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THE ROLE OF FISCAL DECENTRALIZATION IN ECONOMIC GROWTH

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FISCAL DECENTRALIZATION AND ECONOMIC DEVELOPMENT

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The point of departure for my contribution to this symposium is the striking contrast in the extent of fiscal centralization of the industrialized and the developing countries: government in the developing nations appears to be far more centralized (as measured by existing fiscal indices) than in the industrialized countries. This marked differential in degrees of fiscal centralization is widely documented. Over two decades ago in an empirical study of fiscal federalism (Oates, 1972), I found, for a sample of 58 countries, that measures of fiscal centralization were significantly and negatively correlated with levels of per capita real income. And, more recently, using a sample of 43 countries, my sample statistics (1985) revealed an average share of central-government spending in total public expenditure of 65 percent in the subsample of 18 industrialized countries as contrasted to 89 percent in the subsample of 25 developing nations. In terms of public revenues, the average share of central governments in the developing countries was in excess of 90 percent![1]

These measures thus suggest that central government in the developing countries assumes the lion's share of fiscal responsibility. Bird (1986), among others, has expressed some legitimate reservations concerning the validity of fiscal data from the developing nations and the resulting summary measures of the sort I have just cited. There are, in particular, some serious problems regarding the extent of coverage and comparability. Moreover, there is considerable variability among countries within the samples. Nevertheless, the generalization that the developing countries are characterized by relatively high degrees of fiscal centralization appears to stand up pretty well. There are various kinds of corroborating evidence. Writing some 37 years ago, for example, Martin and Lewis (1956) observed that "The weakness of local government in relation to central government is one of the most striking phenomena of under-developed countries" (p. 231).

While this systematic difference in fiscal centralization across industrial and developing countries is a well-established property of fiscal structure, its meaning and implications are much less clear. What are we to make of this? In particular, is fiscal decentralization a "cause" or a "result" of economic development? Or, more likely, is it a more complex outcome of the interplay of a variety of forces that accompanies economic growth?

A better understanding of these relation-

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ships is important, for there is much current interest in the potential contribution of fiscal decentralization to economic development. Shifting greater responsibility to local authorities is seen by many as a way to break the "grip" of central planning and mismanagement that has bedeviled efforts to set poorer nations on a course of self-sustaining growth. Both political leaders within the developing countries and advisors from without have sounded the call for decentralization as a mechanism to make policy more responsive to local needs and to involve the local populace in processes of democratic governance. As de Valk (1990) points out, it is interesting in this regard that this "resurgence of interest in decentralization" appears to have less of a political focus and more of a concern with increasing "effectiveness and efficiency" in development planning and implementation (p. 5).

From a sharply contrasting point of view, the growth of the local public sector may be seen as largely the result of economic development. The contention here is that, as economies mature and incomes rise, the economic gains from fiscal decentralization emerge. At some point, it becomes worthwhile to differentiate outputs in local jurisdictions according to local demands. This appears to be the view, for example, of Bahl and Linn (1992), who argue that "Decentralization more likely comes with the achievement of a higher stage of economic development" (p. 391) and that the "threshold level of economic development" at which fiscal decentralization becomes attractive "appears to be quite high" (p. 393). From this perspective, it is economic development that comes first; fiscal decentralization then follows.

My purpose here is to explore somewhat more systematically the sources and implications of this observed inverse relationship between fiscal centralization and the level of economic development. I begin with a more historically oriented exploration of the trends in fiscal centralization that yields a very different picture of the matter from the cross-sectional pattern just cited. From this perspective, I turn to some of the issues that Bird raises in his paper, putting them in the context of the developing countries.

THE EVOLUTION OF THE LOCAL PUBLIC SECTOR

Let me begin by returning to the Bahl-Linn thesis that a major role for the local public sector tends to emerge at the later stages of economic development. This view is based largely on the modern theory of local finance that envisions the local sector as responding to a variety of different tastes for local services. There are two strands to the argument. First, the local sector is seen as responsive to local demands. Making use of the median voter model or other models embodying some sensitivity to voter preferences, the analysis of local finance envisions the local sector as providing outputs of local services that are closely tailored to the demands of the local constituency. In the median-voter framework, the equilibrium level of local services mirrors faithfully the median of the preferred levels of outputs of local residents.

The capacity of the local sector to satisfy consumer preferences is enhanced by a second dimension to the theory of local finance based on consumer mobility. Drawing on the famous Tiebout model (1956), this strand of the literature describes a world of mobile households that "vote with their feet" by choosing as a jurisdiction of residence a community which provides the most desirable fiscal package. Thus, both through responsiveness to the local electorate and through fiscal mobility (the "voice" and "exit" options as Hirschman (1970) has called them), the local sector makes an important contribution to efficient resource allocation by ensuring that individuals, as in their choices of private goods, are able to obtain outputs of local services that equate fairly accurately marginal benefits and costs.

The Bahl-Linn contention is that this vision of the local sector has descriptive and normative power primarily in the industrialized countries. The local sector functions very differently in developing countries; it is sometimes a manipulative and exploitative instrument. It is only at well-advanced stages of economic development that a responsive local sector, like that sketched out previously, can be expected to emerge.

This view would seem to imply that, from the perspective of the evolution of the local public sector over time, we should expect to observe a continuing growth in the relative importance of local finance. This suggests that we might gain some insight from supplementing our cross-sectional data on fiscal centralization with some time-series studies of the evolution of local finance.

Some limited empirical work on this matter exists. I have pulled together elsewhere (Oates, 1975) data on a few industrialized countries, and Wallis and I (Wallis and Oates, 1988) have assembled a detailed body of twentieth century data on the U.S. public finances. These data, covering the last century or so, describe a process that does not correspond at all well to the view described earlier. In fact, if we pick up the story late in the nineteenth century, we find a very striking process of public-sector *centralization* in progress. In the United States, for example, the central-government share of total government spending was only around 30–35 percent at the turn of the century; by 1955, this share had risen from about one-third to two-thirds of public expenditure. Likewise, for the United Kingdom, the central-government share of total expenditure rose from 57 percent in 1895 to 75 percent in 1955 (Oates, 1975).

Thus, the trend in vertical fiscal structure over most of this period was toward increased fiscal centralization. This led de Tocqueville in *Democracy in America* to the ". . . opinion that, in the democratic ages which are opening upon us . . . centralization will be the natural government" (1980, vol. II, p. 296). In a like vein, Bryce (1901), writing at the turn of the century, saw centralization as a prevailing tendency; in his view, ". . . the centripetal forces are permanent and secular forces, working from age to age" (p. 844), and he notes ". . . the normal tendency to aggregation and centralization" (p. 844) in the public sector. McWhinney (1965) has gone on to enshrine "Bryce's Law," the proposition that ". . . federalism is simply a transitory step on the way to governmental unity" (p. 105).

This surely does not sound like a process of growing reliance on local government! It is certainly true, of course, that the trend toward increased centralization was hastened in the first half of the twentieth century by cataclysmic events. Two World Wars and the Great Depression placed heavy demands on central governments. Such violent social disruption and the predominant role for central government that it produced gave rise, in the view of Peacock and Wiseman (1961), to certain "displacement effects" that were never fully rectified after the events. Central government took on, and never relinquished, its predominant role in the public sector.

The evidence does suggest, however, that centralizing tendencies played out around the middle of the twentieth century. Fiscal centralization ratios for most of the industrialized countries appear to have peaked in the 1950s and, since that time, have actually declined modestly (Oates, 1975; Pommerehne, 1977). These more recent trends appear to have belied any simplistic notions of increasing fiscal centralization. What we seem to be observing is a more complicated process with both decentralizing and centralizing forces at work, a process that is resulting, for example, in devolution in a number of OECD countries and, at the same time, in a new top layer of government in the European Community!

A historical view thus presents a much more complex and less clear view of the relationship between fiscal decentralization and economic development. What are we to make of this regarding the current state of the developing nations? My own sense is that the historical experience of the industrialized nations is, in this particular respect, of limited relevance to the developing countries. This is largely because the latter have a very different starting point for their process of economic growth. As Conyers (1990), among others, stresses, "Most less developed countries inherited relatively centralized systems of government from their colonial powers, and in the first years of independence there was often a tendency to maintain—if not strengthen—central control and centralized systems of planning, in order to encourage a sense of national unity and reinforce the new government and its policies" (p. 16). Many of these countries have thus effectively initiated their modern statehood with highly centralized government sectors. They have not undergone the kind of evolution that seems more characteristic of the industrialized countries.

This suggests that the potential of fiscal decentralization for facilitating economic development has to be evaluated largely in terms of the particular circumstances of the developing countries in their current state. The evolution of the public sector in the industrialized countries may contribute some insights, but it is unlikely to provide a "model" for the evolution of the public sector in the developing countries. I might add here that I think there is some truth in the Bahl-Linn contention that economic growth creates an environment favorable to the gains from fiscal decentralization (Oates, 1975). But it does not follow from this that local government finance has little to offer the developing countries at this juncture in history. This issue requires consideration on its own terms. In the next section, I offer some thoughts on all this, drawing on Bird's useful treatment of decentralized finance.

FISCAL DECENTRALIZATION TO FACILITATE ECONOMIC DEVELOPMENT

The 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. Although this proposition has been developed mainly in a static context (see my treatment of the "Decentralization Theorem,' 1972), the thrust of the argument should also have some validity in a dynamic setting of economic growth. There surely are strong reasons, in principle, to believe that policies formulated 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 centrally determined policies that ignore these geographical differences. There is, incidentally, no formalized theory of such a relationship between fiscal decentralization and economic growth; it would probably be useful to work through such a theory (in which investment programs are "jurisdiction-specific") to determine the parameters on which these gains depend and some idea as to orders of magnitude.

While some basic theory would be helpful here, such theory does not come to terms with the fundamental issue of how local government actually works in developing countries. The economic case for decentralized finance is based on the presumed responsiveness of local governments to the welfare of their respective constituencies. But is there good reason to believe that such responsiveness exists? As Conyers (1990) argues, ". . . decentralization may increase the participation of people at the local level, but sometimes it is only a small privileged elite group who get to participate" (p. 18). And such elites may pursue their own narrowly focused self-interest. In short, will decentralization simply involve exchanging a central "tyrant" for a local tyrant with resulting policies that do not address the welfare of the local populace?

The whole issue of corruption is a closely related matter. Myrdal (1968) among others has made much of the debilitating effects of corruption on efforts to promote economic growth. Is there reason to expect that such practices are likely to be more or less prevalent at local, as contrasted to more centralized, levels of government? There exists little systematic evidence that I know of that sheds much light on these questions of the operation of decentralized finance, but they are clearly matters of great importance. While there is a compelling case, in principle, for decentralized finance, the case is obviously compromised if local government fails to perform.

In this regard, it does seem to me that certain conditions must be satisfied if local government is to have the capacity to perform effectively. These are conditions that Bird stresses in his paper and that effectively give local officials the scope for autonomous fiscal decisions and which provide the right kind of signals and incentives. I want here to echo Bird's emphasis on two particular conditions.

First, local authorities need their own independent sources of revenues. There is an important issue of "balance" in the vertical structure of revenues. Intergovernmental grants from central to local governments have an important role to play in the fiscal system, but they cannot be excessive. In some developing countries, such intergovernmental transfers account for the largest share of local revenues. This can undermine the autonomy and vitality of decentralized decision-making. If local governments are to have real and effective fiscal discretion, they must raise a significant portion of their funds from their own revenue sources. This is important for two reasons. First, in a political setting, central funds nearly always come with strings attached. If regional and local governments are heavily dependent on transfers from above, it is inevitable that central intrusion into expenditure decisions will be pervasive. Decisions concerning the menu and levels of local programs will become the result of negotiations between central and local authorities, undercutting local fiscal independence. Second, heavy reliance on grants destroys the incentives for responsible local decisions. It is essential that localities in choosing to expand or contract various programs consider carefully the cost of these decisions. If funding comes from "above," there may be little real economic cost to the locality associated with these decisions. Funding from own revenues, *especially at the margin* of local programs, is critical if decentralized choice is to play its proper role in the fiscal system.

The second condition, closely related to the first, concerns the nature of own revenues. In his paper, Bird devotes considerable attention, quite rightly, to the "characteristics of a good local tax." It is important in the vertical "assignment" of revenue instruments to ensure both that local taxes do not induce distorting movements of economic goods and activity *and* that they are tied, at least roughly, to benefits in order to provide the right sorts of cost signals to the community on local fiscal decisions. This second issue is not so easy in developing countries because of the absence of the requisite institutions for revenue administration. Korea presents an interesting case in this regard. Oh (1991), in his discussion of the ongoing devolution of the public sector in Korea, describes the shift of certain parts of the tax base to local government. Local government in Korea is coming to play a greater role in the raising of its own revenues, which, as we have discussed, is essential to the development of real local autonomy. At the same time, however, we find that the major tax being transferred to local government is the tobacco tax. While this tax is indeed the source of considerable revenues and puts local government on a sounder fiscal footing, it is not a very "good" local tax by Bird's criteria.

The property tax is, in my view, quite a good local revenue source, especially in conjunction with local user fees wherever possible. Requiring local property owners to pay for local services is both reasonably fair and provides the requisite cost signals to the community. But many developing countries do not have the administrative capacity at present to implement property taxation. There is, incidentally, much interest in all this, and there are ongoing efforts to provide assistance in the development of property tax systems in several developing countries. This is an important issue.[2]

In sum, decentralized finance appears, in principle, to have a potentially useful role to play in economic development. But the translation of this potential into a real contribution to economic growth depends on a number of crucial conditions regarding the responsiveness of local institutions to local welfare which, in turn, depends importantly on the proper structure of fiscal institutions.

ENDNOTES

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[1] Other studies have produced comparable findings. Bahl and Nath (1986), for example, found an average central government share in total public spending of 85 percent in their sample of developing countries. See also Pommerehne (1977) and Wasylenko (1987).

[2] See Bird (1992) and Bahl and Linn (1992) for extended treatments of these taxation issues in developing countries.

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