A Transaction Cost Theory of Federalism

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Institutional theories of legislative delegation view the relationship between the legislature and administrative agencies as hierarchical (Epstein and O'Halloran, 1999). Depending on the policy at stake, the legislature can retain authority for defining the details and carrying out policy, or it can delegate that authority to executive agencies. Applying examples from the study of annexation and boundary change, we argue that this approach can also be applied to the relationship between states and local governments in the U.S. system of federalism. While states maintain authority for defining the details and carrying out policy in some areas, in other policy arenas states use grants of home rule and procedural and substantive legislation to delegate responsibility to local governments. This paper expands some of the arguments presented by the local boundary change literature to a more general transaction cost theory of federalism and examines the implications of transaction cost federalism for local annexation behavior.

The importance of state level rules in conferring or restricting powers and autonomy of local governments has been highlighted in contemporary studies of local boundary change (Burns, 1994; Clingermayer and Feiock, 2001; Carr and Feiock, 2001). Directly and indirectly states shape the constitutional and substantive rules that affect local governments. State constitutional level rules include provisions for the creation of lower-level governments, including the incorporation of municipalities. State-municipal relations can be depicted as hierarchies of nested institutions (see McCabe and Feiock 2001). This literature has shown that state rules constrain local actions and those local institutions, such as city charters and local home rule powers, result from a state legislature's choice to centralize or delegate authority. The autonomy granted local governments varies across state and by policy area. The hierarchical framework may help to explain differences in patterns of policy delegation, and the consequences of "intergovernmental contracts" for local level policy decisions. The framework elaborated here builds upon the work of Williamson (1975, 1988, 1999), Dixit (1996), Horn (1995), and Epstein and O'Halloran (1999). We view state level rules as contracts established between the state, acting as principal, and its local governments, acting as agents. These contracts are subject to transaction costs and, for that reason, have embedded mechanisms that attempt to prevent local government from reneging.

Intergovernmental Relations and Transaction Costs

Delegation of authority from legislative bodies to the bureaucracy has been explained in terms of a transaction costs (Horn, 1995; Epstein and O'Halloran, 1999). Legislatures face a tradeoff between internal costs of policy production and external costs of delegation, similar to the make-or-buy decision faced by firms in the economic market. Legislatures also face a delegation decision with regard to local governments. The same tradeoffs present in bureaucratic delegation characterize intergovernmental relations, but here the tradeoff is in the relationship between levels of government, specifically between state and local governments.

Our understanding of state-local relations have, for the most part, been adaptations of theory designed to explain the state's relationship with the national government. State-local relations, much more than federal-state relations, can be viewed as hierarchical. The right to exercise governmental powers is given to local governments by the state constitutions and/or legislative acts. Dillon's rule holds that local governments are "creatures of the state" and can only undertake activities the state specifically authorizes. This is consistent with a hierarchical view of the relationship between a state and its local governments, allowing states to create, modify, or extinguish local governments, which are best thought of as municipal corporations (Ross and Levine, 2001). Recent work by Frug (1980) and others argues that the legal context of intergovernmental relations allows states to hold control over local governments so as to generate powerless cities. For example, rural-dominated state legislatures have been frequently accused of limiting large cities' actions through hostile charters and statutes (Burns and Gramm 1997). State rules are and intergovernmental agreements are legally enforceable, even if costly to do so (Inman and Rubenfield 1997).

Transaction costs in the local market prevents certain transactions from occurring due to collective action problems and difficulties in establishing credible commitments. State level rules structure local actors' current and future behavior by solving market failures and by securing cooperation that ensures gains from political transactions. Mutual benefits resulting from negotiation and compromise accrue to the actors involved and are possible because political institutions, like economic ones, facilitate cooperation and are beneficial to all involved. In the following seections, a transaction cost approach to intergovernmental institutions is outlined to explain why and how state governments delegate authority to local governments.

Economic Transaction Costs

The decision faced by state governments is one between vertical integration and delegation. With the first solution, centralization or vertical integration, state government would be responsible for writing and implementing policy without local government influence. A single hierarchical structure at the state level is not reasonable since it becomes too centralized, costly, and inflexible to handle the thousands of decisions to be made. Coordination of the subunits representing the local governments in this hierarchy would be very complex and difficult to achieve.

The second solution is delegation, where the local governments are free to select the governance structures and policies that minimize local transaction costs. If local governments make policy decisions without state level direction, they are operating in a free market of sorts. Market failures can be barriers to efficiency, particularly where externality problems result in spillover effects among jurisdictions (see Feiock 2002 for a discussion of quasi-market failures resulting from governmental competition). Where issues cut across jurisdictions or are regional in character, delegations to local governments will result in less than efficient market allocations. It can also result in polices that would enhance welfare not being adopted due to collective action problems. For these reasons, state intervention (or non-delegation) would leave the all jurisdictions better off, particularly if the solutions under vertical integration reflect the preferences of the state median voter.

Generally, the relationship between state and local government falls somewhere between the extremes of vertical integration and delegation because the degree of centralization or decentralization is determined by the amount of economic and political transaction costs involved in the exchange. In the context of fiscal federalism, provision of public goods confronts tradeoffs between two dimensions of efficiency: scale economies in production and the ability to accommodate variations in preferences. The problem is then to determine if and when should state legislators intervene in local policy choices and how.

The argument for vertical integration can be justified in Coasian terms. Coase (1937) proposed that certain market transactions involving large negotiation costs should be integrated under the hierarchy of the firm. Likewise, inefficiencies in local policy making and choice make state action necessary to reduce transaction costs and achieve more efficient solutions. In the case of local market transactions, the costs of negotiation and market failure correction may be high so that state command-and-control is able to economize on these costs (Epstein and O'Halloran, 1999). This may particularly be the case where cooperative action among local governments is necessary. Intergovernmental agreements, even among few jurisdictions often fail to achieve efficient outcomes (Coates and Munger 1995) and local governments often engage in non-cooperative behavior when significant benefits might arise from cooperation (Feiock 2002).

However, state intervention also suffers from inefficiencies that result from the inability to determine what is best for each individual community or failures of bureaucracy or implementation. The type and degree of intervention (i.e. the features of the contract) become a matter of weighting the transaction costs experienced at the local level against the transaction costs experienced under various hierarchical arrangements (contracts) between state and local governments. Decisions concerning specific policy can either be left to local governments (i.e. the market) or can be centralized at the state level when extra-local impacts are likely. Ultimately, decisions regarding boundaries, economic development, or any other issues of interest to both state and local governments are made with this framework.

If we regard cities as analogous to firms competing in a political market, we need to know when state intervention or regulation of these markets is necessary, and what contractual arrangement between a state and its local governments would minimize economic and transaction costs? In each state, the legislature chooses the contract (legislation, rules, etc.) that minimizes transaction costs since they are not able to enter in individual agreements with each local government. Ideally, only inefficient transactions should be regulated to avoid the loss of local autonomy and choice and allow the capture of high-powered market incentives resulting from competition among local governments (Williamson, 1985; Frant, 1996). In practice, however, state legislators have political incentives to elaborate a contract that minimizes their political transaction costs and maximizes their chances of reelection. The governance structure adopted in each particular instance will be the most attractive from the point of view of the median state legislator according to the logic of political efficiency (Epstein and O'Halloran, 1999).

Political Transaction Costs

State legislators regulate local policy markets in order to overcome inefficient transactions and allocations created by local government activity. However, it would be naïve to believe that state legislators are uniquely concerned with economic efficiency. In fact, state officials' goals encompass other values including, individual goals such as reelection. Hence, when contracting with local governments, state legislators will write a contract that maximizes their reelection chances motivated by the logic of political efficiency and minimization of political transaction costs. In the exchange between state and local governments, six types of costs are usually present: agency costs, legislative decision-making costs, uncertainty costs, commitment costs, sunk costs, and influence costs. Each type will be defined and its implications for the creation of intergovernmental rules discussed.

Agency Costs

States face agency problems because local governments are numerous and difficult to monitor. Principal-agent relationships involve two costs – adverse selection and moral hazard (Moe, 1984). First, principals face adverse selection costs because of the ex-ante information asymmetry present in the relationship between principals and agents. In their role of principals, state governments will elicit information from their agents (local governments), but only the agents have full knowledge of the information being required by the principals and can use this knowledge to their own advantage. The number of local governments varies across states and, therefore, the difficulty in monitoring local actions will also vary, with the expectation that increases in the number of local governments in a state increases agency and monitoring costs faced by state legislators. The argument that fragmentation increases agency costs is countered by the idea that local governments compete among themselves to improve performance. If this second argument is true, information asymmetries will decrease with fragmentation and states will be better able to monitor local government activities. Moreover, just like their state level counterparts, the local officials behavior is shaped by the political incentives and and electoral cycles. This might make state action a potential efficient intervention.

Second, moral hazard results from ex-post opportunistic behavior on the part of agents. The extent of this problem depends in part on the “types” of cities. The actions of non-opportunistic governments may conform with state-level goals, even with minimal monitoring and enforcement. On the other hand, opportunistic governments may respect the letter of the law while attempting to escape the legislature’s intentions and engage in actions with harm neighboring jurisdictions or decrease overall efficiency. Previous work has linked government structure to local government “type” and thus the moral hazard problem (McCabe and Feiock 2001; Feiock and Kim 2001; Bae and Feiock 2001).

Mayor-council governments may be more profoundly influenced by high-power incentives than manager-council governments. Frant (1993) describes the council-manager system as a distinct governance structure where professional managers have different, and lower-power incentives from those of elected executives. City managers are attentive to their professional peers and to norms of professional management espoused by organizations, such as the International City/County Management Association. Studies of service contracting (Stein, 1991) and administrative reform (Ruhil et al., 1999) for example, suggest that pursuing efficiency in their management strategies increase employment opportunities for professional local government managers.

Because mayor-council governments are more subject to high-power incentives, there will be greater potential for opportunistic behavior and high agency costs in states where this form of government is dominant. As in the case of adverse selection, shirking or non-compliant behavior results from information asymmetry favoring the agents.

State level rules transmit information to local governments regarding the preferences of the state government enacting the legislation. External and/or internal controls can be relied upon to minimize the transaction costs incurred in the contract. In the first case , the principals (state governments) devise incentive structures and sanctions to reduce the costs incurred by adverse selection and moral hazard. These external controls can prompt local government agents to perform according to the principals' expectations and comply with the letter and intention of state law. In the second case, principals can also achieve the cooperation of the agents using internal controls such as trust, credible commitments, and cooperation between the two levels of government. Internal controls rely more on social and moral commitment and reputation, and opportunities for reduction of conflict.

States officials seek to structure the relationship between the two levels of government in such a way that minimizes their economic and political transaction costs. Political actors, like the economic ones, are rationally bounded and, hence, the contracts are always incomplete holding loopholes and ambiguity as to its provisions (Williamson, 1988). Disagreements on the terms of the contract are likely to occur *ex-post* leading to negotiations between parties to fill the gap in the original contract. Under these conditions, ex-post power relations matter substantially. Transaction cost analysis refers to this as the residual rights of control

Legislative Opportunity Costs

Exchanges between state and local governments involve distinct preferences. States may want to direct or limit local choices, whereas localities seek to maximize their discretion and state support (financial and/or technical) when implementing a contract. When enacting legislation, state legislators face legislative opportunity costs (Horn, 1995). A detailed contract involves substantial time and effort. Crafting the contingencies and details in specific pieces of legislation is more costly and time consuming than forging contracts that allow greater local government discretion in implementation.

Several types of opportunity costs can be identified, but two deserve special consideration: financial and time/agenda constraints. Fiscal opportunity costs derive from budget constraints and limitations. The fiscal capacity of state and local governments determine the range of policy alternatives that can be adopted. It also limits the financial incentives available to direct individual behavior.

There are many issues that can be addressed by elected officials at a given point in time. Because officials face these pressures upon their time, their agenda reflects the choice of a set of issues to consider in detriment of others. In order to include a new issue, another may have to be dropped. Not only the number of issues that can be addressed at one point in time is limited but also the longer legislators spend on a specific piece of legislation, the less time will be available to introduce other legislation (Horn, 1995). States with part time legislatures and with limited legislative staff resources may be especially sensitive to opportunity costs.

On one hand, a detailed mandate will most likely include provisions to control its implementation and to evaluate its results. Sanctions will be included and a “police patrol” type of control will be used as a tool of oversight (McCubbins and Schwartz, 1984). If, on the other hand, the legislation is vague, local governments will have larger discretion in its implementation and state legislatures will be less involved in the implementation process. A “fire alarm” type of oversight will be adopted with the legislature choosing to intervene only in cases of clear failure to implement the contract. In terms of legislative opportunity costs (time, effort and money) strict detailed legislative rules will be more costly to implement than more vague legislation. Nevertheless, when detailed contracts are approved, the implementation and outcomes at the results at the local level will more closely mirror state preferences.

Uncertainty Costs

When a contract is approved, it may be difficult for each local government within a state to determine how it will be affected by that piece of legislation. Contracts entail financial and technical consequences for local governments and may exacerbate conflicts between local groups with different preferences. The degree of support for a contract then depends upon a third set of political transaction costs – uncertainty costs (Horn, 1995). If local level preferences are aligned with the goals of state legislation, we can expect a high degree of support for the contract at the local level, independent of the contract features (Jenks, 1994). As a consequence, uncertainty costs affecting state legislators will be low. When local governments face fiscal pressures, lack the technical competence or face local opposition, contract implementation may entail greater uncertainty costs for state legislators.

The approval of a piece of legislation by state legislatures does not guarantee its implementation. In order to implement a contract several enforcement strategies can be adopted. Typically, three strategies are available: coercive (command-and-control), cooperative (incentive-based), and mixed strategies (Burby and Paterson, 1993; Jenks, 1994). The coalition enacting the mandate at the state level may rely on one or more of these strategies in order to minimize the uncertainty costs resulting from implementation.

Commitment Costs

Once the enacting coalition changes, there is no guarantee that the same enforcement strategy will be followed, with the same degree of stringency, or that the commitment to the contract will persist. This commitment problem affects local governments because it makes uncertain the flow of intergovernmental transfers in terms of financial and technical assistance. Hence, commitment costs will be smaller in local governments better equipped to deal with the mandate and higher in communities more dependent of intergovernmental assistance because these communities demand more from state governments in order to respect the terms of the contract.

When designing a contract state governments will attempt to minimize commitment costs by including provisions that safeguard future attempts to renege on the contract. From the perspective of the state legislator, commitment costs can be minimized by securing an agreement that creates a "stable structure of exchange" (North, 1990: 50) both over space and time. In this fashion, state legislators are able to control part of the commitment problem, even if, ultimately, commitment costs depend on local governments' perception of state legislators' actions.

Aligning Transaction Costs and Contract Features

State level legislation to direct local behavior and choices is triggered by the need to minimize economic and political transaction costs. Ideally, state legislatures would adopt individual agreements with each local government that minimizes transaction costs. This would be extremely costly in terms of financial cost, time, and political feasibility. In practice, one contract (piece of legislation) is designed to encompass the expectations of the state legislature to its local governments and be drawn with the same goal of transaction cost minimization.

In sum, state grants of home rule, enabling legislation and substantive policies should include mechanisms to control agency problems, incorporate provisions to assure credible commitments and prevent future coalitions from reneging on the contract, create realistic goals for local governments to achieve and/or provide financial and technical assistance in accomplishing those goals, and achieve all this without compromising other pieces of legislation, state legislative activities, and the chances of reelection of state legislators. It is anticipated that future work will empirically examine the character of these state level rules by estimating a model that takes into account the economic and political transaction costs facing state decision makers.

Local Government Behavior

Based on the arguments presented above, we expect intergovernmental institutions – the contractual relations embedded in state regulations, policies, and grants of authority – to affect political action and behavior at the local level (Allard, 1997). The effect of these contractual relationship between state and local governments should be manifest in two ways. First, state level rules act as constraints to local behavior resulting in outcomes consistent with the preferences of state-level principals. Second, local governments will exhibit adaptive behavior in order to pursue their self-interest, engaging in what Sbragia (1996) called the politics of circumvention. The extent to which these two behaviors present themselves will be a function of the motives and interests of local governments and the characteristics of the contractual rules embedded in state laws.

Sbragia (1996) argued that throughout the twentieth century local governments became increasingly immersed in complex framework of limitations constructed by state governments and the courts. To address these limitations, localities promoted legal, financial, and organizational strategies of circumvention that allowed them to pursue their own goals without violating the rules established by their principals.

In the case of local borrowing, Sbragia suggests that two complementary mechanisms were adopted as strategies to circumvent general-obligation bond restrictions imposed by state governments: the issuance of revenue bonds and the creation of public authorities. The two instruments are interrelated because one of the distinguishing features of a public authority is the ability to use revenue bonds as its major method of finance In a similar vein, Burns (1994) highlighted the important role of state legislatures in the formation of local governments. Diverse state legislation affects the ability of cities to zone, prevents them from taxing neighbors, restricts annexations, constricts voting rights in special districts elections to property owners, and imposes diverse tax limitations.

Empirical work has addressed the politics of circumvention by local governments. Principal-agent theory has been applied to interpret the adoption of state level limits on local taxes and expenditures (TELs) and their implications for local finances. This work suggests that while TELS have reduced property tax dependence they have created incentives to increase revenue from fees and charges (McCabe and Feiock, 2000; 2001). Empirical work by Carr and Feiock (2000) concludes that smaller, but more frequent, annexations are an integral part of the adaptive behavior displayed by local governments facing state level constraints on annexations. From this perspective it seems clear that change at the local level can be influenced by the character and stability of state level institutions.

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