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Local decentralization and local economic growth: A cross-sectional examination of US metropolitan areas

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Abstract

This paper builds on the growing empirical literature that explores the relationship between government structure and economic growth. It uses a new data set of 314 US metropolitan areas to examine the relationship between local decentralization and local economic growth. The results indicate a negative relationship between the central-city share of metro area population and economic growth and a positive relationship between both the number of municipalities per 100,000 residents and the number of counties per 100,000 residents and economic growth. Those findings provide support for the hypothesis that decentralization enhances economic growth.
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1. Introduction

Decentralization is increasingly seen as a tool to promote economic development. As Oates [14] explained, "[t]he basic economic case for fiscal decentralization is the enhancement of economic efficiency: the provision of local outputs that are differentiated according

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to local tastes and circumstances results in higher levels of social welfare than centrally determined and more uniform levels of outputs across all jurisdictions."

There are two primary mechanisms involved here. The first is related to Hayek's [8] knowledge problem, which states that the wide dispersion of knowledge dooms central planning to failure.[1] Decentralized authorities are much better equipped to provide the economically efficient quantity and quality of public goods. They are in a better position to be responsive to variations in local demand.

The second mechanism is related to the idea of government as monopolist. As Brennan and Buchanan [4] explained, "The potential for fiscal exploitation varies inversely with the number of competing governmental units in the inclusive territory." More recent work on "market-preserving federalism" echoes this theme. "The fundamental political dilemma of an economic system is that a state strong enough to protect private markets is strong enough to confiscate the wealth of its citizens" (Weingast [21]). Increased competition between individual governments can limit government's ability to extract monopoly rents, thereby enhancing economic efficiency, and thus economic growth.

There is a growing empirical literature that tests this theory of a link between fiscal decentralization and economic development. Much of that work has utilized the nation as its unit of analysis. For example, Kim [10] found a positive relationship between fiscal decentralization and economic growth using an international panel data set. Using data for 80 countries, Huther and Shah [9] also found a positive correlation between fiscal decentralization and economic growth. In contrast, Davoodi and Zou [5] found a negative relationship between fiscal decentralization and economic growth in developing nations, but no relationship in developed nations. And Xie et al. [22] found a negative, but not very significant, relationship between the aggregate local share of US government spending and US economic growth.

One problem with utilizing the nation as the unit of analysis is that there are numerous important differences (e.g., cultural and institutional) between countries that are very difficult to quantify, and thus difficult to incorporate into an econometric test. In addition, national and state boundaries can be relatively arbitrary, and substantial variation can occur amongst local economies within those boundaries. Furthermore, reliable historical data can sometimes be difficult to obtain for more than a relatively small number of countries. One way to get around those problems is to examine smaller political units within a single nation.

[1] "The economic problem of society is … a problem of the utilization of knowledge not given to anyone in its totality. … [This] is at least one of the main problems of economic policy—or of designing an efficient economic system. … This is not a dispute about whether planning is to be done or not. It is a dispute as to whether planning if to be done centrally, by one authority for the whole economic system, or to be divided among many individuals" (pp. 519–520).

"If we can agree that the economic problem of society is mainly one of rapid adaptation to changes in the particular circumstances of time and place, it would seem to follow that the ultimate decisions must be left to the people who are familiar with these circumstances, who know directly of the relevant changes and of the resources immediately available to meet them. We cannot expect that this problem will be solved by first communicating all this knowledge to a central board which, after integrating *all* knowledge, issues its orders. We must solve it by some form of decentralization. … We need decentralization because only thus can we ensure that the knowledge of the particular circumstances of time and place will be promptly used" (p. 524).

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