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Decentralization and economic growth revisited: an empirical note

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Abstract

Although it is theoretically expected that decentralization leads to efficient provision of local public services and stimulates economic development, there is a mixed picture of the decentralization effect on economic growth across earlier empirical studies. Using the instrument variables (IV) technique with the latest cross-country data for the period from 1997 to 2001, this paper found that fiscal decentralization has a significant positive impact on per capita GDP growth. Therefore, when the focus is placed on the latest information on the economic situation in the latter 1990s, decentralization, particularly on the fiscal expenditure side, is instrumental in economic growth.

JEL classification: C21; H11; H72; O11

Keywords: Fiscal decentralization; Political freedom; Growth regression

1. Introduction

Decentralization is now a political-economy trend in both developing and developed countries. In theory, there is no doubt that decentralization leads to efficient provision of public services and results in rapid economic development. From the empirical viewpoint, however, it remains controversial whether there is any relationship between decentraliza-

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tion and growth. In reality, decentralization is a complicated phenomenon and is characterized by various aspects at different levels. The aim of this paper is to empirically readdress the question of whether any forms of decentralization stimulate growth, using the latest cross-country data from 1997 to 2001.

With regard to the linkage between decentralization and growth, there has been a marked inconsistency between economic theory and empirical evidence. As pointed out by Davoodi and Zou [3], it is an unquestioned belief in the basic theory that due to informational advantage based on a physical and institutional proximity to local residents, the devolution of political and administrative power to lower level governments leads to improved economic efficiency in local public service delivery and thus augments the growth rate at the national and regional levels. This is the so-called Oates' Decentralization Theorem. The fundamental assumption underlying this belief is that residents could move and choose between jurisdictions that provide different packages of local public goods and taxes. In this Tiebout mechanism based on "voting with feet," local governments are required to respond to the residential demand for public services in an efficient and effective way. Otherwise, residents would consider moving away to municipalities that are better managed.

Nevertheless, the existing evidence does not necessarily support the above theory. Actually there is a mixed picture of the effect of decentralization on economic growth both in cross-country analyses and in studies within a single country. Davoodi and Zou [3], investigating the impacts of fiscal decentralization on economic growth with cross-country data from 1970 to 1989, show that there is a significant negative relationship between fiscal decentralization and growth in developing countries, and none in developed countries. They interpret this unexpected negative correlation to mean that the measurement of fiscal decentralization fails to capture different welfare effects of capital and current spending. Excessive current expenditure by local governments is unlikely to lead to higher growth. In addition, another possibility is that local governments are not being responsive to local citizens' preferences and needs since the responsibilities and authority imparted to them, as well as their financial resources and administrative capability, are insufficient.

Zhang and Zou [15] also find that a higher degree of fiscal decentralization is associated with lower regional economic growth in China. Based on annual data on 28 provinces in China during the period from 1986 to 1992, the coefficient of fiscal decentralization, which is measured by the rate of per capita provincial budgetary spending to per capita central budgetary spending, is estimated at -0.054. This means that an increase in sub-national government level expenditure causes a decline in the real growth rate of regional income. Since the 1970s, China has promoted fiscal reforms with the aim of decentralizing fiscal expenditure and ensuring the central government's role on the fiscal revenue side (World Bank [12]). In the first half of the 1990s, there was a concern that the fiscal decentralization in China was implemented too rapidly and too extensively (Ma [6], Zhang and Zou [15]). Paradoxically, nevertheless, China has been exhibiting a remarkable and stable economic performance since the latter 1990s.

The final evidence contradictory to Oates' Decentralization Theorem is provided by Xie et al. [14]. They, examining how to relate fiscal decentralization to regional growth in the US economy from 1948 to 1994, find that the decentralization effect is hardly significant. The insignificant coefficients on sub-national government expenditure shares are