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Fiscal decentralization and deficits: International evidence

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ABSTRACT

This paper investigates macroeconomic effects of fiscal decentralization, which has been a neglected area of research. Panel evidence for 16 countries over 1980–1998 indicates that expenditure and revenue decentralization reduce budget deficits. A principal finding is that the fiscal disciplining effect of fiscal decentralization increases with population size. Interestingly, absence of local elections is associated with greater effectiveness of fiscal decentralization. The benefits of expenditure decentralization decrease with ethnolinguistic fractionalization and quality of governance.

1. Introduction

Fiscal decentralization (FD) occurs through devolution of responsibilities for public spending and revenue collection from the central to local governments. FD has been a feature of economic reform programs based on the following arguments: (i) decentralization of spending increases efficiency because local governments have better local information and hence can better match policies with the preferences of citizens (Samuelson, 1954; Oates, 1972, 1993); (ii) decentralization of fiscal activity increases accountability and transparency of public good delivery (de Mello, 2000a); and (iii) taxpayers are more willing to cooperate with the accountable local governments (Wasylenko, 1987).[1] Following on from these arguments, we would predict that FD decreases government deficits. With the exception of De Mello, 2000b), this prediction has not received much attention.[2] De Mello (2000b) examined fiscal structures in a number of countries and reported negative effects on fiscal balances due to coordination failures in intergovernmental fiscal relations, especially in low-income countries.[3] The study reported here goes beyond de Mello (2000b) in addressing the role of the institutional and structural factors that influence the relationship between FD and budget deficits and in treating separately expenditure and revenue decentralization.

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[1] Panizza (1999), in an overview of the theoretical literature on FD, groups studies according to optimal division of powers (decentralization theorem), the role of organization costs, and competition among jurisdictions.

[2] See however King and Ma (2001) and Neyapti (2004), both of which found a negative relationship between revenue decentralization and inflation. Davoodi and Zou (1998) found a negative relationship between FD and growth in less developed countries. Martinez-Vazquez and McNab (2006) view the empirical evidence on the relationship between FD and growth as mixed. Thiessen (2003) demonstrates that, for high-income OECD countries, there is an intermediate level of FD beyond which the positive growth effect disappears. Jin and Zou (2002) demonstrate that expenditure decentralization increases the size of aggregate government but revenue decentralization has the opposite effect. Kappeler and Välilä (2008) show based on European data that FD boosts the relative share of economically productive public investment such as infrastructure.

[3] De Mello (2000b) measures coordination failures due to common pool and agency problems by expenditure decentralization and sub-national revenue autonomy and dependency.

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An investigation of the effects of FD on budget deficits should address both expenditure and revenue aspects of FD. The literature emphasizes that decentralization of fiscal expenditures may increase the efficiency of local public good delivery when a country is large, heterogeneous, or ethno-linguistically fractionalized because it is especially in these cases that local governments are in a better position than the central government to assess local preferences.[4]

While decentralizing budgetary spending may be efficiency enhancing, expenditure and revenue decentralization can have drawbacks. Local governments may have limited tax bases or fail to take full advantage of existing tax bases, and local debt issuance and management capacity may be limited.[5] Limited revenue autonomy of local governments implies that their expenditure autonomy is also limited, making local governments mere spending units of central governments. The common pool problem arising from not-fully internalized costs of local fiscal actions may lead fiscal imbalances to increase. These disadvantages may be so great as to outweigh the increased likelihood of taxpayer compliance in revenue collection when fiscal activity is decentralized. Moreover, FD without an effective central redistributive system may result a more unequal income distribution if revenue bases vary across regions (see, for example, Zhang, 2006 and Bouton et al., 2008).

There are various arguments against expenditure decentralization. First, local governments may lack of economies of scale in the provision of public goods; information and coordination costs may be higher for local governments because of lack of institutional and administrative capacity.[6] Secondly, if local vested interests are powerful, decentralization may increase corruption and social fragmentation in the absence of local accountability.[7] Thirdly, decentralization may increase competition and political tension among local governments. Fourthly, coordination problems across different tiers of the government may lead to a deficit bias and thus hinder fiscal reforms and implementation of macroeconomic adjustment. Finally, the central government may unable to credibly commit to a hard-budget constraint (no bailout of the local government) due to political concerns (Goodspeed, 2002). The literature therefore proposes arguments both in favor and against the effectiveness of fiscal decentralization in improving fiscal performance.[8] Tanzi (2000) notes that the effectiveness of FD in improving allocative efficiency depends on such factors as the size of country, the extent of privatization in the economy; ability of local governments to raise revenue; transparency; and local administrative and institutional capacity.[9]

In view of the foregoing arguments and the common pool problem (see Hillman, 2009 chapter 9), decentralization of fiscal activity is predicted to increase the fiscal burden. This problem can in principle be limited or eliminated through local accountability and “good governance”. Efficiency gains of fiscal decentralization in large heterogeneous countries may compensate for the increase in the spending bias. I account for structural and institutional factors, including country size, quality of governance, local accountability, and the extent of ethnolinguistic fractionalization and test the hypothesis that the disciplining effect of FD is conditioned by these factors.

The evidence presented in this paper provides strong support for the hypothesis that both expenditure and revenue decentralization reduce budget deficits. The effectiveness of fiscal decentralization in reducing deficits is enhanced by greater population, although deficits increase with population size on average. There is also suggestive evidence that the benefits of FD through fiscal discipline increase when governance and local accountability are inadequate. Ethnolinguistic fractionalization enhances the effectiveness of revenue decentralization in achieving fiscal discipline but not expenditure decentralization. Output growth, income levels, and governance and local accountability reduce budget deficits. The impact of the size of the government is significantly positive, as expected. These results generally survive robustness tests.

The structure of the paper is as follows. Section 2 presents the data and methodology. Section 3 reports the empirical findings. Section 4 concludes.

2. Data and methodology

Sub-national levels of government are not uniform across countries. For consistency, this study takes the sum of local and state and provincial levels of government where both available as the indicator of sub-national government activity.[10] Expenditure decentralization is measured as the share in total government spending of the spending of both state and provincial governments and local governments (*FDexp*). Revenue decentralization (*FDrev*) is measured in the same manner, using data on revenues

[4] Adam et al. (2008) provide evidence in favor of increased public sector efficiency associated with FD in the OECD region. Kyriacou and Sagales (2009) show that the evidence regarding FD's effect on government efficiency depends on countries' level of development and institutional characteristics.

[5] There may be legally imposed limitations on sub-national borrowing in some cases.

[6] See, for example, Blanchard and Shleifer (2000), and Bradhan and Mookherjee (1998).

[7] Based on a study of Russian case, Fleinkman and Pleakanov (2005) observe that decentralization distorts incentives particularly in rentier regions, and propose a higher degree of intraregional decentralization in such regions.

[8] Among the empirical cross-sectional studies, de Mello (2000a) shows that higher *social capital*, defined as confidence in government, civic cooperation and associational activity, is positively related with fiscal decentralization. De Mello and Barenstein (2001) also find evidence that good *governance* is positively related with sub-national spending levels, and the higher are non-tax revenues the stronger is this relationship. Fisman and Gatti (2002) find a strong negative relationship between expenditure decentralization and *corruption,* although Treisman (2000) observes no significant relationship between the two variables, due possibly to different measures of corruption and inclusion of more control variables. Based on the case of China, Chen (2004) argues that revenue decentralization may lead to a helping-hand form of corruption. Case studies on the effects of FD are generally inconclusive (see, for example, Barrett, 2000; Dethier, 2000; Eaton, 2001; Faguet, 2001; Feltenstein and Iwata, 2005; Hope, 2000; Lin and Liu, 2000; Neyapti, 2005; Norris et al., 2000).

[9] See for example Panizza (1999), Von Braun and Grote (2002), and De Mello (2000a). Tanzi (2008) argues that historical and global developments are important for determining optimal fiscal arrangements (see also Vaubel, 2009, and Tanzi, 2009). Stegarescu (2009) proposes that integration has increased FD in the OECD region.

[10] For a check of robustness, I also repeated the regression analysis using two other alternative definitions of decentralization: i) the ratio of state and provincial government expenditure (or revenues) to the total of central and state and provincial expenditures (or revenues) and ii) the ratio of local spending (or revenues) to the total of central and local expenditures (or revenues). The results of those regressions are discussed.