ECONSTOR
Make Your Publications Visible.

A Service of
ZBW
Leibniz-Informationszentrum Wirtschaft
Leibniz Information Centre for Economics

Saavedra, Loenardo Letelier

Article

Decentralising the public sector: Fiscal Decentralisation as a Mechanism to Modernise the State - Truths and Myths

CESifo DICE Report

Provided in Cooperation with:
Ifo Institute – Leibniz Institute for Economic Research at the University of Munich

Suggested Citation: Saavedra, Loenardo Letelier (2004) : Decentralising the public sector: Fiscal Decentralisation as a Mechanism to Modernise the State - Truths and Myths, CESifo DICE Report, ISSN 1613-6373, ifo Institut für Wirtschaftsforschung an der Universität München, München, Vol. 02, Iss. 1, pp. 15-20

This Version is available at:
https://hdl.handle.net/10419/166794

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

WWW.ECONSTOR.EU

Mitglied der Leibniz-Gemeinschaft

Fiscal Decentralisation as a Mechanism to Modernise the State: Truths and Myths

Leonardo E. Letelier Saavedra*

It has been argued that generally Fiscal Decentralisation (FD) enhances public sector efficiency and thereby constitutes a powerful mechanism to modernise the State. The extent to which such a view is supported by the empirical evidence is, however, a contestable issue. In the same way as the theoretical debate on the subject matter has been intense, the empirical evidence has made significant progresses in providing a more accurate diagnostic about the effects of FD. This paper presents a comprehensive review of this controversy, trying to distinguish between the truths and the myths concerning the potential benefits of FD.

Three questions are still open on the debate we are dealing with. One is the extent to which every government's function has to be decentralised. Whilst some evidence suggests that education and health are attractive areas to look upon, this is far from being clear for most other functions. Secondly, although FD appears to be good in some cases, it seems to be equally relevant to discuss whether this is valid for all countries, regardless of their institutional development and other idiosyncratic characteristics. Finally, even if we acknowledge that some countries and specific policies are the optimum candidates to be decentralised, there is still the need to specify the way in which this FD will take place. Although more FD involves some kind of devolution of public resources in favor of lower tiers of government, this may adopt a wide range of forms. In order to shed light on these questions, we first briefly describe the most important theoretical arguments both in favor as well as against FD. Secondly, the empirical evidence on these hypotheses is presented.

The theory on Fiscal Decentralisation

A common starting point on the subject under analysis is the so-called Decentralisation Theorem developed by Oates (1972). It asserts that "…the level of welfare will always be at least as high (and typically higher) if Pareto-efficient levels of consumption are provided in each jurisdiction than if any single uniform level of consumption is maintained across all jurisdictions" (Oates 1972, 54). Since any hypothesis on the subject entails a particular set of assumptions about the real functioning of independent jurisdictions, many theories can be built upon the theorem. They can be sorted into those that identify the likely positive effects of FD and those that emphasise its weaknesses. In this regard, Oates's theorem is a useful benchmark to take as a starting point. The theorem explicitly assumes no costs of FD and the absence of inter-jurisdictional externalities.

Pro-decentralisation hypotheses belong to three basic categories. The first one is what may be labeled the "information argument", which emphasises the gains derived from the fact that decentralisation gets public officers and politicians closer to the people they are supposed to serve. Since information on real local needs will be more easily available, public policies will be more efficiently designed. The second hypothesis hinges upon the analogy between decentralisation and the functioning of a competitive market. This is based on the assumption that fiscally decentralised jurisdictions will interact with each other in a similar way as firms compete in the market place. Accountability is being enforced by the "voting with the feet" mechanism, whereby residents penalize badly performing local governments by exerting their right to exit. Thirdly, the public choice school has popularised what might be called the Leviathan hypothesis, whereby decentralisation prevents tax-

* Leonardo Letelier S. is a researcher at the Department of Government, Institute of Public Affairs, University of Chile.

payer's exploitation by government's bureaucrats and in so doing it protects citizens from the dangers of the Leviathan.

However trendy, FD has numerous detractors. A first strand of criticism stresses the weaknesses of the view that competitive private firms may be assimilated to the case of independent jurisdictions playing in the political market. In the first place, there is the old and highly theoretical issue as to whether a competitive equilibrium between jurisdictions does indeed exist. Closely linked to this point is the extent to which individuals make their decisions about migration on the basis of the current performance of the particular tier of government they belong to. It may be hypothesised that some kind of "citizen's surplus" exists, which makes citizens value cultural affinities, ties of friendship, family and local economic connections beyond the performance of the jurisdiction where they live.

Secondly, a key issue to the caveats on FD is the assumption about externalities. Their existence raises numerous problems about the functioning of competitive jurisdictions making independent decisions. The case for externalities can easily be extended to the issue of tax competition and its potential effects on the efficient funding of local public goods. In so far as subnational governments are faced with a trade-off between higher tax rates and smaller tax bases, more FD leads to significant distortions in local tax structures. Similarly, decentralisation of some national public policies might result in severe coordination costs and underprovision of local public goods. The potential for this to jeopardize fiscal balance and macroeconomic stability has been widely discussed.

A third type of criticism can be put under the label of "technological" arguments. They hinge upon the characteristics of the particular technologies that are needed for the efficient provision of public goods. As long as decentralisation results in the loss of economies of scale, local budgets will rise excessively relative to what might be expected under a more centralised arrangement. On the one hand, it might be argued that developing countries need a significant degree of centralisation to build up its basic infrastructure. On the other, if economies of scale are a factor worth considering in the provision of some public goods, it follows that decentralisation may appear as a very expensive "good" which developing countries can hardly afford.

Fourthly, efficient local public provision can also be negatively affected by the shortage of some kind of input. This is likely to be the case when it comes to lower tiers of government's officers and their capacity to provide highly skilled quality public management. Moreover, access to up-to-date and comprehensive information will be initially available at the highest administrative level. Alongside the public management quality is the concern for corruption. Excess closeness of local officers from private local interests is a potentially dangerous fact in poor countries.

What we know about the effects of Fiscal Decentralisation

The first conclusion we can draw from the hypotheses above is that FD might improve the allocation of resources and thereby enhance growth. Evidence on this is, however, far from clear (Martinez-Vazquez and McNab 2003). The table below shows that neither cross-country estimations nor country-specific studies provide systematic evidence on the effect of FD on growth. Results seem to be sensitive to the data set being used in the estimations (Ebel and Yilmaz 2002), the proxy for decentralisation, the set of control variables in the regressions and the specific country being analysed (Zhang and Zou 1997, 1998; Lin and Lui 2000). A recent study on the case of Russia suggests that even the specific form of subnational governments' revenues appears to be relevant in the likelihood of FD having an effect on growth (Desai, Freinkman and Goldberg 2003).

If we accept that no strong evidence exists which relates FD with growth, it is still feasible that the quality of growth may indeed be effected. As long as quality of life involves good governance, it follows that a comprehensive account of indicators on government's performance should be positively related to FD. Existing evidence from the table below shows that generally FD appears to enhance good governance. In a well-quoted paper, Huther and Shaha (1998) found a significant and strong correlation between FD and a composite index of "good governance". Further support to this finding is given by De Mello and Barenstein (2001). Their results suggest that governance is only improved

when FD is very high and sub national governments' funding comes from non-tax revenues. Interestingly, while De Mello and Barenstein conclude that only a high degree of FD may lead to a significant effect on governance, further evidence given by Braun and Grote (2000) shows that this effect is decreasing on the level of FD. Closely related with the concept of good government is the potential relationship between decentralisation and corruption. The evidence available allows us to say that, while FD seems to reduce corruption when this is measured as the share of subnational governments on the general government's expenditures or revenues (Fisman and Gatti 2002; De Mello 2000a, Huther and Shah 1998), this result is reversed when the political definition of decentralisation is adopted (Treisman 2000a).

A similar research line has focused on more specific functional areas of government. Evidence showing that social capital might be positively affected by FD is provided by De Mello (2000a). By using cross country data, Letelier (2001) and Lindaman and Thurmaier (2002) support the finding that FD enhances the role of government on education and health. Country specific results confirms this in the case of Chile (Vega 2002) and Argentina (Habibi et al. 2003). A closer look at the health issue raises new questions on the type of countries in which this conclusion is applicable. Whereas immunisation appears to respond positively to FD in low income countries, the opposite occurs in middle income countries (Khaleghian 2003). In this regard, the strength on political institutions appears to be a precondition for decentralisation to have a significant impact on the infant mortality rate (Robalino, Picazo and Voetberg 2001). Evidence of the effect of decentralisation on the level and quality of the current infrastructure is still scant and subject to further review. Whilst Faguet (2001) shows that decentralising policies implemented in Bolivia which started in 1994 had a major impact on the allocation of public investment in favor of those areas more in need, Humplick and Estache (1995) provide cross country evidence showing that decentralisation may result in a higher variance in performance across regions.

The argument that FD improves various aspects of basic human needs leads to the conclusion that even if FD dos not affect growth directly, it does so indirectly through some of the factors commonly recognized in the literature as being responsible for growth. As this appears to be relevant in education and health, it might also be the case for other variables. One of them is the potential for fiscal imbalance stemming from FD. Fornasari, Webb and Zou (1999) perform long- and short-run estimates of the effects of FD on government expenditures and fiscal deficit. In the steady-state long-run estimates, their results show that no significant effects of FD can be detected. When it comes to the short run, FD clearly increases the central government's deficit. The main lesson to be learnt is that general fiscal imbalance is more likely to arise when a process of FD is in progress. Similarly, the lack of clear cut rules that limit the support of the central government to heavily indebted subnational governments seems to be a key factor in understanding why FD will probably worsen fiscal balance in developing countries. In support of this, De Mello (1999, 2000b) shows that FD is more likely to deteriorate fiscal balance in non-OEDC countries. Nevertheless, when using a more accurate measurement of FD, Ebel and Yilmaz (2002) find that FD is equally conducive to fiscal imbalance in OECD countries. As far as inflation is concerned, Treisman (2000b) finds no clear relation between FD and the level of inflation. However, Treisman also finds that decentralisation tends to perpetuate the existing pattern of monetary policy regardless of the current level of inflation. While high income federations exhibit more stable inflation patterns over time, low-income federations that started with higher degrees of inflation tend to worsen the initial situation very rapidly.

What we do not know about Fiscal Decentralisation

There are at least three avenues through which future research on the effects of FD might be enriched. The first one refers to testing the benefits of FD by using a more accurate cross-country measurement of it. The fact that different results are obtained when two alternative data set are used in order to estimate similar or even identical models, confirms that a lot is still to be done in order to produce better quality data on FD. In particular, it would be of much help to have better cross-country measurements of tax autonomy and the share of block grants as opposed to categorical grants being given to subnational governments. Whilst some measurements of this kind do exist for the OECD countries (Ebel and Yilmaz 2002), similar information is still far from

Empirical evidence on the effects of Fiscal Decentralisation	
Growth	
• Woller and Phillips (1998)	No strong relationship is found. (*)
• Davoodi and Zou (1998)	Developing countries appear to respond negatively, albeit not significantly, to FD (*).
• Zhang and Zou (1997)	Evidence of a significant effect of FD on growth for India.
• Zhang and Zou (1998)	A negative relationship is found for China.
• Lin and Liu (2000)	A positive relationship is found for China.
• Xie, , Zou, and Davoodi (1999)	No evidence of systematic effects of FD on growth for the USA.
• Ebel and Yilmaz. (2002)	Evidence is not clear for a sample of OECD countries. Results are very sensitive to the measurement of FD (*).
• Desai, Freinkman and Goldberg (2003)	Generally, FD enhances growth in the Russian Federation. However, the effect of FD is negative on regions in which local revenues mostly derive from sources other than taxes. This is the case of natural resources and transfers from the federal government.
Life Quality	
• Humplick and Estache (1995)	Weak evidence in favor of the hypothesis that FD strengthens infrastructure. Decentralization results in higher variance in performance across jurisdictions (*).
• De Mello (2000a)	FD affects social capital positively (*).
• Braun and Grote (2000)	FD Improves the human Development Index. It does it at a decreasing rate (*).
• Faguet (2001)	Evidence for Bolivia shows that decentralizing policies started in 1994 produced major changes on 13 different areas of public interest.
• Letelier (2001)	A positive and strong relationship is found between FD and government s performance on education and health (*).
• Robalino, Picazo and Voetberg (2001)	FD reduces infant mortality rate in low-income countries with strong political institutions.
• Lindaman and Thurmaier (2002)	A positive and strong relationship is found between FD and government s performance on education and health (*).
• Vegas (2002)	Decentralized publicly funded schools perform better than non-decentralized ones in Chile.
• Habibi et al. (2003)	It shows that for the case of Argentina, the process of FD affected positively and significantly the outputs of health and education.
• Khaleghian (2003)	FD improves immunization in low-income countries, but it worsens it in middle income countries.
Governance	
• Huther and Shaha (1998)	Evidence of a positive relationship between FD and a composite index of good governance (*).
• De Mello and Barenstein (2001)	FD affects governance positively. Non-tax revenues are the best way to fund sub national governments.
Corruption	
• Huther and Shah (1998)	FD reduces corruption (*).
• Treisman (2000b)	Five alternative definitions of decentralization show that corruption is higher in federal countries. (*)
• De Mello (2000a)	FD reduces corruption (*).
• Fisman and Gatti (2002).	FD reduces corruption (*).
Fiscal Imbalance	
• Fornasari, Webb and Zou (1999)	No significant effect is detected in the long run. In the short run FD clearly increases the Central Government deficit (*).
• De Mello (1999)	FD may lead to coordination failures between levels of government. Evidence confirms this for developing countries (*).
• De Mello (2000b)	Tax autonomy exerts a negative effect on subnational and central government balances. This is more likely to occur in developing countries with fragile institutional arrangements.
• Treisman, D. (2000a)	No clear relationship between decentralization and the level of inflation is found. However, political decentralization reduces the variability of inflation over time.
• Ebel and Yilmaz (2002)	Evidence is not clear for a sample of OECD countries. Results are very sensitive to the measurement of FD (*).
* Cross-country evidence.	

being available as far as developing countries are concerned. This is not only relevant from the viewpoint of making more robust predictions on the impact of FD, but it would also shed light on the particular form of FD that enhances the provision of public services. Since fiscal autonomy involves varying degrees of maneuvers on taxes, grants, borrowing and user charges, it certainly matters what the optimal share and the specific design of these sources is. Regardless of the data quality problem, more research is clearly needed at the country level. Although the empirical literature is abundant in

case country studies, these are very seldom based on rigorous statistical analysis. For example, a public policy target being commonly considered but largely disregarded in the empirical literature, is the potential effect of FD on innovation. Various countries grant subnational governments and/or publicly supported service producing units in order to promote innovation in the areas of education, health, public investment and the like. Although the well-known review by Oates (1999) reports two studies on the subject matter, they both refer to the United States, use very limited information and their results are rather inconclusive.

Finally, there is still the question as to whether FD is indeed an exogenous variable at the disposal of the policy maker. An obvious question is why – decentralisation being so clearly beneficial to some areas of public interest – the national median voter is not always willing to undertake radical reforms in this respect (Panizza 1999; Letelier 2003). One possible answer is that even if the median voter is well informed about the effects reported above, he will face numerous constraints to achieve the optimum. Elections in developing countries are very often non-democratic and subject to various imperfections. Additionally, FD is not a cost-free policy. On the one hand, economies of scale and extra coordination costs might be important in the provision of some public goods. On the other, typically low income countries with weak institutions might not be willing to put their precarious fiscal stability at jeopardy by conceding subnational governments more leeway to decide on taxes, expenditures and borrowing. If we accept that any form of decentralisation is at least in part being explained by development, it follows that policy recommendations should be qualified in terms of the country at stake and the public function being decentralised.

Conclusions

This paper offers a typology of the main theoretical arguments in favor and against FD, and it provides a comprehensive review on the empirical literature about its likely effects. On the theoretical front, three basic arguments in support of decentralisation are identified. They are the information argument, the analogy between decentralisation and the functioning of a competitive market, and the Leviathan argument. The core of the academic criticism on FD can be summarised by five basic points. Firstly, there is the potential of externalities between jurisdictions, which leads to differences between the national social optimum and the targets being achieved by decentralised jurisdictions as a group. Secondly, the set of assumptions on which the well-known Tibout model is built has been subject to severe critiques. Thirdly, it has been argued that local government's officers and politicians are not as capable of obtaining and close to up-to-date relevant information as their central government counterparts. Finally, the potential for corruption stems from the extreme proximity of local officers to private local interests.

Whilst the empirical literature is not conclusive about the potential effects on growth, it does show that the quality of growth may be significantly improved by FD. In particular, there exists substantial evidence that decentralisation improves the quality of public education, health and other indicators of good governance. Concerning the impact of FD on fiscal balance, results are very sensitive to the definition of decentralisation being used, the set of control variables in the regressions, the extension of time over which this impact is being measured, and more importantly, the type of countries being considered in the sample. Some of this evidence, and specially that on the effects of inflation, shows that FD is more likely to worsen the initial situation in developing countries, while it tends to perpetuate the current performance over time. The strength of institutions appears to be a fundamental condition for FD to be beneficiary.

A lot more work is still to be done in order to capture normative aspects on the measurement of FD. Country case studies based on robust statistical techniques is certainly the most promising future research avenue for empirical studies on this field. Finally and most importantly, the empirical literature is generally based on the assumption of decentralisation as an exogenous variable. While this might be a sound assumption for some specific decentralising policies in specific countries, it does not seem to be the case for the aggregate trend of FD in large samples of countries. The degree to which public officers and politicians are indeed able to promote decentralisation hinges upon the dubious view that this is a factor explaining development rather than a consequence of it.

References

Braun, J. V. and U. Grote (2000), "Does Decentralisation Serve the Poor?" IMF Conference on Fiscal Decentralisation, Washington D.C.

Davoodi, H. and H. Zou (1998), "Fiscal Decentralisation and Economic Growth: A cross-country Study", *Journal of Urban Economics* 43, 244–57.

De Mello JR L. (1999), "Intergovernmental Fiscal Relations: Coordination Failures and Fiscal Outcomes", *Public Budgeting and Finance* 19(1), 3–23.

De Mello JR L.(2000a), "Can Fiscal Decentralisation Strengthen Social Capital?", IMF Working Paper, Fiscal Affairs Department.

De Mello JR L.(2000b), "Fiscal Decentralisation and Inter-governmental Fiscal Relations: A Cross-Country Analysis", *World Development* 28, 365–80.

De Mello JR L. and M. Barenstein (2001), "Fiscal Decentralisation and Governance: A Cross-Country Analysis", IMF Working Paper, Fiscal Affairs Department, Washington, D.C.

Desai R. M., L. M. Freinkman and I. Goldberg (2003), "Fiscal Federalism and Regional Growth. Evidence from the Russian Federation in the 1990s", World Bank Policy Research Working Paper 3138,Washington, D.C.

Ebel, D. and S. Yilmaz, S. (2002), "On the Measurement and Impact of Fiscal Decentralisation", World Bank Policy Research Working Paper 2809, World Bank, Washington, D.C.

Faguet, J. P. (2001), "Does Decentralisation Increase Responsiveness to Local Needs?: Evidence from Bolivia", World Bank Policy Research Working Paper 2516, World Bank, Washington D.C.

Fisman, R. and R. Gatti, R. (2002), "Decentralisation and Corruption: evidence across countries", *Journal of Public Economics* 83 (3), 324–45.

Fornasari, F., S. Webb and H. Zou (1999), "Decentralized Spending and Central Government Deficit: International Evidence", LCSPR/DECRG. Processed, World Bank, Washington, D.C.

Habibi N., C. Huang, D. Miranda, V. Murillo, G. Ranis, M. Sarkar and Stewart F. (2003), "Decentralisation and Human Development in Argentina", *Journal of Human Development* 4 (1), 73–102.

Humplick, F. and A. Estache (1995), "Does Decentralisation Improve Infrastructure Performance?" in E. Antonio, ed., Decentralizing Infrastructure: Advantages and Limitations, World Bank Discussion Paper Series 290, Washington D.C.

Huther, J. and A. Shah (1998), "Applying a Simple Measure of Good Governance in the Debate on Fiscal Decentralisation", Policy Research Working Paper 1894, World Bank, Washington D.C.,

Khaleghian, P. (2003), "Decentralisation and Public Services. The case of Immunisation", World Bank Policy Research Working Paper 2989, World Bank, Washington D.C.

Letelier, L. (2001), "Effect of Fiscal Decentralisation on the Efficiency of the Public Sector: The Cases of Education and Health", Proceeding of the IIPF Conference on Public Finance, August 2001, Linz, Austria.

Letelier, S. L. (2003), "Explaining Fiscal Decentralisation", XVI Seminario Regional de Política Fiscal, ECLAC, Santiago.

Lin, J. Y. and Z. Liu (2000), "Fiscal Decentralisation and Economic Growth in China", *Economic Development and Cultural Change* 49 (1), 1–22.

Lindaman K. and K. Thurmaier K. (2002), "Beyond Efficiency and Economy: An Examination of Basic Needs and Fiscal Decentralisation", *Economic Development and Cultural Change.* 50(4), 915–34.

Martinez-Vazquez, J. and McNab, R. M. (2003), "Fiscal Decentralisation and Economic Growth", World Development, 31 (9), 1597–17.

Oates, W. (1972), Fiscal Federalism, Harcourt, Brace, Jovanovich, New York.

Panizza, U. (1999) "On the Determinants of Fiscal Centralisation: Theory and evidence", *Journal of Public Economics* 74, 97–139.

Robalino D., O. Picazo and A. Voetberg (2001), "Does Fiscal Decentralisation Improve Health Outcomes?", Policy Research Working Paper 2565, World Bank, Washington D.C.

Treisman, D. (2000a), "The Causes of Corruption: A Cross-National Study", *Journal of Public Economics* 76, 399–457.

Treisman, D. (2000b), "Decentralisation and Inflation: Commitment, Collective Action, or Continuity?", *American Political Science Review*, December.

Vegas, E. (2002), "School Choice, Student Performance, and Teacher Characteristics: The Chilean Case", Policy Research Working Paper 2833, World Bank, Washington D.C

Von Braun J. and U. Grote U. (2000), "Does Decentralisation Serve the Poor?", IMF Conference on Fiscal Decentralisation, Washington D.C.

Woller, G. and K. Phillips K. (1998), "Fiscal Decentralisation and the LDCs' Economic Growth: An Empirical Investigation", *The Journal of Developing Studies* 34(4), 139–48.

Xie, D., H. Zou and H. Davoodi (1999), "Fiscal Decentralisation and Economic Growth in the United States", *Journal of Urban Economics* 45, 228–39.

Zhang, T. and H. Zou (1997), "Fiscal decentralisation, The Composition of the Public Spending, and Regional Growth in India", Development Research Group Working Paper, World Bank, Washington D.C. World Bank.

Zhang, T. and H. Zou (1998), "Fiscal Decentralisation, Public Spending, and Economic Growth in China", Journal of Public Economics 67, 221–40.