some supportive evidence exists concerning the former 'assumption', the validity of the second 'assumption' has received much less attention – and will be the focal point of this contribution. Note that I will thereby define 'good government performance' as 'higher efficiency' of public service provision. Obviously, economic efficiency is only one among many public concerns (e.g., effectiveness, equity, responsiveness, adequateness, appropriateness, and so on) and my focus on it should not be taken to mean that it is more important than the remaining issues. Yet, efficiency has received increasing attention in recent years (e.g., in the New Public Management discussions since the late 1980s), and it is not unreasonable to assume that voters desire as many public goods as possible for a given fiscal cost (implying a desire for economically efficient policies).

From a theoretical perspective, the link between voter involvement and public sector efficiency can be analysed in a principal-agent setting. Local government officials act as agents for the population, who – as principals – desire the government to provide public goods. However, a clear conflict of interest arises in that politicians (or bureaucrats) in charge of public goods provision may benefit

from less productive activities: e.g., higher salaries, lower effort, over-employment within their service, and so on. Given that politicians (or bureaucrats) tend to be better informed about the true cost of providing public goods than the general population, there is an incentive to invest in such less-productive activities. These, however, induce budgetary slack (or inefficiency). Importantly, the extent of budgetary slack is affected by whether or not the principal assumes an active role in supervising the actions of his agent. Recent experimental evidence shows that stricter monitoring of the agent reduces information asymmetries between principal and agent, thereby limiting possibilities for wasteful spending and rent extraction by the agent. Consequently, a more active citizenry can be argued to increase supervision of and pressure on government officials, thus generating higher effort and enhanced performance.

This, however, is not the end of the story. One crucial caveat to this line of argument is that voters may misperceive the true cost of public good provision (referred to as 'fiscal illusion'). Consider, for example, a situation where local governments receive intergovernmental grants to fund certain projects. As public goods are then partially funded by revenue received from higher-level governments, there is an imperfect mapping of citizens who consume and finance these goods. In that case, voters' function as efficiency guards may be impaired because they perceive that other people's money is being wasted. That is, they may start to put less weight on the careful use of public money since it, at least in part, originates from external transfers (rather than from one's own pocket). This suggests that in transfer-dependent municipalities, the association between voter involvement and government efficiency may be severely weakened.

To evaluate this proposition, we employ data for 987 municipalities in Baden-Württemberg for 3 years (1998, 2002 and 2004). Clearly, to test the above story, we need measures of government efficiency, voter involvement and fiscal autonomy. Following a vast number of academic studies, government efficiency will be evaluated by the relation between total expenditures and the provision of five types of public goods: (a) 'Education' (measured by the number of students in Grund- and Hauptschulen), (b) 'Social Security' (measured by the number of

kindergarten places and the population over age 65), (c) 'Public Facilities, Sport, Recovery' (measured by the surface of public recreational facilities), (d) 'General Administration' (proxied by total population) and (e) 'Business development' (measured by the number of employees paying social security contributions). More services for a given amount of spending thereby indicate higher economic efficiency. While imperfect, this ratio represents a commonly accepted proxy for the economic efficiency of the public sector.

Voters' political involvement is captured using three variables. The first measure is voter turnout, defined as the number of votes cast relative to the number of eligible voters. Voter turnout has often been shown to be strongly positively related to people's interest in and knowledge of politics. As such, it indicates a politically interested electorate that has the ability (in terms of knowledge and interest) and desire (given that it actively turns out to vote) to supervise and hold accountable its politicians. The second measure of voter involvement is an indicator variable for the existence of freie Wählervereinen (a grassroots type of organization resulting from local initiatives and *not* linked to the traditional political ideologies). The existence of such groups indicates that at least some citizens are ready to incur the cost of organization to resolve local policy issues; hence, their members must feel sufficiently politically involved to create such an organization. Our third and final measure of voter involvement is the share of eligible voters to the total population. This captures the extent to which inhabitants of a given municipality are *able to* control their politicians through the ballot box (not the extent to which they actually do, which is captured by the voter turnout measure above).

Finally, we measure fiscal autonomy by exploiting municipalities' need to receive Schlüsselzuweisungen under the municipal fiscal equalization scheme. If municipalities' Finanzkraft (calculated as tax revenues plus Schlüsselzuweisungen received two years ago) exceeds their Finanzbedarf (calculated as the product of a Kopfbetrag and the number of inhabitants), they obtain no Schlüsselzuweisungen. If Finanzbedarf exceeds Finanzkraft, they do. Since awarding such additional grants increases a municipality's grant-dependence and reduces its fiscal autonomy, we define *'independent'* municipalities as those that obtain no

Schlüsselzuweisungen and *'dependent'* municipalities as those that do. This generates a dummy variable equal to 1 for 'independent 'municipalities, and 0 for 'dependent' ones. In 2004, 'independent' municipalities made up approximately 9.4% of all communities.

Our main estimation results – i.e. on the *interaction* between involvement and fiscal autonomy (note that these interaction terms indicate how the effect of voter involvement on efficiency changes with the degree of fiscal autonomy) – are summarized in Table 1. Since the variables are defined such that negative signs in Table 1 imply a reduction in inefficiency (or an increase in efficiency), Columns (1) to (3) provide significant support for the intermediary role of fiscal autonomy of the involvement-efficiency relation. That is, the interaction between the dummy variable for fiscally autonomous (i.e. 'independent') municipalities and voter turnout (Independent Municipality*VT) as well as its interaction with the presence of free voter unions (Independent Municipality*FVU) show highly significant negative coefficients. The coefficient of the third interaction variable (Independent Municipality*RatioEV/POP) is unexpectedly positive but remains statistically insignificant. These findings strongly suggest that in municipalities with a higher degree of fiscal autonomy, the efficiency-enhancing effect of voter involvement is more powerful. Moreover, the size of the coefficient estimates indicates that this effect is strongest for free voter unions. This makes intuitive sense as establishing a free voter union is a more active (and costly) way of involvement compared to the simple act of voting. As such, it can be expected to have less far-reaching consequences on political decision-making.

Table 1: Determinants of Baden-Württemberg's local government cost efficiency

Variable	(1)	(2)	(3)
Voter turnout (VT)	-0.0056** (-2.46)	-	-
Independent Municipality * VT	-0.0079** (-2.03)	-	-
Dummy free voter union (FVU)	-	0.1469** (2.37)	-
Independent Municipality * FVU	-	-1.2045** (-5.77)	-
Ratio eligible voters/population (Ratio EV/POP)	-	-	-0.0608** (-5.38)
Independent Municipality * Ratio EV/POP	-	-	0.0078 (0.83)

Note: N=2961. ** (*) denotes significance at the 5% (10%) level. Results for control variables are suppressed to preserve space (for further details, see Geys et al., 2010).

While proper caution is due when drawing policy implications from our analysis (given that we are forced to rely on proxies for voter involvement and government efficiency), our results provide some food for thought. At first sight, they suggest that one should try to encourage citizens to be more active in the political process. This, however, is not an easy route to take. For example, in the period considered here voter turnout in local council elections fell from approximately 67% in 1994 to 52% in 2004. Nonetheless, a more detailed reading of our results shows that increased involvement might not be the only way to boost local government performance. An alternative is to increase the degree of local governments' fiscal (or revenue) autonomy. Even though actual involvement declines, our results suggest that higher budgetary slack can then still be avoided by making municipalities depend to a stronger degree on own funding. In such a setting, an active citizenry will put more weight on the careful use of public money.

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