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Institutions, Decentralization and Growth

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Introduction

Decentralization is in fashion and has become a fundamental concern all over the world. It is not only the central governments of developed countries which are embarking on decentralization but also other central governments of developing countries around the world. They are decentralizing fiscal, political and/or administrative responsibilities. In developing countries we have examples of Moldova (IMF, 1999 WP/99/176) which is currently undergoing a reform of its system of intergovernmental fiscal relations, decentralizing the local government; Uganda (Livingstone and Charlton, 2001); Indonesia (Brodjonegoro and Asanuma, 2000); Philippines (Eaton, 2001); and South Africa (Ahmad, 1998).

In the theoretical literature it is agued that the results of decentralization are influenced by features of political institutions. Empirical literature has tried to show that the effect of decentralization on economic growth, quality of government, and public goods provision strongly depend on two aspects of political centralization: (1) strength of national party system (measured by fractionalization of parliament and age of main parties); and (2) subordination (whether local and state executives are appointed or elected) (Enikolopov and Zhuravskaya, 2003). Successful implementation of decentralization is mostly a function of the existing institutions. Institutional development aimed at better governance, better implementation for fiscal decentralization and other policies, will take years if not decades, to complete. However, such institutions cannot be imported and must be built domestically. Since fiscal decentralization is not isolated from other challenges, the institutional changes that take place need to fully take into account the country's changing environment.

Contemporary economic literature does not seriously question whether decentralization affects the quality of government, economic growth and efficiency of public goods provision. However, the effect of decentralization depends on political and economic incentives of local public officials. Economic incentives that help to align

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politicians' private interests with public goals are provided by such mechanisms as inter-jurisdictional competition (Enikolopov and Zhuravskaya, 2003). Political incentives, i.e. local governments' accountability are provided by political institutions, which ensure that careers of local politicians depend on whether, they pursue efficient policies. In the absence of accountability, strong economic incentives at the local level may result in corruption, provincial protectionism, and capture vested interests (Tanzi, 1996; Sonin, 2003).

Fiscal decentralization may indeed have a direct impact on economic growth, but the theoretical foundations for the relationship remains largely underdeveloped. The impact of fiscal decentralization on economic development is a widely debated topic in the development literature. A number of scholars have argued that the decentralization of a nation's fiscal structure is an effective strategy to promote economic growth and. development.

The purpose of this paper is to discuss the link between institutions and fiscal decentralization and to explore the extent to which fiscal decentralization impacts on growth.

The reminder of the paper is organized as follows. Section 2 presents a theoretical discussion on decentralization, which includes what is and types of decentralization, appropriate form of decentralization, and the rationale for decentralization. Section 3 discusses the role of institutions in fiscal decentralization. Section 4 discusses the impact of fiscal decentralization on growth. My conclusion follows in section 5.

What is Decentralization?

This section provides a brief overview of the main types of decentralization, which can be occurring across countries, and even within the same country as well as sector. It is pertinent to make such distinction among different types of decentralization to facilitate the discussion of the design and impact. For instance, the type of decentralization selected within a country will depend on its design, which will consequently depend on the political structure and administrative issues of that country. The impact of decentralization will differ depending on what type of decentralization is carried out: the political, fiscal and administrative arrangement, which characterize decentralization, and what the objectives of

decentralization are. It is important to introduce consistency in any discussion of decentralization to avoid "comparing apples and oranges" and to ensure that we can draw lessons where applicable.

The term decentralization is not easy to define since this label encompasses a wide variety of institutional arrangements. "Decentralization seems often to mean whatever the person using the term wants to mean" (Bird, 1993: 208). The term "decentralization" constitutes different concepts, which must be carefully analyzed in any particular country before determining if projects or programs should support reorganization of financial, administrative, or service delivery systems. The broad definition of decentralization encompasses the transfer of authority from the central government to intermediate and local government or quasi-independent government organization and/or the private sector. Decentralization is a complex multifaceted concept. It is important to distinguish different types of decentralization because they have different characteristics, policy implications, and conditions for success.

Decentralization is a political reality worldwide that varies greatly among and within countries. In the face of this consideration, before making any assumption about this overwhelming process of institutional change, it is important to distinguish between different forms of decentralization. This is particularly important if we want to account for the consequences of decentralization or focus on its causal mechanism. At present there are four main forms of decentralization: political, administrative, fiscal, and market decentralization. Distinguishing between these different concepts is important in order to highlight the many dimensions to successful decentralization and the need for coordination among them. Nonetheless, there is clearly an overlap in the definition of these terms and the precise definitions are not as important as the need for a comprehensive approach. Political, administrative, fiscal and market decentralization can also appear in various forms and combinations across countries, within countries and even within sectors.

Appropriate form of decentralization

Assuming the existence of appropriate conditions, all these forms of decentralization can play an important role in broadening participation in political, economic and social activities in developing countries. Where it works effectively, decentralization helps alleviate bottlenecks in decision-making that are often caused by central government planning and control of important economic and social activities. Decentralization can help cut complex bureaucratic procedures and it can increase government officials' sensitivity to local conditions and needs. Besides, decentralization can help national government ministries reach larger numbers of local areas with services; allow greater political representation for diverse political, ethnic, religious, and cultural groups in decision-making; and relieve top managers in central ministries of "routine" tasks to concentrate on policy. It can also increase political stability and national unity allowing, citizens better control of public programs at the local level.

However, decentralization is not a universal remedy, and does have potential disadvantages. First, decentralization may not always be efficient, especially for standardized, routine, network-based services. Second, it can result in the loss of economies of scale and control over scarce financial resources by the central government. Third, weak administrative or technical capacity at local levels may result in services being delivered less efficiently and effectively to some areas of the country. Fourth, administrative responsibilities may be transferred to local levels without adequate financial resources and make equitable distribution or provision of services more difficult. Fifth, decentralization can sometimes make coordination of national policies more complex and may allow functions to be captured by local elites. Finally, distrust between public and private sectors may undermine cooperation at the local level.

Rationale for decentralization

Most of the decentralization, which has been carried out in the 1990s has arisen from political motives. For example, in Africa, the spread of multi-party political systems is creating demand for more local voice in decision making. In some countries, such as Ethiopia, decentralization has been a response to pressures from regional or ethnic groups for more control or participation in the political process. In the extreme, decentralization represents a desperate attempt to keep the country together in the face of these pressures by granting more autonomy to all localities or by forging

"asymmetrical federations." A variation on this theme has been decentralization as an outcome of long civil wars, such as in Mozambique and Uganda, where opening political opportunities at the local levels has allowed for greater participation by all former warring factions in the governance of the country. Furthermore, in many countries, decentralization simply has happened in the absence of any meaningful alternative governance structure to provide local government services. Yet in some cases (particularly in East Asia) decentralization appears to be motivated by the need to improve service delivery to large populations and the recognition of the limitations of central administration.

Although politics seemingly is the driving force behind decentralization in most countries, fortunately, it may be one of those instances where good politics and good economics may serve the same end. The political objectives to increase political responsiveness and participation at the local level can coincide with the economic objectives of better decisions about the use of public resources and increased willingness to pay for local services. At least five conditions are important for successful decentralization:

(i) The decentralization framework must link, at the margin, local financing and fiscal authority to the service provision responsibilities and functions of the local government - so that local politicians can bear the costs of their decisions and deliver on their promises;

(ii) The local community must be informed about the costs of services and service delivery options involved and the resource envelope and its sources - so that the decisions they make are meaningful. Participatory budgeting, such as the one in Porto Alegre, Brazil, is one way to create this condition;

(iii) There must be a mechanism by which the community can express its preferences in a way that is binding on the politicians —so that there is a credible incentive for people to participate;

(iv) There must be a system of accountability that relies on public and transparent information, which enables the community to effectively monitor the performance of the local government and react appropriately to that performance- so that politicians and local officials have an incentive to be responsive; and;

(v) The instruments of decentralization—the legal and institutional framework, the structure of service delivery responsibilities and the intergovernmental fiscal system— are designed to support the political objectives.

Fulfilling these conditions (or at least having local governments improve upon the central government's record) is achievable but a tall order.

Successful decentralization is closely related to observing the design principles of: finance following (clear assignment of) functions; informed decision making; adherence to local priorities; and accountability. However, applying these principles in practice has not proven to be simple. Country circumstances differ, often in delicate and complex ways; consequently the policy and institutional instruments that establish decentralization have to be shaped to the specific conditions of individual countries.

Political Decentralization

The objective of political decentralization is to give citizens or their elected representatives more power in political decision making. It is often associated with pluralistic politics and representative government. However, it can also support democratization by giving citizens, or their representatives more influence in the formulation and implementation of policies. Advocates of political decentralization postulate that decisions made with greater participation will be better informed and more relevant to diverse interests in society, than those made only by national political authorities. This concept implies that the selection of representative from local electoral jurisdictions allows elected officials to know better the needs and desires of their constituents.

Nevertheless, political decentralization often requires constitutional or statutory reforms, the development of pluralistic political parties, the strengthening of legislatures, creation of local political units, and the encouragement of effective public interest groups.

Fiscal Decentralization

Fiscal decentralization entails shifting some responsibilities for expenditures and/or revenues to lower levels of government. There is one important factor in determining the type of fiscal decentralization. This is the extent to which sub-national entities are given autonomy to determine the allocation of their expenditures. Yet the other important factor is their ability to raise revenue. It is essential to clarify where local governments can determine the allocation of expenditures themselves versus those where the center

mandates expenditures and local levels simply execute those expenditures. When statistics on sub-national finance are available (most notably in the IMF's Government Finance Statistics) these two types of expenditures are usually aggregated and one figure provided on "percentage of sub-national expenditures". To this end, analysts must be very careful when using this as an indicator of local autonomy, as autonomy will not be enhanced unless the funds are not tied by the center. At any rate, some countries do derive the benefits of local expenditure autonomy as a result of local governments' ability to access the funds and circumvent the central mandate!

Unitary and federal governments provide different opportunities for fiscal decentralization. Unitary countries do not have sub-national governments that are constitutionally empowered to make decisions over a specified range of government (e.g. central, province, and district). Federal governments, on the other hand, have constitutionally protected sub-national governments and thus, the possibilities for independent decision making are clearly stronger under these systems. It is noteworthy that local governments (as opposed to state or province) may not necessarily enjoy constitutional protection under the federal system. In practice, however, the extent and nature of decision making power exercised by lower tiers varies widely from country to country in both federal and unitary countries and may change (in their direction) from time to time. At the extremes, some nominally federal countries (e.g., Venezuela) may be considerably less decentralized in reality than in nominally unitary countries (e.g., Canada).

Despite the complexity of the existing situation in many countries, both theory and experience suggest strongly that it is important to state expenditure responsibilities as clearly as possible in order to enhance accountability and reduce unproductive overlap, duplication of authority, and legal challenges. Many would argue that decision-making should take place in accordance with the principle of "subsidiary", that is, at the lowest level of government, consistent with allocative efficiency (e.g., the geographic area that internalizes the benefits and costs of decision-making for a particular service). The optimal size of jurisdiction for each service could theoretically differ. However, in practice, economies of administration and transactions costs lead to "grouping" of roughly congruent services at local (e.g., street lighting, refuse removal, regional (rural-urban roads, refuse disposal), and national (intercity highways, environmental policy) levels. Decentralized decision-making enlarges possibilities for local participation in development. In addition, national allocative objectives may be carried out by local governments responding to incentives created by national grants and regulations as well as inter-local or interregional agreements. National governments have obvious roles with respect to both stabilization and distribution, and due attention must be paid to possible local conflicts with these policies.

Institutions and Fiscal Decentralization

Drawing on past experience sometimes even the policies, which promise to produce gain from the majority of the public, fail to deliver. Often times, the failure to implement them is attributable to institutional problems. In a society with weak institutions, the rules and organization to coordinate human behavior are undeveloped, if not faulty. Consequently, even the policy designed to produce winsome solution often leads to an increase in division and unequal asset distribution. The existence of such situations does not lead to the sustainable development that benefits the poor and the majority.

What are institutions?

Institutions are socially devised constraints on individual actions. They are sets of rules that are recognized and frequently followed by members of the community and that impose constraints on the actions of individual members (North, 1991). More broadly, World Bank (2002) defines institutions as the rules and organizations, including informal norms that facilitate coordination of human behavior. These rules comprise of both formal and informal. The informal ones evolve from norms to traditions and the formal ones form regulations, laws, and constitutions, which are more difficult to change. Organizations include government agencies, parliament, firms, police, court and civil society.

What comes out clearly from the two definitions is that although institution can be constraining for individuals, they are effective to the community. It is obvious that the community would be better off if people follow rules, than it would be the case in the absence of rules. In view of this, institutions facilitate and liberate the community rather than constraining it. Nonetheless, at individual level, institutions impose constraints as North's definition.

From the point of view of the World Bank (2002), the key function of institutions are: (a) to pick up signals about needs and problems; (b) to balance interest by negotiating change, forging agreements

by avoiding conflicts and stalemates; and (c) to execute and implement solutions by credibly following through on agreements. To this end, in a society with well-functioning institutions, individuals can enter into a number of complex contracts and exchange with low transaction costs. This encourages innovation, technical progress and creates an environment that would enable people in the society to work with each other to achieve their joint potential.

Societies without well-functioning institutions, on the other hand, will go to the opposite end. Weak institutions generate uncertainty and cause mistrust among members of society. Consequently, the economies of scale are foregone since this environment will not encourage people to work together to achieve their joint-potential. With weak institutions, it is often the case that a big proportion of economic activity is located in the informal sector. Besides, with different levels of institutional development, two societies starting from similar situations can end up with different levels of corruption. One with weak institutions ends up with a bad equilibrium, with low level of rule obedience due to weak law enforcement. The other with well-developed institutions prospers in a good equilibrium, with high level of obedience. In the case of bad equilibrium, the number of violators may be so large that the probability of getting caught and punished for breaking the rule is low. Here people rationally choose not to obey the rule. In the good equilibrium case, on the other hand, individuals who contemplate rule violation face a high probability of getting caught and punished, and so people rationally choose to obey.

Fiscal Decentralization and Economic Growth

During the 1990s many developing and transitional countries have either embarked on or stated their intention to embark upon some type of fiscal decentralization initiative (Dillinger, 1994). Often one of the stated objectives of fiscal decentralization is to foster economic growth. The interest in fiscal decentralization as an engine for economic growth is not limited to developing and transitional economies, but has emerged to the forefront of the policy agendas of most OECD countries (World Bank, 1999). These broad-based policy agendas call for a closer examination of the potential relationship between fiscal decentralization and economic growth.

Traditionally, the theory and practice of fiscal decentralization has paid little attention to the objective of economic growth. Only quite recently have normative discussions of fiscal decentralization added economic growth to the traditional list of public finance objectives of efficiency in the allocation of resources, horizontal fiscal imbalances and economic stabilization (Bird and Vaillancourt, 1997; and Fischer, 1993).

Instead, the traditional argument for fiscal decentralization is that it may provide greater economic efficiency in the allocation of resources in the public sector (Oates, 1972; Broadway and Widasin, 1984). Under the assumption that public officials respond to the desires of the constituents, sub-national governments are better able to match differing preferences across jurisdictions. Gains in efficiency are enhanced if taxpayers are mobile because they can migrate or sort themselves out among the jurisdictions that best match their preferred tax-expenditure package, as first discussed by Tiebout (1956).[1] In a nut shell, if the preferences of the public goods differ across regions or individuals, the level of welfare achieved through uniform provision of public goods by a central government is inferior to that, which can be attained by decentralized provision which allows for differences across jurisdictions.

Overall, the lack of direct concern with the objective of economic growth in the theory and practice of fiscal decentralization is premised on the lack of attention given to this objective in public sector economics. However, public sector economics has paid indirect attention to the objective of economic growth by focusing on issues such as how taxation may distort economic incentives toward savings and investment, how to evaluate the relative worthiness of public investment projects (as for example in the theory of cost-benefit analysis), or how to improve the performance of private markets through spending on education and health systems or investment in basic infrastructure.

The general implicit assumption in the public sector economics has been that economic growth is fuelled by growth in the quantity and quality of economic inputs (labour, capital and natural resources) and by technological changes in the private sector. The role of the private sector is to facilitate, or not to impede, this process.

What is known about the effect of decentralization on economic growth?

The current state of the fiscal decentralization literature exhibits the dearth of empirical information on the effects of decentralization, not only on economic growth, but also on the traditional objectives of economic efficiency, income distribution, and economic stability. The analysis of the direct role of the public sector in economic growth is relatively a new area of study, with the contribution of fiscal decentralization to economic growth only emerging in the 1990s. What follows is a brief account of the existing evidence on the potential relationship between fiscal decentralization and growth.

From economic growth to fiscal decentralization

We know very little about the relationship between decentralization and economic growth. Empirical evidence for the way in which decentralization affects growth has been contradictory and is plagued by measurement, specification, and analytical problems. There is stronger evidence for a relation in the other direction, that is, from growth to decentralization—but the interpretations of this correlation between high income and decentralization have varied.

Evidently, there has been scanty research of causation line from decentralization to growth. However, amusingly, there has been extensive empirical analysis of the reverse question: to what extent is the level of decentralization a function of the level of economic development? There is strong evidence that most measures of fiscal decentralization across countries, such as share of expenditures or revenues of sub-national governments in the general government budget, are positively correlated with the level of economic development, generally measured by per capita income (Oates, 1972; Pommmerhne, 1977; Bahl and Nath, 1986; Wasylenko, 1987; and Panizza, 1998).

Nevertheless, there is less consensus in the literature regarding how to interpret the fact that decentralization is a more common and deeper phenomenon in industrialized countries. One possible explanation is that decentralization is like a superior good. It is only at relatively high levels of per capita income that decentralization is demanded or becomes "attractive" to taxpayers in the sense that its benefits can be more fully exploited without the problem of the disadvantages that tend to be more present in countries at lower levels of development (Bahl and Linn, 1992). This relationship between economic development and the depth of decentralization may also be because many developing countries inherited highly centralized systems at the time of their independence from their colonial powers (Conyers, 1990). However, there is apparent wide agreement with Oates (1993) assessment that empirical relationship between the level of development and the presence of fiscal decentralization should not be interpreted to say that there is monotonic relationship between the two such that decentralization intensifies without bound with per capita income, or that a decentralized system of public finances will not offer advantages to countries at lower levels of economic development (Martinez-Vazquez and McNab, 2001).

From fiscal decentralization to economic growth

The existing recent studies in this area fall under three categories: (1) studies to quantify the role of government expenditures on economic growth; (2) studies on the relation of public infrastructure spending on economic growth; (3); and studies on the impact of decentralization on economic growth.

Studies to quantify the role of government expenditures on economic growth

A good number of studies have made an attempt at quantifying the role of government expenditures on economic growth, the question of what impact decentralized government expenditures have on economic growth remains largely unaddressed.

Aschauer (1989) and Barro (1990) find that an increasing share of central government consumption in GDP is negatively related with growth in per capita income. In an earlier study, however, Ram (1986) found a positive relationship between central government consumption in GDP and economic growth in per capita income. Devarajan, Swaroop, and Zou (1996) examine the impact of the composition of public expenditure on economic growth and find that while an increase in the share of current central government expenditure has positive and statistically significant effect on growth, the capital component of public expenditure has a negative impact on per capita growth. The hypothesis assumes that developing country governments may have been allocating too many resources to capital investments at the cost of more productive current expenditure.

Studies to measure the impact of public infrastructure spending on economic growth

Other researchers have found that public infrastructure spending has a positive significant impact on growth (Aschauer, 1989 and Easterly and Robello, 1993). In addition, there is some evidence that the efficiency of public expenditures can differ considerably across countries. Gupta, Honjo, and Verhoeven (1997) evaluate the efficiency of government expenditures on education and health in 38 countries in Africa and find that, on average, countries in Africa are less efficient than countries in Asia and Western Hemisphere. They do suggest that the observed inefficiencies may be a result of relatively high government wages and intra-sectoral allocation of government resources.

Invariably, none of the studies discussed above is concerned with the potential impact of the degree of decentralization (or governmental composition of the public expenditure or revenue assignment) on economic growth. Nevertheless, an emerging line of research has attempted to test the presence of a direct link between fiscal decentralization and economic growth. The few studies which have directly examined the relationship between decentralization and growth come up with mixed results. Liu (2000) concludes that fiscal decentralization positively and significantly influences economic growth in China. Zhang and Zou (1997) show that fiscal decentralization has positive and sometimes significant effect on regional economic growth in India. However, their 1996 work on China; and Davoodi, Xie and Zou's (1995) work on the United States find fiscal decentralization to be associated with lower growth. In a larger sample of developed and developing countries, Davoodi and Zou (1998) find that decentralization has a negative relationship to growth in developing countries and no discernible effect on growth in developed countries. Likewise, Wollen and Phillips (1998) fail to find a statistically significant and robust relationship between fiscal decentralization and economic growth for a panel of developing countries. However, their findings suggest that there exists a statistically significant though trivial inverse relationship between the level of revenue decentralization and economic growth rates in their sample of developed countries. Several methodological problems in these studies discount even these mixed results and much more needs to be done to ensure that the measured decentralization growth relationship is robust.

Although the theoretical foundations of the literature still need to be further developed, these studies have not only provided the first empirical estimates of the potential effect of decentralization on economic growth but have also provided insights into different aspects of this relationship (Martinez-Vazquez and McNab, 2001). For example, fiscal decentralization could be measured, as is done in the literature, in a single dimension (for example, the share of expenditure or revenue of sub-national governments in the general government) then we should not expect a monotonic relationship between decentralization and growth (Davoodi and Zou, 1998). That is, it is not necessarily true that the more decentralized a county's fiscal system becomes, the faster its economy will grow, but rather, we should expect that there exists an optimal degree of fiscal decentralization (sub-national governments' share of expenditure (revenues) is 100 percent). Of course, the bounds are imposed by the fact that there are some public goods, those with nation-wide benefits, which can be more efficiently provided at the national level. However, within the context of more complex, multidimensional definitions of decentralization (for example, an index of encompassing tax autonomy and budget discretion), it may be possible to obtain multiple optima, and even a monotonic relationship between decentralization and economic growth. The recent literature on the empirical relationship between decentralization and growth also raises several estimation issues for future work. These issues are discussed in detail in Martinez-Vazquez and McNab (2001).

Theoretical linkage between fiscal decentralization and economic growth

The brief review of empirical literature seems to suggest clearly that we may be off track from understanding and consequently properly testing the relationship between decentralization and economic growth. To date the empirical work on the potential impact of fiscal decentralization on economic growth has offered thus far inadequate detailed discussion of why we should expect this relationship to exist. Being able to respond to this basic question is important to enable us to construct better and more discerning empirical tests. In addition, the lack of a theoretical framework has also hampered the statistical work. Finally, there is a wide agreement on the desirability of developing such theoretical framework (see Oates, 1993; Bird, 1993; Prud'homme, 1995; and Peterson, 1996).

It is therefore important to examine in brief the means through which fiscal decentralization may affect economic growth. This may provide the basis for the development of a theoretical framework in future.

One of the key questions to be posed here is whether there is a direct linkage between decentralization and growth. Oates (1993) argues that, intuitively, the static proposition that fiscal decentralization enhances efficiency should have a parallel in dynamic setting of economic growth. On the face of this, expenditure for infrastructure and social sector that respond to regional or local differences are likely to be more effective in enhancing economic development than central policies which may ignore those differences. Nonetheless, Oates is not very explicit about what this means. The fundamental question is why, for instance, $1 million spent on roads or education at the sub-national level should be more growth-enhancing than the same amount of money spent at the national level. The direct effect, pointed out by Oates, suggests that if sub-national governments have an advantage in making public expenditures more efficient (by better satisfying the needs and preferences of local taxpayers based on better knowledge of these preferences), then this "static "advantage can also be present in a "dynamic" sense by having sub national government expenditures be more growth-enhancing. On closer look, this argument would seem to need further development.

Indirect linkage between fiscal decentralization and economic growth

Even in if direct link between fiscal decentralization and growth derived by Oates (1993) did not exist, there would appear to be several potential indirect linkages between fiscal decentralization and economic growth.

(a) The nature of efficiency and measurement

What is not disputable in theory and practice of fiscal decentralization is that given certain conditions, sub-national governments can be more efficient. This can mean two things. First, the same amount of funds spent at the sub-national level can lead to individual welfare. This can be for some services since local and regional governments are better at understanding the preferences and the needs of their constituencies and can more easily adapt their expenditure policies to achieve them. This increase in welfare through decentralized expenditures can be termed the greater *"consumer or allocative efficiency"* of decentralized expenditures (Martinez-Vazquez and McNab, 2001).

Second, it is also possible, but by no means a foregone conclusion, that spending the funds through sub-national governments can lead to greater "producer efficiency". That is, the same services or infrastructure can be put in place at a lower cost, or a particular budget can yield larger quantities or better quality of services and infrastructure when the funds are spent at sub-national level. By and large, there would be little dispute with the contention that fiscal decentralization can result in greater consumer efficiency. The lack of disagreement is not because there have been measurements of these effects. In fact tests of this type have been few and far between.

The assertion that fiscal decentralization can result in producer efficiency, however, would be disputed by many. What kind of evidence is there on differences in producer efficiency? The question put forward by Prud'homme (1995), Tanzi (1996), and others is whether or not local governments operate on the same production frontier as the central government and whether or not this question would receive the same answer in developed as well as in developing and transitional economies. On the other hand, Shah (1999) argues that the institutional environment in developing countries necessitates a greater degree of decentralization because of the high transaction and administrative costs implied by centralized system. In addition, decentralization may result in greater producer efficiency in that it involves experimentation and innovation in the provision of goods and services.

In practice, sub-national governments in many countries have been in the forefront of privatization of public services (World Bank, 1999). But on the whole, there is little empirical evidence in one way or another about whether local governments are more or less producer efficient than central governments.

For the sake of argument, we can answer that at least in some cases, decentralization leads to greater consumer efficiency. However, it is quite evident that neither of these two potential effects of decentralization, greater consumer efficiency and greater producer efficiency are recorded in the national accounts. Greater consumer

efficiency implies greater individual welfare but no independent measure exists to date.

If the greater efficiency associated with fiscal decentralization is not directly accounted for in the conventional measures of output and economic growth, how is it that greater efficiency may affect measured growth?

(b) What is the nature of the link between greater efficiency and measured economic growth?

If fiscal decentralization leads to greater producer efficiency, then the indirect link between fiscal decentralization and growth is somewhat intuitive. National accounts measure public output by the level of expenditures, regardless of which level of government spends the funds. But if decentralized governments can produce more output (or better quality output) than the central government, with the same level of expenditures, then greater producer efficiency at sub-national level is occurring. Eventually, the higher quantity or quality of the locally provided services, the true output, would result in increased income and therefore in measured economic growth.

As regards consumer efficiency, the relationship is less intuitive. A number of complex elements are at play. On the positive side, by better matching the preferences of citizens and increasing the individual welfare, there may be secondary effects on work effort, savings and private investment, all with a positive impact on measured economic growth at a later date. Likewise, it is possible that if public resources are "more efficiently spent" at sub-national level, this would mean, for example, that a better educated and healthier labour force or faster, less costly, transportation will result in greater (measured) economic growth in the future.

To this end, tighter empirical tests of the impact of decentralization on economic growth should focus on whether or not fiscal decentralization, other things being equal (such as expenditure levels, per capita income, and so on), results in improved test scores or other measures of education, or better health status indices (Diamond, 1990). This means that we should test for the presence of direct impacts of fiscal decentralization on the basic components of the growth equation (better quantity and quality of inputs) rather than just directly on economic growth per se. However, the intermediate effect of decentralization on the quantity and quality of some public services, such as roads built by sub national governments, is likely to be more difficult to quantify.

Political institutions and economic growth

Enikolopov and Zhuravskaya (2003) try to shed light on the debate on the effects of decentralization. In pursuit of this objective, they evaluate the effects of decentralization on quality of government, public goods provision, and economic growth, taking into account the structure of political institutions. In particular, they analyze how the level of political centralization changes the results of fiscal decentralization. They do this because previous empirical literature on the effect of decentralization produced mixed results. This can partly be attributable to the fact that it overlooked the importance of political institutions.

Their key finding is that political institutions in particular play an important role in determining the results of fiscal decentralization. In line with theory of Riker (1964), they find that strong national party system is more effective way of securing political centralization needed for efficient decentralization compared to constitutional and administrative arrangements that make local executives directly subordinate to higher-level authorities (Blanchard and Shleifer, 2000).

The results for developing countries strongly support the hypothesis that high fractionalization of parliament and young age of parties reduce the efficiency of decentralization affecting economic growth, quality of government, and public goods provision. Strong parties prove to be important in creating career concerns that provide necessary incentives even for appointed state executives in developing country.

Conclusion

Institutional development for better governance, to allow better implementation of fiscal decentralization and other policies, will take time, if not decades, to complete. However such institutions cannot be imported, they must be home grown. Since fiscal decentralization is not isolated from other challenges, the institutional changes that take place need to fully take into account the changing environment facing the country.

Political institutions, in particular, political centralization, play an important role in determining the results of fiscal decentralization.

The impact of fiscal decentralization on growth is more than an academic question. Whether decentralization affects economic growth has become an important policy issue for developing and transitional countries. Thus, this is an issue of importance both for large countries like China and India and also for small countries like Baltic countries or countries in Africa.

We know very little about the relationship between decentralization and growth. Empirical work on the way in which decentralization affects growth has been contradictory and is plagued by measurement, specification and analytical problems. There is stronger evidence for a relationship in the other direction, that is, from growth to decentralization. However, the interpretations of this relationship between high income and decentralization have varied. We have also seen that there are potentially indirect effects of decentralization on growth including those through consumer efficiency and producer efficiency. Through such indirect effects there are forces at work that will link decentralization to higher economic growth, but there are also others that work in the opposite direction.

In the face of the apparent lack of consistent knowledge on the impact of decentralization on growth, it would seem safe and sound to argue that policy advice and international aid must still focus on improving the design of fiscal decentralization in developing economies. Even if we were to find at some later date that decentralization retards growth, this effect would need to be weighed against the positive impact of decentralization on the efficient allocation of economic resources and other possible benefits such as democratic governance and enhanced accountability (Martinez-Vazquez and McNab, 2001). Presumably, this paper may provide a better understanding of direct and indirect effects of fiscal decentralization and that empirical studies on the relationship between decentralization and growth have generated mixed results.

Notes

[1] Using Hirshmans terminology, Oates (1993) describes the two systems for conveying preferences for public goods to local government officials through "voice" (voting elections and responsiveness to local electorate) and "exit" (fiscal mobility or taxpayers voting with their feet by moving across jurisdictions).

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