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THE ROLE OF FISCAL DECENTRALIZATION IN ECONOMIC GROWTH

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A focus of the Institutional Reform and the Informal Sector (IRIS) Project is an enhanced understanding of the role of institutions and democratic processes in economic growth with a particular emphasis on local organizations and individual initiatives. For such a study, the strengthening of private-sector enterprise will naturally be a basic theme. At the same time, however, there is a fundamental need to reconsider the structure of the public sector and to try to understand more fully how government institutions can contribute to economic performance. In particular, "breaking the grip" of central planning has two dimensions: the development of a healthy and productive private sector and the creation of "local" public institutions that are more responsive to local needs and circumstances than are central planners. It is the latter of these issues that is the subject of this proposed research. My thesis is that fiscal decentralization has a fundamental role to play in the course of economic development.

I have been struck in some of my international empirical work on fiscal decentralization [see Oates (1972, Ch. 5, and

1985)] by the quite marked and systematic differences in public-sector structure between the industrialized and developing countries. Of note here is the finding that fiscal decentralization is much greater in the industrialized, than in the developing, nations. In my recent empirical study of "Leviathan" (1985), the central-government share of total public spending was, on average, .65 in my sample of 18 industrialized countries and .89 in my sample of 25 developing nations. The differences are quite striking with several developing countries essentially totally centralized with central-government expenditure shares of .99. Developing countries, in short, tend to have highly centralized public finances.

While this is a striking "stylized fact," its meaning and interpretation are not straightforward. Is fiscal decentralization a "cause" or a "result" of economic development? Or, more likely, is it the result of a more complex interplay of forces over the process of economic growth? There are some strong reasons for believing that decentralized fiscal choice has a real contribution to make to economic performance. In a static setting, the "Decentralization Theorem" (Oates, 1972, pp. 54-63) makes the straightforward point that "local" provision of certain kinds of public goods in accordance with local benefits and costs results in higher levels of social welfare than a centrally determined and uniform level of provision across all jurisdictions. In short, the tailoring of outputs to local circumstances results in a more efficient pattern of public outputs.

The thrust of this argument should also have some validity in a dynamic setting of economic growth. One dimension of this research will, in fact, be to extend the Decentralization Theorem to an intertemporal setting and to explore the various ways in which decentralized fiscal choice can influence the rate and path of economic growth. There surely are strong reasons, in principle, to believe that the formulation of policies for the provision of infrastructure and even human capital that are sensitive to regional or local conditions are likely to be more effective in encouraging economic development than policies that are wholly centrally determined. There is, at this juncture, no real theory of the relationship between fiscal decentralization and economic growth. One objective of my research will be to construct a conceptual framework for thinking about this issue.

Complementary to these efforts will be an empirical study of fiscal decentralization and economic growth. This will involve both time-series and cross-sectional analyses that will explore the experience of various countries over time and also will compare the public-sector structure and growth performance of a sample of countries. The next two sections of this proposal describe, respectively, the conceptual and empirical components of this research. But I would stress that the components are integrally related: the empirical work will both serve to test certain "hypotheses" emerging from the theoretical work and to suggest how fiscal decentralization interacts with other elements of the economy in the process of economic growth.

1. Toward a Theory of Fiscal Decentralization and Economic Growth

As suggested in the introduction, the basic idea here is that decentralized decisions in response to local conditions can enhance economic efficiency. A first step in the basic conceptual work will be to extend the Decentralization Theorem from a static to a dynamic framework. The objective here is simply to embed the basic principle of increased efficiency from decentralized choice in an intertemporal setting. On first glance, this may seem a trivial exercise--it is virtually a tautology that social welfare increases with outcomes tailored to the preferences of local groups as compared to uniform, centrally determined outcomes. But the exercise has some value. In particular, it reveals the parameters on which the gains from decentralization depend. If cost and demand functions have certain properties, the gains from decentralized public choice may be modest--with other properties, the gains can be quite large. [See the discussion of the Decentralization Theorem in Oates (1972).]

This exercise will involve a basic growth model with two or more "regions" in which investment decisions are region-specific. The analysis will explore growth paths under various forms of investment policies--some of which involve a centrally determined and uniform pattern of investment across the regions and others which allow for regional differentiation in such policies. The analysis should help to get some sense of the working and potential gains from a more decentralized approach to growth policies; it will provide a conceptual framework for thinking about thie issue and for empirical study.

In addition to exploring the potential gains from fiscal decentralization, it is important to extend the analysis to examine the incentive structure for local fiscal choice [Bird (1990)]. This takes us into the realm of "public choice" and the study of various collective decision rules [Bennett(1990)]. The public finance literature has, in fact, raised some basic concerns about the "competitive" character of local policies for economic growth [Fisher (1988, Ch.21)]. George Break, for example, has argued that fiscal competition among decentralized jurisdictions is likely to be destructive from a broader perspective. Break (1967) contends that "tax competition" among states and localities to attract "new business...tends to produce either a generally low level of state-local tax effort or a state-local tax structure with strong regressive features" (pp.23-4). The basic argument then is that decentralized fiscal competition to promote economic growth is likely to lead to distortions in resource allocation.

Oates and Schwab (1988) take issue with this general contention. In a model of local fiscal choice in which jurisdictions compete for a mobile stock of national capital, they find that, for their basic case, such competition is efficiency enhancing: local fiscal competition leads to an efficient allocation of capital across localities. This result is not overly robust in that it is easy to amend the model in ways that can introduce distortions. But the analysis does suggest that in a setting in which local choices are made in accord with majority rule, fiscal outcomes are economically efficient. The Oates-Schwab model is, however, a static one and needs to be extended to a dynamic framework. They have extended the model to a two-period case in a more recent paper (1989).

For purposes of analysis, one can envision the regions or localities as productive units, each with distinctive contributions to make to overall national growth. The issue then becomes one of allocating investment and using other growth-enhancing measures in such a way as to optimize growth for the country as a whole. One issue of central importance here is "balance" among the regions. It may well be that to maximize the national rate of economic growth requires that some regions grow much more rapidly than others. In view of concerns with regional equity, this may not be a politically acceptable course for development. Indeed, much of the literature on regional economic development focuses on disparities among regions and addresses policies to bring "lagging" regions up to higher levels of eocnomic performance [e.g., Zimmerman (1990)]. The theoretical work will, for this reason, explore possible conflicts between policies for maximizing national growth with various sorts of "constraints" to recognize the concern with regional imbalances.

One further dimension to decentralization is the revenue side of the public budget. Local governments often rely heavily on revenue sources (such as property taxes and user fees) that receive less attention from the central government. The result is that a relatively decentralized public sector will tend to have a rather different tax structure from a more centralized fiscal system. This issue has received some attention in the literature on fiscal federalism where it is known as the "tax-assignment problem"--the issue of the assignment of particular revenue instruments to different levels of government [see McLure (1983)]. Tax structure obviously has important implications for capital formation and growth; consequently, it will be useful to explore the likely shifts in tax structure as the fiscal system becomes more decentralized and to examine the implications of these shifts for capital formation and growth.

2. Empirical Research on Fiscal Decentralization and Economic Growth

Complementary to the conceptual work sketched out above will be a series of empirical efforts to study the relationship between fiscal decentralization and economic growth. This will involve both time-series and cross-sectional analysis. It should be instructive to look at the experience over time of some of the industrialized countries--and to see how fiscal decentralization varied over the course of development. Wallis and Oates (1988a, 1988b) have explored some of these relationships for a panel data set, using the 48 coterminous states in the United States for their sample. The idea here will be to develop a better sense of the interaction between economic growth and fiscal decentralization.

At the same time, there is, I suspect, something to be learned from a cross-sectional analysis that seeks to explain econometrically the differences in the extent of fiscal decentralization across countries and the differences in growth rates with reference to fiscal decentralization. Much of my initial effort will involve the construction of a data base with which to address these issues. The data exist. Both the IMF and OECD publish regularly figures on public-sector finances that provide a breakdown between central and decentralized government units. Usaing these data, one can construct various summary measures of fiscal decentralization: the central government share of public expenditure, the central government share of revenues, etc. Such "centralization ratios" have been used in the literature for purposes of econometric analysis of public sector structure.

One strand of the empirical work will thus involve looking for suggestive relationships between rates of economic growth and measures of fiscal decentralization (after controlling for other determinants of growth). The econometric modelling will draw on (and interact with) the conceptual work described in the preceding section.

A second strand will focus on the experience of a number of developing countries. Looking at growth performance over the past few decades, I hope to examine in greater depth (including a close look at individual institutions) the role that fiscal decentralization has (or has not) played in the developing countries with a relatively successful growth effort as compared to those countries that have fared less well.

Finally, I have one specific, and potentially intriguing, study in mind. Rati Ram (1986), in a recent and provocative paper, has analyzed the relationship between government spending and economic growth using a large sample of 115 countries. Drawing on the Summers-Heston (1984) data base, Ram estimated an econometric model that incorporates an "externality" effect of the government sector on private output. In the Ram model, the provision of public services provides infrastructure that enhances productivity in the private sector. Ram's analysis generates estimates of this externality effect for his sample of 115 countries. If his results are reliable (and this requires careful consideration), they provide an intriguing set of measures of the "effectiveness" of the government sector in promoting economic growth. My proposal is to take his measures as variables to be explained--and to see if they bear any relationship to the indices I will develop of fiscal decentralization. If decentralized fiscal choice is, in fact, a mechanism through which economic growth can be encouraged, we would expect to find that Ram's measure of public-sector "effectiveness" on private-sector growth is positively related to the degree of fiscal decentralization. I have an honors student who is writing his thesis this year on this precise topic. And his work will get this effort underway.

3. Some Further Notes

In summary, my research plan is basically one in which I hope to move forward on both conceptual and empirical fronts at the same time. The theoretical work on economic growth and fiscal decentralization will, I hope, interact in fruitful ways with empirical efforts to understand how decentralized fiscal choice has influenced (and been influenced by) economic development.

Part of the early work will entail a quick literature survey. I am quite familiar with the research on fiscal federalism that bears on this study. However, I know less well the literature in economic development that addresses the issue of fiscal decentralization and its impact on economic performance. It is thus important to become familiar with this body of work.

I may be able to draw on the collaborative efforts of John Edwards at Tulane University. John's research interests span two fields: local public finance and economic development. He has published extensively in both fields and has done substantial work on local finance in the developing nations. I have spoken with John about this work--and he has expressed an interest in taking part in it.

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