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Fiscal decentralization and economic growth reconsidered ☆

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Abstract

Recent studies examining the relation between fiscal decentralization and economic growth have failed to take account of the extent of the independent taxing powers available to sub-national governments and thus have substantially overstated the degree of effective decentralization. Results from a cross section study of 19 OECD member countries suggest that when the measure of fiscal decentralization is limited to the revenues over which sub-national governments have full autonomy, its impact on economic growth is not statistically significant.
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1. Introduction

The relationship between fiscal decentralization and long-run economic growth is ambiguous. Several economists have made the case for fiscal decentralization as a means of promoting long-run economic growth based on the view that it leads to better resource allocation and a more productive, and possibly smaller, public sector. This might be because locally determined policies are better able to take account of regional and local conditions in the provision of public goods, such as infrastructure and education (Oates [1]), or that competition among different levels of government promotes lower tax rates and the efficient production of public goods under

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revenue constraints (Brennan and Buchanan [2]), or that it provides incentives for local governments to innovate in the production and supply of public goods and services (Vazquez and Mc Nab [3]), or because there are greater incentives to save when public goods are tailored under fiscal federalism to young and old workers (Brueckner [4]). In contrast, others (e.g., Tanzi [5] and Ter-Minassian [6]) have stressed the problems that fiscal decentralization can create for macroeconomic policy coordination generally, and for implementing stabilization policies in particular.

The relatively few empirical studies of the relationship between fiscal decentralization and economic growth have tended to have rather mixed results. Most empirical studies have focused on the share of sub-national government revenue or expenditure in consolidated (national and sub-national) government revenue or expenditure as the measure of fiscal decentralization. Studies that have reported a positive and statistically significant impact using these measures include: Iimi [7], who reported a significant and positive impact of expenditure decentralization on per capita GDP growth in a panel of 51 developed and developing countries covering 1997–2001; Akai and Sakata [8], who found that the ratios of local government revenue and expenditure to combined state and local government revenue and expenditure had a positive and statistically significant impact on state GDP in a panel study of US states covering 1992–1996 (though when the revenue measure was restricted to 'own' revenues of sub-national governments the results were no longer statistically significant); Yilmaz [9], who distinguished between unitary and federal states in a panel study of 46 developed and developing countries using annual data for 1971–1990, and found that fiscal decentralization had a positive and statistically significant impact on growth in unitary states; Thießen [10], who reported a positive relation between decentralization and growth when decentralization is increasing from low levels, but that as decentralization increased, the relation eventually turned negative in a cross section of high-income OECD economies using annual data for 1973–1998; and Lin and Liu [11] who reported that the marginal retention rate of national budget revenues collected at the provincial level had a positive and statistically significant impact on the growth of real per capita GDP in China following the fiscal decentralization of the 1980s. In contrast, Zang and Zou [12] found a negative relation between fiscal decentralization and the growth of provincial incomes in China during 1980–1992. Studies that have found no significant statistical relation between growth and fiscal decentralization, include: Davoodi and Zou [13], who reported a negative but not statistically significant effect of expenditure decentralization on economic growth for developing countries and no clear relationship for developed countries using panel data for 46 developed and developing countries covering the period 1970–1989; Woller and Phillips [14], who reported no significant relationship between the ratios of sub-national revenues and expenditure to total revenue and expenditure using average data for 1974–1991 for 23 developed and developing countries; and Xie, Zou and Davoodi [15], who found no such statistically significant relationship when looking at fiscal decentralization and state income in the USA.[1]

A serious problem with much of the literature on the macroeconomic impact of fiscal decentralization is that it fails to make an appropriate distinction between "administrative" and "substantive" decentralization by not recognizing that high sub-national revenue and spending shares do not necessarily indicate high local autonomy. This is particularly the case in the empirical literature where the measures of decentralization used are often poor proxies for the degree of autonomy that sub-national governments have in practice. For example, revenue decentralization

[1] In a related study, Stansel [16] defined fiscal decentralization in terms of the number of municipalities and counties per 100,000 residents and reported a positive and statistically significant relation between these variables and metropolitan area growth in the United States; however, his study did not consider financial indicators of fiscal decentralization.

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