Chapter 1

Fiscal decentralisation and inclusive growth: An overview

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Inclusive growth is now high on government agendas in many countries. This chapter provides an overview of the role of fiscal decentralisation for inclusive growth. Considering the large size of sub-national spending, the potential of fiscal decentralisation to enhance efficiency and equity is significant. But there are competing theories on the effect of fiscal decentralisation: according to normative public finance theory, fiscal equalisation has an important role to play for equity and efficiency. On the other hand, political economy theory suggests that reducing the vertical fiscal gap is good for government performance and economic growth. The empirical literature also shows mixed results. However, many empirical studies show that the interaction between fiscal decentralisation and institutions, the stage of economic development and political economy constraints exercise important roles in determining the success of fiscal decentralisation. Rather than rely on "one size fit all" prescriptions, policymakers should consider the importance of institutional complementarities to reap the full potential of fiscal decentralisation.

Introduction

In recent years, there has been an increased attention to the issues of inequality. The traditional economic thinking on inequality has been based on the concept of an efficiency-equity trade-off, which was proposed by Okun in his seminal book *Equality and Efficiency: The Big Tradeoff* (Okun, 1975). However, this paradigm has been recently challenged by leading scholars such as Stiglitz and Piketty. In discussing the relevance of the so-called Okun's law, Stiglitz (2016) stipulates that "one of the ways that our understanding of growth and development has changed is that we now see equality, growth, and stability as *complements*". The central theme of Piketty (2014) is that widening income and wealth inequality threatens the long-run prosperity and stability of the market economy. The new view on the relationship between inequality and economic prosperity is now widely shared by international organisations as well, as discussed by the World Bank (2009), IMF (Ostry, 2011, 2014), OECD (2011) and WEF (2015).

In recent years, the OECD has been particularly active in discussions on inclusive growth. According to the OECD, "We are at a critical crossroad. For years, we counted on economic growth as the only engine of prosperity, failing to realise that this model was leaving many behind" (OECD, 2017). With the recognition of the limitations of traditional thinking on economic growth and inequality, the OECD launched the Inclusive Growth Initiative in 2012. Obviously the scope of the discussion on inclusive growth is broad. OECD (2014a) defines Inclusive Growth as "economic growth that creates opportunity for all segments of the population and distributes the dividends of increased prosperity, both in monetary and non-monetary terms, fairly across society". Following this broad definition, the OECD has conducted extensive research on three key policy themes of inclusive growth: multidimensionality of inclusive growth, equal opportunity (regardless of gender, place of residence or ethnic origin), and policy relevance.[1]

Although there has been extensive research on inclusive growth, one key area that has not yet been dealt with in depth is the relationship between inclusive growth and fiscal decentralisation. The traditional literature on fiscal decentralisation has mainly focused on the efficiency benefits of fiscal decentralisation. The seminal paper by Tiebout (1956) demonstrates that the mobility of residents creates a market-type mechanism that induces an efficient provision of local public services by allowing residents to choose communities that best meet their demand for local public services. Oates's (1972) famous decentralisation theorem states that an efficient level of public services is provided at the lowest level of government because there is a better match between the preferences of residents and the provision of public services at this level.

While the traditional literature on local public finance focuses on the efficiency of public service provision, another strand of the literature has focused on the effects of fiscal decentralisation on economic growth. Starting from the pioneering studies of Zou (1996), Devarajan et al. (1996), and Davoodi and Zou (1998), there has been a vast empirical literature testing the effect of fiscal decentralisation on economic growth. However, the relationship between fiscal decentralisation and economic growth has not been found to be conclusive, according to recent surveys (see Baskaran et al., 2016 and Martinez-Vazquez et al., 2016). The empirical evidence on the relationship between fiscal decentralisation and economic growth is not clear-cut, because the success of fiscal decentralisation very much depends on the design of fiscal decentralisation, which is often influenced by politics and institutions as well as economic considerations. Therefore, as discussed in detail in this volume, the nature of fiscal decentralisation and the interaction between fiscal decentralisation and institutions are crucial factors for the success of fiscal decentralisation.

Another important question regarding fiscal decentralisation is its effects on disparities across regions and communities. As discussed by, for example, Oates (2006) and Sellers et al. (2017), an implication of the Tiebout model is that the residential sorting that occurs as a result of the "voting with feet" mechanism results in fiscal disparities across communities. This means that the efficiency and equity trade-off may arise not only in the context of Okun's law, but also in the context of Tiebout's sorting mechanism. Even in the absence of the residential mobility that underlies the Tiebout model, disparities across communities and regions occur for many other reasons such as geographical advantages (historical agglomeration), natural resources or ethnic segregation. Since spatial disparities often give rise to as much economic and political tensions as disparities across individuals, discussions on how to lessen spatial disparities have a long tradition in the literature on fiscal decentralisation.

Although interregional and interpersonal disparities are closely related, there is an important theoretical difference between interregional and interpersonal redistribution as discussed in detail by Boadway (2001, 2004). Including the seminal works by Mirrlees (1971) and Okun (1975), the efficiency cost of interpersonal redistribution has been one of the key topics in the public economics literature, although Okun's law has recently been challenged by the argument for inclusive growth. On the other hand, there is a theoretical basis for the argument that interregional redistribution doesn't involve trade-offs between efficiency and equity. This is because the income segregation (spatial disparities of income) predicted by the Tiebout hypothesis does not in itself aggravate the individual income distribution. In other words, a more unequal distribution of income across geographical space, *ceteris paribus*, does not imply a more unequal distribution of income across individuals.[2] Therefore, while the reduction of interpersonal income inequality requires redistributive fiscal policies that involve progressive taxation and redistributive public expenditures, reduction of spatial inequality requires ensuring the equal treatment of equals regardless of the place of residence. The proposition that horizontal equalisation across localities enhances *both* equity and efficiency was put forward as early as the 1950s by the seminal papers of Buchanan (1950, 1952). Important later papers include Buchanan and Goetz (1972), Flatters, Henderson and Mieszkowski (1974), Boadway and Flatters (1982), and Albouy (2012).[3] A key insight from these studies is that a household's locational choice is affected not only by labour productivity but also by the fiscal capacity of sub-national governments. In the case when households choose their locations by taking into consideration not only wages and productivity but also the fiscal capacity of sub-national governments, migration between localities is not efficient in the sense that the total productivity of the economy is not maximized. Thus, if a household faces differences in the local tax burden or benefits from public services across localities, migration leads to inefficient resource allocation. Therefore fiscal equalisation that ensures the equal treatment of equals also eliminates differential net fiscal benefits so that both efficiency and equity are enhanced. As Boadway (2001) puts it, "there is no conflict between horizontal equity and efficiency either: in fact, the two are complementary". It is noteworthy that the literature on fiscal equalisation established a theoretical framework that shows the possibility of the complementarity between equity and efficiency long before the recent discussions on inclusive growth.

The theoretical argument related to differential net fiscal benefits and fiscal equalisation is interesting and important because it implies that, from the perspective of achieving both efficiency and inclusiveness (equity), a strong theoretical basis exists for redistribution across localities. However, the extent to which fiscal incentives drive mobility across localities is an empirical question. Unfortunately, there are only a few empirical studies that estimate the magnitude of fiscally-induced migration (see Watson, 1986; Wilson, 2003; Day and Winer, 2006). Moreover, the results of these studies are mixed. Boadway (2001) notes that there are at least two reasons why the empirical evidence on fiscally-induced migration is not conclusive. Firstly, the empirical results depend on whether one takes a flow perspective (*e.g.*, one-year migration as in Watson (1988)) or a stock perspective (*e.g.*, multiple-year migration as in Wilson (2003)) in estimating the impact of fiscal equalisation on migration. Secondly, although the literature on fiscally-induced migration focuses on labour migration, differences of net fiscal benefits between localities have an impact not only on labour migration but also on business activities (Boadway, 2001). Therefore, the impact that differential net fiscal benefits have on the inefficiency of resource allocation across localities can be much larger when the economy as a whole rather than just the labour market is considered. Finally, although not explicitly discussed by Boadway (2001, 2004), the central government's location-specific investments are another type of fiscal incentives that influence the household's locational choice, especially in developing countries. For example, in many developing countries and even in some developed countries, "primate" city favouritism, discussed by Ades and Glaeser (1995), Kim (2011), and Duranton (2008, 2015), is a much more direct fiscal incentive that causes inefficient fiscally-induced migration of labour and capital.[4]

The discussion so far focused on the role of fiscal equalisation to prevent inefficient migration of persons and businesses. However, in the absence of mobility, the case for fiscal equalisation can be purely based on an equity rationale, as discussed in Boadway (2001, 2004). In many countries, the responsibilities of providing important redistributive expenditure such as education, health, and welfare are shared between the central and local governments. Therefore, the principle of horizontal equity implies that local governments should be able to provide a standard package of these redistributive expenditure at standard tax rates so that individuals can get access to a standard level of public services regardless of their residence. The fiscal equalisation system of the Nordic countries is a good example (see Kim and Lotz, 2008).

Seen from these perspectives, there is a strong inclusive growth rationale for the role of fiscal equalisation. However, the implementation of intergovernmental transfers in practice faces many challenges because of incentive problems. For example, intergovernmental transfers create an incentive for recipient local governments to manipulate local tax bases and spending needs in order to increase the amount of transfers they receive. Also, when local public services are largely provided by intergovernmental transfers rather than own-source revenue, the accountability of local governments is weakened because local residents do not pay attention to the fiscal management of local governments. So, although from the perspective of normative public finance theory ("first generation" fiscal federalism theory based on the hypothesis of benevolent government), fiscal equalisation can enhance both equity and efficiency, from the political economy viewpoint ("second generation" fiscal federalism theory that focuses on political economy constraints), it faces a trade-off between equity and efficiency.[5] As discussed by, for instance, Boadway (2004) and Blöchliger and Charbit (2008), and OECD/KIPF (2016: Chapter 4), there are ways to mitigate such incentive problems. However, due to the information asymmetry between central and local governments and political and institutional constraints, many countries have challenges in having a well-designed system of intergovernmental transfers.

In an empirical study on the effects of intergovernmental transfers or the “vertical fiscal gap”, Sorens (2016) contrasts the above two divergent views on fiscal equalisation and calls the positive view the *public finance perspective* and the negative one the *political economy perspective*. Based on a meta-analysis of the econometric literature conducted on the effects of intergovernmental transfers, Sorens concludes that the results of empirical studies are more consistent with political economy perspective. In particular, he finds that, in federal democracies, vertical fiscal gaps lead to higher government debt and spending as well as undermine voter knowledge and public-sector efficiency.

The fact that empirical studies generally find negative effects of vertical fiscal gaps on economic and government performance suggests two policy options: improvement of the design of intergovernmental transfers or reduction of the vertical fiscal gap. As discussed by Alber and Valdescalici (2012), ‘mature federations’ with a strong federal political culture are less linked to the growth of power decentralisation. In those countries, the purpose of fiscal reform tends to be improving the coherence of the existing intergovernmental fiscal relations. The 2008 fiscal reform in Switzerland, which involved rearrangement of competences between the confederation and the cantons and the reorganization of the equalisation system is such an example. However, as discussed by Karpowicz (2012), in ‘emerging federations’ such as Spain, Italy and Belgium, the purpose of fiscal reform tends to be the reduction of vertical fiscal gaps.[6]

In the case when a country pushes for the reduction of vertical fiscal gaps by replacing intergovernmental transfers with an increase of local governments’ own sources of revenues, horizontal equity might be sacrificed according to the traditional (normative) public finance theory (Boadway, 2001, 2004). However, as Sorens (2016) discusses, second generation fiscal federalism theory (the political economy perspective) advocated by Weingast (2009) predicts that the reduction of vertical fiscal gap enhances the accountability of local governments and mitigates the problem of soft budget constraints so that the productivity of the public sector increases. In addition, the reduction of intergovernmental transfers may create stronger incentives for workers in a low-wage region to migrate to a high-wage region. As the size of the labour force in the high-wage region increases, the level of wage in the high-wage region decreases and the opposite is true for the low-wage region. Also, firms have incentives to move to the location where the labour force and land are less expensive. Thus the convergence hypothesis put forward by Barro and Sala-i-Martin (1991, 1992) implies that the reduction of vertical fiscal gaps does not necessarily widen spatial disparities.

Given that different theories predict different effects of fiscal decentralisation, whether and how fiscal decentralisation affects growth and inclusiveness is an empirical question. As discussed in detail by Baskaran et al. (2016), Martinez-Vazquez et al. (2016) and Sorens (2016), the results of empirical studies on the effects of fiscal decentralisation on economic growth, government performance, regional convergence, and regional disparities vary significantly. However, a key insight from these empirical studies is that institutional complementarities matter. In an empirical study on the effect of fiscal decentralisation on economic growth based on a sample of OECD countries, Filippetti and Sacchi (2014) find that fiscal decentralisation has a positive effect on economic growth when tax decentralisation is coupled with administrative and political decentralisation. On the other hand, Enikolopov and Zhuravskaya (2007) find that political centralisation significantly improves outcomes of fiscal decentralisation such as economic growth, quality of government, and public goods provision in an empirical study based on developing and transition countries. In a study on the effect of fiscal decentralisation on regional disparities, Rodríguez-Pose and Ezcurra (2010) and

Lessmann (2012) find that fiscal decentralisation tends to reduce regional disparities in developed countries, but increases disparities in developing countries. In a study on the interaction between fiscal decentralisation and governance quality, Kyriacou et al. (2015) find that fiscal decentralisation promotes regional convergence in countries with high government quality but leads to wider regional disparities in countries with poor governance.

The relationship between fiscal decentralisation and institutional complementarities implies that, for the success of fiscal decentralisation, its design needs to be evaluated from a broad perspective of the political and economic institutions and the development stage of a country. In this regard, Bardhan (2002) notes that the implications from the classical literature on fiscal decentralisation such as Tiebout (1956) do not apply to developing countries because of several factors such as lack of mobility especially among poor people, weak institutions of local democracy and lack of political accountability, importance of poverty alleviation by targeted programmes, a built-in tendency toward vertical fiscal imbalances, and the lower quality of staff in local bureaucracies. The relationship between different dimensions of decentralisation in developing countries investigated by Enikolopov and Zhuravskaya (2007) is a particularly important issue. Blanchard and Shleifer (2001) argued that China's economic success was achieved by fiscal decentralisation combined with – unlike Russia – political centralisation. Bardhan (2016) describes the economic success of China as a "unique hybrid institutional case" and notes that this balance has been difficult to achieve in other countries. What is noteworthy in the case of China is that it significantly increased rather than decreased the vertical fiscal gap in the 1994 fiscal reform. This might need to be changed in the future, but the experience of China which has the record of sustained economic growth for more than forty years illustrates the complex nature of institutional complementarities related to fiscal decentralisation.

In sum, seen from a broad perspective, whether or not fiscal decentralisation promotes inclusive growth is a moot question. In many OECD countries, sub-national governments collect a large amount of tax revenue and assume the responsibility of providing essential public services such as health, education, and welfare. Even in countries where the size of local government revenue is relatively small (such as the United Kingdom and the Netherlands), the size of local spending is much larger due to intergovernmental transfers. As documented by Boadway and Shah (2009), local governments in developing countries also play an important role in providing infrastructure, education, health and social services. Therefore, given the potential of fiscal decentralisation to improve both efficiency and equity, the success of fiscal decentralisation is one of the keys to inclusive growth of any country. The challenge lies in understanding the complex and country-specific nature of fiscal decentralisation.

The chapters in this volume address fiscal decentralisation and inclusive growth from several different angles: two chapters (Blöchliger and Akgun, Dougherty and Akgun) investigate the effects of fiscal decentralisation on economic growth; three chapters (Vermuelen, Kim, and Sow and Razafimahefa) on education and public service delivery (infant mortality rates and school enrolment rates); and three chapters address country cases (Rao on India, Smith et al. on England, and Eijkel and Vermeulen on the Netherlands) related to reforming intergovernmental fiscal relations. The wide range of issues covered in this volume demonstrates the diverse nature of fiscal decentralisation. The chapters also show that institutions, economic development stages, and political economy constraints are key elements of fiscal decentralisation.

Notes

1. See, for example, OECD (2011), OECD (2012), OECD (2014a), OECD (2014b), and OECD (2017).
2. This is under the assumption that income segregation does not involve political and ethnic tensions. Spatial inequality may reinforce interpersonal inequality when political and ethnic discrimination are at play (Kanbur and Venables, 2005; Ezcurra and Rodríguez-Pose, 2017).
3. See Boadway (2001, 2004) for detailed discussions.
4. "Primate city favouritism harms the favoured primate city by making it larger than it should be. It also harms smaller cities, which are, in effect, heavily taxed" (Duranton, 2015: 63).
5. For a review on the evolution of the theory of fiscal federalism, see Oates (2005, 2008).
6. It should be noted that China took a different route. The fiscal reform in 1994 drastically increased vertical fiscal gap (see, e.g., Shen and Zou, 2012).

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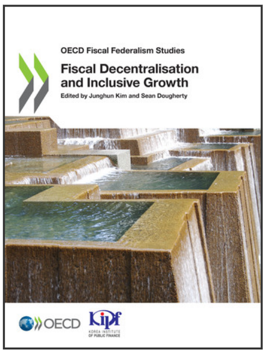

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