Government decentralization as a commitment in non-democracies

Mark Gradstein∗

Ben Gurion University
CEPR, UK
CESifo, Germany
IZA, Germany

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ABSTRACT

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In the past several decades, many countries, among them non-democratic, chose to decentralize their governments. One prominent and well researched example is China’s decentralization in 1980–1990s. This paper proposes a rationale to account for a voluntary devolution of centralized power by a non-democratic ruler through decentralization. The idea is that decentralization serves as a commitment device to ensure that ex post chosen policies reflect regional preferences, thereby boosting individual productive effort incentives, hence tax revenues used to provide national public goods. Thus, it helps to overcome the holdup problem, enhancing efficiency and possibly benefitting the non-democratic ruler.

1. Introduction

Tradeoffs involving fiscal decentralization versus a centralized government structure have been extensively studied since the seminal work of Oates (1972), and Tiebout (1956). In its beginning, literature tended to view developed countries as its paradigm, implicitly assuming a democratic country as its focus. Yet, in the last several decades many developing countries have decentralized with explicit objective of improving service delivery (World Development Report, 2004), and it appears that that they have grappled with similar issues (as well as with additional ones). Consequently, more recent work addresses government decentralization in the context of development (Bardhan, 2002). While many of the countries that have pursued decentralization are democracies, some are not. A good example of decentralization in a non-democratic setting is provided by the recent history of China, where local decentralization, at the village level and then at the province level, started taking place in 1980s, incidentally, prior to the introduction of elections there. Consequently, local administrative units have obtained much autonomy in policy making. Scholars suggest that this process enhanced efficiency and might have well been responsible for China’s spectacular economic growth in recent decades (Qian and Weingast, 1997). Insights from China’s
decentralization process have recently led the theory of fiscal federalism to be applied to non-democratic settings as well (e.g., Weingast, 1997).

In this paper, viewing China’s 1980s’ move toward decentralization as a prototypical case, we address tradeoffs involved in such a transition both in democracies and in non-democracies. In particular, one question we ask is what makes voluntary devolution of centralized power by ruling elites possible. In this paper, we argue that a non-democratic ruler faces a holdup problem. In the absence of policy commitment device, policies chosen by the ruler under centralized decision making tend to poorly reflect regional preferences, thus impeding incentives. In contrast, decentralization constitutes a policy commitment device. More specifically, in our context, this commitment device ensures that ultimately chosen equilibrium policies better reflect individual preferences. As these preferences are assumed complementary to productive incentives, this, in turn, ensures that a larger amount of such efforts will be generated. In this view, therefore, decentralization is a way to ultimately enhance efficiency by partially solving the holdup problem. This rationalizes a voluntary devolution of power by the ruler via decentralization.

It should be noted that the mechanism identified here is different from and complementary to the agency view of decentralization. The agency view focuses on the ability (or lack thereof) of decentralized decision making to monitor local politicians through local elections, and there is a debate as to its efficiency in doing so (Keefer, 2007; Khemani, 2007). A theoretical perspective on political agency and its empirical validity in the context of development have been developed in several papers elsewhere (Albornoz and Cabrales, 2013; Bardhan and Mookherjee, 2005, 2006; Besley, 2006; Besley et al., 2005; Joannis, 2014; Seabright, 1996). While both mechanisms can be used to understand, for example, the impetus and the rationale behind China’s decentralization reforms of the 1980s, the agency approach emphasizes the political and accountability portion of it, whereas the mechanism exhibited here puts squared emphasis on the effect of government decentralization on tailoring policies to local preferences and is, therefore, more in line with the traditional fiscal federalism approach (Oates, 1972). It should be noted that there exists a vast literature that explores the pros and cons of decentralization from various perspectives and, in particular, detrimental potential of decentralization has been pointed out (e.g., Bardhan and Mookherjee, 2006; Cai and Treisman, 2004, among others). This paper aims, therefore, to contribute to this literature by clearly laying out the commitment incentives to pursue decentralization in non-democracies. This framework should be helpful in interpreting decentralization processes that have taken place in past decades. Hatfield and Padró i Miquel (2012), is another important related work. There, the politically determined degree of centralization balances redistribution motives with the desire to commit to policies that prevent capital flight. Here, instead, we abstract from capital mobility, and decentralization serves a different purpose than in Hatfield and Padró i Miquel (2012). Also, our model adds insights as to the institutional comparisons of decentralization incentives.

In addition to the literature on fiscal decentralization, the paper is also related to recent work on the determinants of democratization. Part of this work (Acemoglu and Robinson, 2008; Bertocchi and Spagat, 2001; Gradstein, 2007, 2008) views democratization as a commitment mechanism employed by ruling elites in order to advance own goals. In particular, in Gradstein (2007), democratization is pursued by ruling elites to ensure that it can lead to high quality institutional choices, while inducing higher investment and growth. This paper can be viewed as an extension of this line of thought, suggesting that, more generally, devolution of power can be viewed as useful by political leaders or ruling elites, out of strategic motives. The common thread here is that the choice of a governance model serves as a commitment. Comparison of decentralization incentives in democracies versus non-democracies is another novel contribution of this paper, which has clear empirical implications, discussed later in the paper.

The rest of the paper proceeds as follows. The next section provides further motivation through the description of China’s decentralization process. Section 3 then lays out the basic model. Section 4 explores policy choices undertaken under the assumption that policies can be directly committed to. Section 5 contains the main analysis, whereby a centralization mode is chosen in the first, constitutional stage; Section 6 presents a simple extension to the case of a democracy; and Section 7 concludes.

2. Decentralization in China

Prior to late 1970s communist China was a highly centralized country in terms of its public finances. However, fiscal decentralization was envisioned already by the Chairman Mao in the famous quote: “The central authorities should take care to give scope to the initiative of provinces and municipalities, and the latter in their turn should do the same for the prefectures, counties, districts and townships; in neither case should the lower levels be put in a strait-jacket.” The initially highly centralized organization of public finances, lacking in fiscal incentives for local governments was on the verge of collapse by 1980 (Shen et al., 2012).

The period 1979–93 was marked by fiscal reforms “aimed at promoting local development though increasing the responsibilities of local governments and increasing their autonomy in carrying out fiscal functions...” (Shen et al., 2012) The

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1 And the survey in Martinez-Vazquez and McNab (2003) illustrates the difficulty in signing off whether or not decentralization is effective in leading to faster growth.

2 Sometimes this is done under threat – of insurgency, rioting, etc., see Cervellati et al. (2008), and references therein. This paper is more related to the part of the literature where democratization occurs peacefully.
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