Chapter 7
Explaining the Relation Between Efficiency and Financial Condition:
Empirical Analysis on Local Governments

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ABSTRACT

There is a risk of presupposing that enhancing efficiency will simply improve financial health in local governments. However, there are several reasons to think that the healthy governments could be the least efficient ones. This chapter aims to contribute to this discussion by using a sample of the 132 largest Italian local governments during the period 2005-2014. The results show that the taken-for-granted positive effect of efficiency on financial condition is observable only when efficiency refers to current expenditures, but such a positive effect has not been observed in the case of capital expenditures.

INTRODUCTION

Financial condition and efficiency of public entities in general, and local governments (LGs) in particular, are two key issues, largely debated by previous literature because of their relevance for policy-makers. On the one hand, financial condition, financial sustainability or financial health refers to the financial situation of governments,

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which is essential for a correct decision-making process. Good financial condition means that local governments are able to provide public services while they can satisfy their present and future financial obligations (CICA, 1997; CICA, 2009; GASB, 1987).

Several previous studies have dealt with the definition and representation of financial condition, attempting to develop indicators to represent the financial health of local governments (CICA, 1997; GASB, 1987; Groves, Godsey & Shulman, 1981; Wang, Dennis & Sen, 2007). Moreover, scholars have also proposed models as alert systems to identify poor financial health and prevent financial distress (e.g. Brown, 1993; Carmeli & Cohen, 2001; Kloha, Weissert & Kleine, 2005a; Zafra-Gómez, López-Hernández & Hernández-Bastida, 2009a). Other lines of research are focused on factors that determine financial health of local governments, such as demographic and socio-economic conditions (e.g. Cahill & James, 1992; Rodríguez-Bolívar, Navarro-Galera, Alcaide-Muñoz & López-Subirés, 2016; Zafra-Gómez, López-Hernández & Hernández-Bastida, 2009b), bureaucracy, transparency, corruption phenomenon (e.g. Bisogno, Nota & Ianuardo, 2017), political factors (García-Sánchez, Mordán & Cuadrado-Ballesteros, 2014), and so on.

On the other hand, efficiency is one of the main pillars of the New Public Management (NPM) reforms, along with effectiveness and flexibility. An efficient local government achieves the "best" possible combination input-output – i.e. public resources-public services, namely the "optimal". Therefore, efficiency is considered an important strategic tool (Kalb, Geys & Heinemann, 2012), especially taking into account that the European Economic and Monetary Union established restrictions with a view to attaining budgetary stability. That situation led governments to assign their resources more efficiently to meet international restrictions without damaging public services delivery (Benito, Bastida & García, 2010).

Given the relevance of this issue for governments, efficiency has been largely investigated from different point of views, e.g. management, operational researches, applied economics, etc., and also by public sector researchers. Two main streams emerge: firstly, on the basis of the NPM approach, several studies are focused on the dichotomy between private and public management of public services, asking if the use of the private sector guarantees greater efficiency (e.g. Benito et al., 2010; Bhattacharyya, Harris, Narayanan & Raffiee, 1995; Dijkgraff, Gradus & Melenberg, 2003; McDavid, 2008; Ohlsson, 2003; among others). Secondly, several studies have essentially assessed the efficiency by considering internal and external factors, such as socio-economic, political, and environmental variables (Geys & Moesen, 2009b; Geys, Heinemann & Kalb, 2010; Kalb, 2010; Tanaka, 2006).

However, notwithstanding the relevance of these issues individually, previous literature has rarely studied if a relationship between financial condition and efficiency does exist and what could be the practical implications of it. As far as we know,

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