

Decentralization and political institutions[☆]

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Abstract

Does fiscal decentralization lead to more efficient governance, better public goods, and higher economic growth? This paper tests Riker's [Riker, W. (1964) "Federalism: Origins, Operation, Significance," Little, Brown and Co, Boston, MA.] theory that the results of fiscal decentralization depend on the level of countries' political centralization. We analyze cross-section and panel data from up to 75 developing and transition countries for 25 years. Two of Riker's predictions about the role of political institutions in disciplining fiscally-autonomous local politicians are confirmed by the data. 1) Strength of national political parties significantly improves outcomes of fiscal decentralization such as economic growth, quality of government, and public goods provision. 2) In contrast, administrative subordination (i.e., appointing local politicians rather than electing them) does not improve the results of fiscal decentralization.

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1. Introduction

Political incentives of public officials determine whether fiscal decentralization is beneficial for public goods provision. We define fiscal decentralization as devolution of authority over public revenue and expenditure to lower-level government and use this term interchangeably with federalism. The three classic channels which make fiscal decentralization beneficial – inter-jurisdictional competition (Tiebout, 1956), informational advantages (Hayek, 1948), and higher preference homogeneity (Oates, 1972) – all rely on the premise that local politicians have political incentives to respond to the needs of local population. A classic cost of federalism – regionalist policies in the presence of inter-jurisdictional spillovers (Musgrave, 1969; Oates, 1972) – relies on the premise that political incentives of local politicians make them cater to their own constituency but ignore preferences of populations in other jurisdictions of the country. This logic gives rise to a trade-off between national and local preferences in political incentives of local officials in a federation. On the one hand, to realize the benefits of federalism, local politicians should have sufficiently high weight placed on the preferences of the population of their own jurisdiction. On the other hand, to minimize inter-jurisdictional externalities, local politicians should place some weight on voter preferences in other jurisdictions of the country. Henceforth, we refer to the latter side of this trade-off, i.e., to having local political incentives aligned with national interests, as political centralization. Since political incentives are shaped by political institutions, a fiscally decentralized country needs political institutions that strike a balance between the interests of local and national populations.

Riker (1964), in his seminal book *Federalism: Origins, Operation, Significance*, named two political institutions that achieve political centralization: strong national political parties and administrative subordination (i.e., having central authorities appoint local governments rather than having them being elected). According to Riker, only strong national political parties achieve the necessary balance between national and local interests. On the one hand, even with very strong national political parties, the presence of local elections ensures political accountability of local politicians to their constituencies. On the other hand, strong national parties align political incentives of local politicians with national objectives by affecting career concerns of local politicians. First, strong parties have higher leverage over promotions of local politicians to national-level politics compared to weak parties. Second, political support of a strong national party during local elections is more valuable to local politicians than that of a weak party. Local politicians internalize inter-jurisdictional externalities of their policies in the search for promotion and political support by their national governing party because the party cares about national-level performance.

In contrast to strong national political parties, administrative subordination weakens local accountability. It solves the problem of inter-jurisdictional externalities by having central-level politicians reappoint only those local officials who are “well-behaved” from central officials’ point of view. This, however, undermines the benefits of federalism in the first place: in focusing on pleasing their bosses, appointed officials may stop caring for the preferences of local population even though they know them better than central politicians.

Recently, several papers pointed to an additional potential cost of federalism — “local capture,” namely, the situation when the influence of special interests on public policy is higher at the local compared to the central level (Blanchard and Shleifer, 2001; Bardhan, 2002; Sonin, 2003). Blanchard and Shleifer (2001) indicated that, if local governments are more vulnerable to capture than central governments, then appointing local officials in a federation is beneficial. This condition is very restrictive, however; and it could be the case that neither central nor local authorities serve broad public interests (Bardhan and Mookherjee, 2000). Note that if this condition holds, strong

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