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
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. 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 de-
centralization 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 numer-
ous 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 oc-
cur 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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