Chapter 10

Decentralisation and inclusive growth: Channels and implications

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This chapter discusses the relationship between intergovernmental fiscal frameworks and inclusive growth, encompassing the several channels through which such a relationship could take place. The key variables directly affected by the decentralisation process are economic variables such as gross domestic product (GDP) and its distribution but also other social outcomes, such as educational attainment. All of these contribute to shaping economic growth and its inclusiveness. Inclusiveness means that the gains from growth in economic output, income or other forms of material well-being benefit all members of society. This includes all parts of a country, e.g. growth in a territory as well as the distribution of income across territories. In this context, sub-central and central authorities can contribute to inclusiveness within a country, contributing to an even distribution of economic gains across jurisdictions and income groups, ultimately enhancing well-being for all. Moreover, the quality of the public sector also depends on how responsibilities and functions are shared between government levels. The issue at stake is that the design of fiscal decentralisation does matter for inclusive growth.

Introduction

The role of sub-national governments for overall public finance varies across countries, but has changed relatively little over time (OECD/KIPF, 2013, 2016). As highlighted earlier in this volume based on the OECD Fiscal Network's database, in 2016 sub-national governments were responsible for around one-third of general government spending, while the sub-national share of own revenue averaged 19%. In many OECD countries, most of these lower tiers of government are responsible for core public programmes; this contributes to shaping how the gains from economic activity are distributed between households and across jurisdictions. This implies that intergovernmental fiscal frameworks can critically influence growth and the inclusiveness of an economy. Inclusiveness means that the gains from growth in economic output, income or other forms of material well-being benefit all members of society. This includes all parts of a country, e.g. growth in a territory as well as the distribution of gross domestic product (GDP) or household income per capita across territories. Hence, intergovernmental fiscal frameworks appear to be a fundamental instrument for inclusive growth.

As we have seen with the negative impact of the financial crisis, which was particularly heavy for the EU countries, the need of policy coordination has emerged also in light of an increased economic interdependence. In this vein, the Europe 2020 Strategy puts the notion of inclusive growth at its core. In this strategy, inclusive growth is understood as:

> *"empowering people through high levels of employment, investing in skills, fighting poverty and modernising labour markets, training and social protection systems so as to help people anticipate and manage change, and build a cohesive society. It is also essential that the benefits of economic growth spread to all parts of the Union, including its outermost regions, thus strengthening territorial cohesion. It is about ensuring access and opportunities for all throughout the lifecycle." (European Commission, 2010)*

Broadly speaking, inclusive growth is economic growth that creates an opportunity for all segments of the population and distributes the dividends of increased prosperity, both in monetary and non-monetary terms, equitably across society.

The assumption according to which economic growth automatically delivers higher welfare to people has been recently challenged by scholars (Stiglitz, Sen and Fitoussi, 2009) because economic growth may only increase people's consumption opportunities (i.e. their economic well-being) for a limited number of people in the population, and it may not necessarily translate into higher non-economic outcomes such as education, health, and environmental quality, which are essential for people to participate fully in the economy and society more broadly.[1] Accordingly, the OECD approach to inclusive growth is multidimensional, extending beyond income, and suggesting that the proceeds of economic growth must be shared. This is especially true for education levels (such as secondary and tertiary education), healthcare, life expectancy and public infrastructure. Moreover, inclusive growth refers to equality of opportunity in terms of access to markets, employment prospects, resources and an unbiased regulatory environment for businesses and individuals.

In this context, sub-central and central authorities can contribute to inclusiveness within a country, contributing to an even distribution of economic gains across jurisdictions and income groups, ultimately enhancing well-being for all. Moreover,

the quality of the public sector also depends on how responsibilities and functions are shared between government levels. The issue at stake is that the design of fiscal decentralisation does matter for growth, especially for inclusive growth. This could work through different channels. For instance, the productivity of firms and the well-being of households could depend on the taxes sub-national governments levy and the money they spend on the various policy functions.

Moreover, the intergovernmental fiscal framework could affect the income distribution across individuals and jurisdictions through, for instance, the effectiveness of the government redistributive function. On the one hand, in a fiscally decentralised system, sub-national governments could spend less for social services and move away from progressive taxation, lowering, ultimately, the likelihood of redistribution amongst individuals (and regions) and, thus, increasing income disparities at the national level (Stigler, 1957; Musgrave, 1959; Brown and Oates, 1987). On the other hand, due to decentralisation, greater responsibilities assigned to sub-national governments should close some of the distance between local policy makers and their citizens (Ivanyna and Shah, 2014), favouring policies more sensitive to poverty and interpersonal disparities (Le Galès, 2002; Brenner, 2004), so leading to a more equal distribution of resources across income groups as well as their inclusion in the economy.

In a nutshell, the key variables directly affected by the decentralisation process are economic variables such as GDP and its distribution across individuals and jurisdictions but also other crucial social outcomes, such as educational attainment. All of these contribute to shaping economic growth and its inclusiveness. This chapter will discuss the relationship between intergovernmental fiscal frameworks and inclusive growth, encompassing the several channels through which such a relationship could take place. Finally, some broad implications for society, economy and institutions are provided.

Decentralisation and economic growth: The role of tax design

Since the 1980s, many developed countries have increased their degree of fiscal decentralisation (Blöchliger and Rabesona, 2009; Bodman and Hodge, 2010). One of the traditional theoretical arguments in favour of fiscal decentralisation is that it provides greater economic efficiency in the allocation of public resources (Oates, 1972). With this in mind, both direct and indirect linkages between decentralisation and economic growth have been identified to show greater efficiency (Martinez-Vazquez and McNab, 2003). Results from the recent empirical literature provide, however, a mixed picture and a clear-cut effect of fiscal decentralisation on GDP growth does not always emerge (see Asatryan and Feld, 2015).[2] In any case, a common finding seems to be that tax decentralisation is more conducive to growth than spending decentralisation, as also documented by Blöchliger and Agkun in Chapter 2 and Dougherty and Agkun in Chapter 3. However, some analyses carried out on OECD countries over past decades highlight that when the measure of tax decentralisation is limited to the revenues over which sub-national governments have full autonomy, its impact on economic growth is not statistically significant (e.g. Thornton, 2007). Similarly, Treisman (2006) argues that decentralisation would increase regional incentives to promote growth but, at the same time, it would provide a disincentive for the central government to promote development in aggregate terms because it will not lead to additional revenues.

One crucial point related to this is how public revenues are raised locally. Indeed, fiscal decentralisation is not always implemented in the same way, and there are considerable differences across countries, particularly regarding the design of the tax system. Differences in the taxation structure could have an impact on the incentive system of local policy makers. In this regard, more autonomous taxes may induce responsible local spending behaviour, accountability and, then, more efficiency (Oates, 2005; Weingast, 2009).

Starting from the first generation theory of fiscal federalism, attention was devoted to the tax assignment problem in a multi-layered government structure (Musgrave, 1983; McLure, 1998), claiming that taxation executed by local governments should mostly focus on property taxes and user fees. In line with this argument, Gemmell, Kneller and Sanz (2013) find evidence of positive revenue decentralisation effects on growth in OECD countries during 1972-2005. According to them, the positive sign could merely reflect the fact that local governments collect less from growth-distorting taxes than central governments, such as charges, user fees and property taxes. Indeed, property taxes are generally associated with a higher degree of tax autonomy exerted by sub-national governments over these revenues, since they are mostly based on tax separation schemes (for further details, see Liberati and Sacchi, 2013). The virtues of the local property tax (mostly the immovable component) could be ascribed to its relatively low efficiency costs and benign impact on growth (e.g. OECD, 2010; Norregaard, 2013). This is mainly due to the fact that such taxes are less likely to affect people’s behaviour than income or wage taxes, making the former the most growth-friendly of all major taxes. The positive effect of property tax decentralisation on GDP growth in OECD countries has been confirmed in a recent study by Filippetti and Sacchi (2016) who show that tax decentralisation is more conducive to growth if sub-national taxes accrue mostly from autonomous revenues such as property taxes. This result provides conditional support to a more general tax and growth ranking (Arnold et al., 2011; Acosta Ormaechea and Yoo, 2012), according to which recurrent taxes on property tend to be the preferred tax instrument in terms of long-run GDP per capita.

More importantly, as the search for more “growth-friendly” tax bases (European Commission, 2013) focuses on immovable property – whose taxes are usually levied at the local level – the ongoing debate on tax shifting also involves fiscal decentralisation issues. In this vein, the simulation results for the Netherlands provided by van Eijkel and Vermeulen in Chapter 8 confirm that fiscal decentralisation can foster inclusive growth since, with few exceptions, a tax shift from the national earned income tax to either a local tax on the use of residential real estate or a local head tax does not generate large distributional effects for households in the economy and, at the same time, yields a moderately positive impact on employment. However, the high visibility of (immovable) property taxes is also related to their salience for voters – especially for low-income households – making this kind of tax reform a challenge to implement (see Blöchliger, 2015), regardless of the potential pro-growth effects and inclusiveness of the economy.

Decentralisation and income distribution

The way taxing powers are split between levels of government affects not only efficiency issues, but may also have equity implications which, ultimately, may involve the distribution of economic gains across jurisdictions and income groups. For instance, some studies find that higher tax decentralisation leads to higher income inequality (Neyapti, 2006; Sacchi and Salotti, 2014a), mainly due to the fact that sub-

national tax revenues (e.g. property taxes and user fees) are less progressive than those at the national level. More generally, this is consistent with the normative public finance theory that argues redistribution goals should be reserved to the central government (Stigler, 1957; Musgrave, 1959).

However, many programmes affecting income distribution and the poor have been increasingly devolved to sub-national authorities since there is growing recognition of the vital role of such lower tiers in facilitating, catalysing, and co-ordinating the implementation of pro-poor policies (Bahl, Martinez-Vazquez and Wallace, 2002). Ultimately, those redistributive impacts depend on the specific characteristics of the decentralisation process in each country (Martinez-Vazquez, Lago-Peñas and Sacchi, 2017). Looking at advanced economies, national governments sometimes embark simultaneously on fiscal decentralisation reforms as well as policies toward income inequality and poverty reduction (Ravallion, 1999; Rao, 2002), raising doubts as to whether these reforms are complementary or they could, in fact, undermine each other. In Europe - on top of the already federalised Austria, Germany and Switzerland - Belgium, Italy and Spain have recently introduced widespread reforms in order to enhance regional autonomy (Ezcurra and Rodríguez-Pose, 2010; Sacchi and Salotti, 2014b). At the same time, in recent years many developed countries witnessed significant changes in their income distributions aimed at stabilising income inequality (Smeeding, 2002; OECD, 2008).

Although closely related, income inequality and poverty do not have to respond in the same manner to fiscal decentralisation. It depends on how changes in the distribution affect the poorest. The empirical literature mostly looks at the two issues separately. A number of studies find a beneficial effect of fiscal decentralisation (based on expenditure measures) on income inequality measured by the Gini coefficient (von Braun and Grote, 2002; Tselios et al., 2012). Regarding decentralisation and poverty, the more encouraging results are for developing countries, where positive impacts of political and administrative decentralisation on poverty reduction tend to emerge (e.g. Crook and Manor, 1998). Less conclusive results emerge for developed countries where it is found that higher levels of fiscal decentralisation are correlated with a higher incidence of poverty (only) when this is measured as absolute levels of poverty (Sepulveda and Martínez-Vázquez, 2011). On the other hand, when the Human Development Index (HDI)[3] is used as a proxy for poverty, decentralisation is found to have a positive but nonlinear effect on it. When such broader measure of welfare is considered, we are able to assess how fiscal decentralisation can affect poverty in a variety of ways. Based on the nonlinear effect, one might conclude that sub-national governments can positively contribute to poverty reduction (i.e. the positive effect on the HDI), but only up to a threshold beyond which the local provision of services that most immediately help the poor becomes insufficient to provide effective and durable anti-poverty programmes. All these effects would translate into a lower degree of inclusive growth. However, as shown by Amin-Smith, Phillips and Simpson in Chapter 7 for the United Kingdom, the ongoing institutional reforms, aimed at reducing the degree of marginal fiscal equalisation, should lead sub-national governments in increasing local tax bases, limiting underlying spending needs and, more generally, boosting economic growth and tackling deprivation. Ultimately, these changes are designed to provide local policy-makers with stronger incentives for inclusive growth.

Decentralisation and spending programmes: The education sector

Decentralisation can directly affect income distribution by facilitating access to basic services, and indirectly by means of expenditure composition and the quality of governance. As an example, fiscal decentralisation can alter poverty and income inequality through its effects on the composition of public spending. Arze del Granado, Martinez-Vasquez and McNab (2005) argue that fiscal decentralisation would lead to more welfare spending programmes (e.g. basic healthcare and primary schools) that usually benefit the poorest (e.g. through in-kind benefits).

The issue at stake is that decentralisation can foster inclusiveness-enhancing spending programmes and affect their success when relatively more public money is spent on education or capital investment at the local level, which in turn may affect human capital formation and productivity. Indeed, job quality, education and employment opportunities (as well as health status and its outcomes) usually contribute to building wealth over time, which matters for people's well-being.

Recent contributions highlight that more decentralised frameworks, and in particular the decentralisation of spending power and functions in education, fuel inclusive education (Fredriksen, 2013). Indeed, education (primary and secondary) represents, among other public programmes and services, the bulk of spending and a core responsibility for sub-national governments in both decentralised and highly centralised countries (OECD, 2013). Moreover, the positive effect of fiscal decentralisation can also be seen in terms of educational output (e.g. Habibi et al., 2003) and school efficiency (Sutherland and Price, 2007; Falch and Fischer, 2012). An interesting result, based on a cross-country comparison, is found by Vermeulen in Chapter 5; it reveals that inequality in education outcomes is not more significant in more decentralised countries. In the same fashion, Kim, in Chapter 6, finds evidence that fiscal decentralisation, as measured by expenditure/revenue decentralisation, is associated with better educational achievement for OECD countries.

In a nutshell, the positive relationship between decentralised fiscal frameworks and economic activity pivots on education. The transmission channel from decentralisation to growth seems to run more via human capital and the government's education budgets than another type of investment (such as capital, either physical or intangible).

Decentralisation and regional development

Sub-national governments tend to compete more for mobile production factors, thus having an incentive to spend more on productive investment such as education or infrastructure and less on other public spending. In this perspective, fiscal decentralisation could promote economic growth according to the "productivity enhancement hypothesis" (Thiessen, 2003). Accordingly, the transfer of responsibility, associated with accountability, to sub-national governments may provide incentives for them not only to consider local residents' preferences but also to actively search for innovation in the production and supply of public goods and services.

This is in line with Oates' (1993) seminal arguments, which highlight that the case for fiscal decentralisation leading to greater allocative efficiency should also be applied within a dynamic framework of economic growth. While centrally-determined policies could not consider regional and local conditions in the provision of public goods and services, locally determined policies, for instance regarding infrastructure and education, could favour economic development and growth if local authorities have

input into such policy decisions. Ultimately, fiscal decentralisation can improve technical progress and regional development (Oates, 1999).

Productivity convergence across regions is usually driven by capital and labour mobility, but it could also be driven by knowledge diffusion across firms and jurisdictions, thus depending on intergovernmental fiscal frameworks (Blöchliger, Bartolini and Stossberg, 2016). Indeed, when an environment of imperfect information and, furthermore, a great variety of innovative measures are carried out to try to solve the same regional social and economic problems, innovative jurisdictions generate information that can be very valuable for the rest. Recent contributions show that fiscal decentralisation promotes regional convergence, but only in high-quality governance settings (Kyriacou, Muinelo-Gallo and Roca-Sagales, 2015).

In turn, competition among fiscal communities can make public officials from certain regions provide services at the lowest possible cost, thus increasing the technical efficiency in their jurisdiction (Martinez-Vazquez and McNab, 2003). In this respect, one of the most frequent transmission channels assumed to run from decentralisation to growth is inter-jurisdictional competition, which encourages sub-national governments to attract and retain mobile production factors through fiscal policy instruments such as a reduction in the tax burden or an increase in public investment (Keen and Marchand, 1997; Keen and Kotsogiannis, 2004).

The main idea is that sub-national governments in a decentralised environment tend to over-invest in capital services that raise corporate productivity such as transport and infrastructure and under-invest in consumptive and residential services such as amenities. In this framework, competition for production factors becomes strategic, especially when economies are spatially linked, to the extent that sub-national governments set their policies subject to the policy decisions of their neighbouring jurisdictions (Hauptmeier, Mittermaier and Rincke, 2012), or by merely observing tax and spending policy in neighbouring jurisdictions according to the yardstick competition approach (Besley and Case, 1995).

Implications for society, economy and institutions

The objective of inclusive growth is particularly relevant in high-income countries and emerging market economies, where income inequality has returned to levels not seen in the post-war period. It represents a new approach to economic growth that aims to improve living standards and share the benefits of increased prosperity more evenly across social groups. Inequalities, indeed, could also refer to other non-income outcomes such as educational attainment, health status and employment opportunities, which have become important determinants of growth and well-being. Thus, for sustainable economic growth, governments and policy makers should address the multidimensional nature of inequality and deal with its impact on different segments of the population.

In this framework, decentralised settings could play a favourable role in fostering inclusive growth. Decentralisation is also a multidimensional concept; it covers various aspects of policy and not just fiscal issues. More importantly, through decentralisation different social groups could have a voice in the policy-making process, thus helping to shape policies that reflect their needs and socio-economic conditions. The government's closeness to its people (Ivanyna and Shah, 2014) is typically associated with efficiency gains. Decentralisation of this type represents a vehicle through which people can strengthen their voice and have the decisions that affect their lives be taken

by those both closer to them, and to the reality that they live in. In particular, under decentralisation, benefits from certain public services (e.g. transport, waste collection, land use, local amenities, recreation facilities) accrue naturally to people living in a specific area, which is usually characterised by specific preferences over public goods and services and where economies of scale in the delivery of public services (education, primary healthcare) may be very limited.

Additionally, pursuing decentralisation may favour new forms of collaborative and participatory governance, increase transparency between governments and citizens, and lead to more inclusive policy design and implementation (OECD, 2015). From a political economy viewpoint, sub-national sectors should work in a complementary way with the national levels to create a suitable policy framework for inclusive growth. The complementary rests on the pillar of a better understanding of the role played by local preferences, circumstances and institutional settings in a decentralised system (OECD, 2014a). Specific features of sectoral policies and their effects on outcomes could be better achieved than it would be possible at the cross-country level.

In any case, for decentralisation to be good for inclusive growth, solid intergovernmental co-ordination is required, as is a clear division of responsibilities for the policies implemented at the different levels of government, in order to ensure better targeted place-based policies. For decentralisation to be successful for the inclusiveness of an economy, responsibilities for all levels of government are concerned. This is especially relevant for equity considerations given the potential impact of decentralisation on horizontal equity (e.g. using fiscal equalisation mechanisms), thus mitigating territorial disparities. In this perspective, decentralisation could favour inclusive growth and exploit financial, administrative and other capacities that normally differ across territories and tend to reflect the distribution of population, human capital and wealth. Additionally, as we have learned in Chapter 3 by Dougherty and Akgun, decentralisation tends to boost economic growth for countries that have a relatively higher degree of trade openness, especially if spending is locally financed.

Another relevant issue is the policy area where decentralisation is implemented. Education, for example, is a sector in which countries could gain from decentralising a broader set of functions. This is especially true in countries where the demographic dividend will last longer, as documented by Rao in Chapter 4, in the case of India. In this context, inclusive development is possible only when the fiscally disadvantaged states are empowered to provide comparable standards of public services, such as education. Inclusiveness of the educational system is, therefore, a critical aspect of inclusive growth.

The fact that there is a robust positive relationship between fiscal decentralisation and education provides support to the fact that decentralisation can lead to productive efficiency of public good provision. Moreover, as decentralisation of the education financing structure does not reduce the amount of education expenditure overall, as shown by Kim in Chapter 6, the policy implication would be that fiscal decentralisation encourages the expansion of education expenditure and its performance as well. With this in mind, sub-national governments could have incentives to increase education funding for education performance in their jurisdictions. These findings underline the virtuous effects of education decentralisation, which contributes to improving the quality of human capital and, ultimately, affects economic growth. From this perspective, future research on decentralisation and growth should focus on other individual policy areas, and specific government functions for a positive impact on inclusive growth.

A further lesson drawn from the preceding chapters is that fiscal decentralisation can improve the efficiency of public service delivery, but only under specific conditions, such as adequate political and institutional environments; a sufficient degree of expenditure decentralisation combined with a sufficient decentralisation of revenue (see Chapter 9, by Sow and Razafimahefa). Otherwise, fiscal decentralisation can actually worsen the efficiency of public service delivery. This would suggest that balanced decentralisation – i.e. based on both expenditure and revenue task assignments – is as important as focusing on particular policy functions to be decentralised in order to enhance the inclusiveness of the economy. Accordingly, asymmetric forms of decentralisation, in terms of spending and revenue decisions left to sub-national governments, should be avoided as they could be less favourable for inclusive growth. Instead of decentralisation alone, balanced decentralisation could be a more effective driver for long-term growth (see also Blöchliger and Kantorowicz, 2015). From this perspective, a more balanced assignment of policy functions across layers of government may allow for more flexible administrative arrangements, policy complementarities and better reaping economies of scale and scope as also stressed by Blöchliger and Akgun in Chapter 2.

In the end, it is worth recognising that there is not a single model of decentralisation that is the most conducive to inclusive growth, as institutions should also be adapted to places (OECD, 2014b). The policy agenda of many advanced economies in recent years has dealt with decentralisation and territorial reforms and they are still ongoing in some cases, e.g. in France, Italy and Spain (OECD, 2015). With this in mind, taking into account citizen participation and voice appears to be a crucial ingredient, as also demonstrated by recent public demonstrations and social troubles due to income and wealth distribution issues. Civil society, combined with standard institutional channels, can play an important role in defining policies devoted to all the well-being dimensions that lead to inclusive growth.

Notes

1. Actually, inequality – especially that related to income – is on the rise in OECD countries and remains very high in non-member economies.
2. In addition to works addressing whether decentralisation affects economic growth typically resorting to fiscal decentralisation, there are a few that do not disregard the political and administrative dimension of decentralisation (e.g. Filippetti and Sacchi, 2016). The political component is, indeed, positioned as one of the advantages of the decentralisation process and it should be considered in relation to economic performance.
3. Developed by the United Nations Development Program (UNDP), it combines measures of population health and longevity, knowledge and education, and standard of living.

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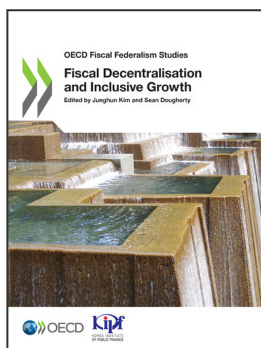

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