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## **Whither Decentralization: Implications for Linking Research and Practice**

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### **Abstract**

This is the Presidential Address at the 2006 Annual Meetings of the Southern Regional Science Association, March 30-April 1, St. Augustine, Florida. It discusses the status of fiscal decentralization in the academic literature and as a matter of policy focus. Although “fiscal decentralization is in vogue” (Oates, 1999, p. 1120), the mechanisms by which it influences economic growth are not well enough understood to provide policy guidance. The conclusion spells out the steps for researchers and policy makers in gaining a better understanding of the implications and processes associated with fiscal decentralization.

*Keywords: Fiscal Decentralization; Sub-national governments; Economic growth*

*JEL classification: H1; H77; O2*

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In discussing my address, a colleague passed along advice given to him by his teen daughter: “Be short and funny.” I promise that I can definitely be *one* of these. We’ll have to wait and see about the other.

My talk this afternoon synthesizes a broad body of research concerning fiscal decentralization with the hope of providing guidance to those interested in policy-relevant and, more importantly, *policy-useful* research. This is reflected in the subtitle of my talk.

To begin, let’s define decentralization as the *shifting* of responsibility from higher to lower levels of government (Oates 1999). This definition emphasizes decentralization as a *process* rather than a *static* condition. The distinction is important given the tendency for empirical research to analyze observed *levels* of decentralization. In contrast, policy dialogue generally concerns changes in institutions that influence decentralization outcomes.

Decentralization is closely tied to two familiar and subtly different concepts (see Tannenwald 1996). Federalism provides for authority via constitutional guarantees. In this context, decentralization comes from sub-national entities wielding their autonomy to a greater extent—it comes via local policy choices. Devolution involves shifting authority for particular functions via statutes. Such is the case with block grant programs. In this context, decentralization is driven by central government decisions to transfer more authority to local governments. Notably, decentralization is influenced by both central and local government decisions.

Why should we, as regional scientists, care about fiscal decentralization? As Oates (1999, p. 1120) commented, “Fiscal decentralization is in vogue.” In fact, using this quote is in vogue! Dozens of recent articles use this exact quote or some very similar statement. Fiscal decentralization has a prominent place in international policy dialogue. It is discussed in a variety of contexts for developed, developing, and transitional governments. It’s discussed in the context of outcomes such as stability, equity, and efficiency. (See for instance, Bird and Ebel 2004 for an overview.)

Indeed, a quick perusal of stylized facts highlights the increasing prominence of decentralization. Decentralization is commonly measured as the observed share of total government revenues or expenditures. This *de facto* measure is flawed, since it reflects local decisions as well as local autonomy. For instance, local governments won’t necessarily implement their full allowed fiscal authority. Still, this common measure is useful for showing the increasing trends in decentralization across the globe.

Ebel and Yilmaz (2002, Figure 1, page 3) show the increasing trend in decentralization for the countries included in the International Monetary Fund Government Finance Statistics Year Book 1998, Country Tables. For these countries, revenue and expenditure decentralization has been on the rise since the 1980s. The percentage share of sub-national governments in total government expenditure rose from just under 30 percent in

1980 to approximately 35 percent in 1998. Similarly, the revenue share of local governments rose from about 21 percent to about 25 percent for the same period.

Arzaghi and Henderson (2005, Figure 3) show the global tendency toward decentralization (or less centralization) for 1975 to 1995. They highlight regional differences in centralization trends. Notably, the decrease in *centralization* is not universal: former Soviet Block countries and Middle East and North African countries did not follow the global trend for this period.

The extent to which decentralization has trickled down to various sub-national levels of government across the global is also unclear. The United States is a good example. As shown in the dark line in Figure 1, there has been an increase in state and local government share of total government current expenditures over the past 30 years.<sup>1</sup> At the same time, the light line in Figure 1 illustrates the decline in the local share of state and local expenditures over the same period. Thus, while the U.S. federal government has become more decentralized (to the state level), U.S. states have become more centralized on average. Obviously, there is a great diversity in the level and extent of change across U.S. states.

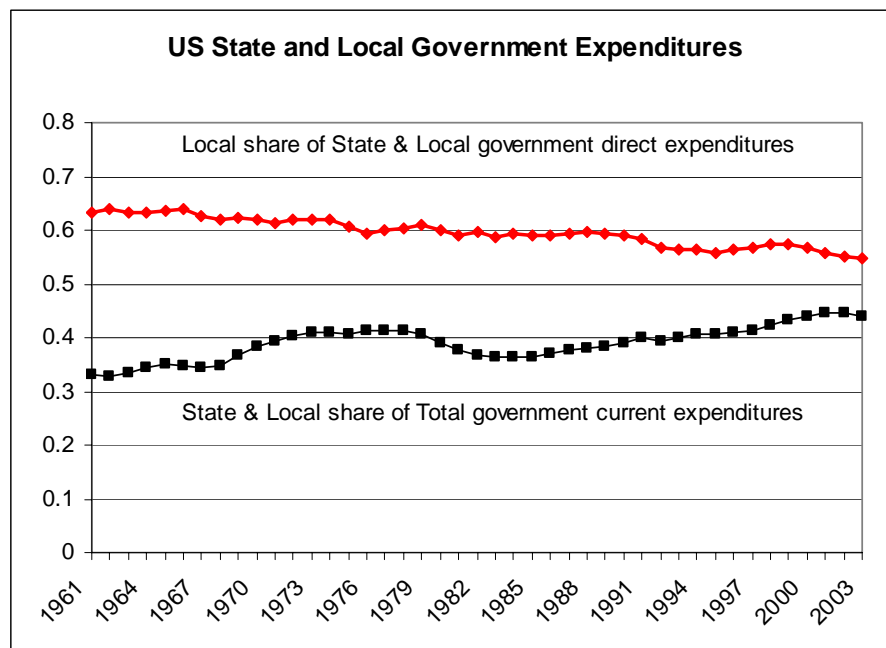


FIGURE 1. Expenditure Decentralization in the US

<sup>1</sup> The revenue data are from the *Economic Report of the President, 2005*. The direct expenditure data are from the U.S. Census Bureau. As of 1996, the Census Bureau, Division of Governments, stopped collecting revenue data for the federal and total governments in a manner consistent with the data for state and local governments.

Academic research on decentralization has also become increasingly in vogue. Based on a search of the ECONLIT online database, setting Title Field = “Decentralization,” Figure 2 shows the trend in the number of journal articles (noted in the dark line) as well as all types of publications for the years 1980-2005. Note that 2005 may be incomplete due to publication and database preparation delays. There was a noticeable increase in publications around the early 1990s and a second peak in 2004. These peaks reflect the concurrent international policy dialogues.

Lacking a universal theoretical foundation, the empirical literature related to fiscal decentralization can be (and has been) characterized as diverse and disjointed. Figure 3 highlights five major themes related to the fiscal decentralization literature. The themes are represented by the ovals and are labeled with bold text blocks. For background, I will quickly summarize the themes and some of the overlaps.

The top oval represents literature on Oates’ popular Decentralization Theorem, which cites the benefits of bringing government closer to the people. Decentralization encourages citizens to empower local government with more fiscal responsibilities. To the extent that public spending might otherwise be underprovided, decentralization enhances efficiency, holding spillovers and externalities constant.<sup>2</sup>

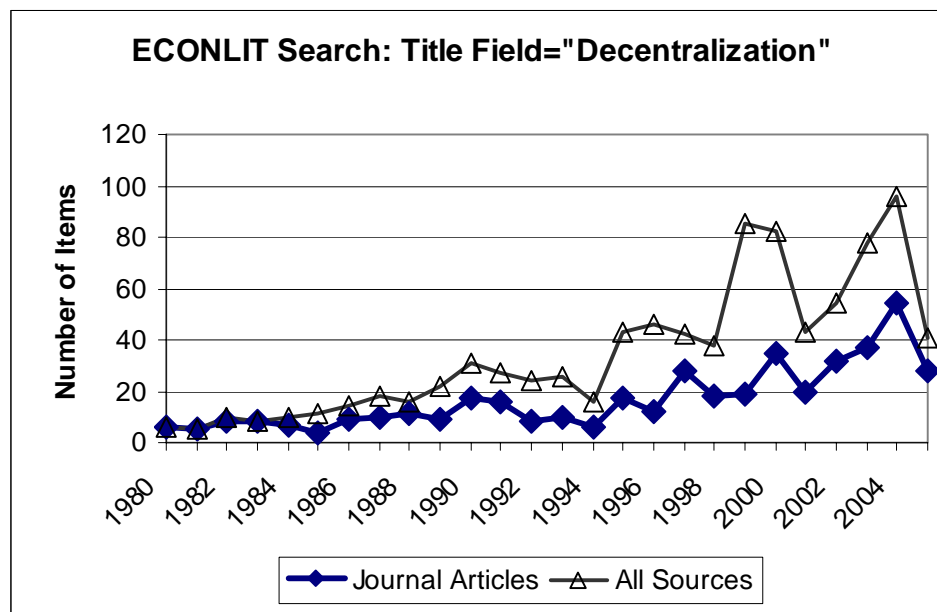


FIGURE 2. Trend in Number of Articles on Decentralization

<sup>2</sup> See Oates (1972, 1985, 1993, 1999) and Wallis and Oates (1988).

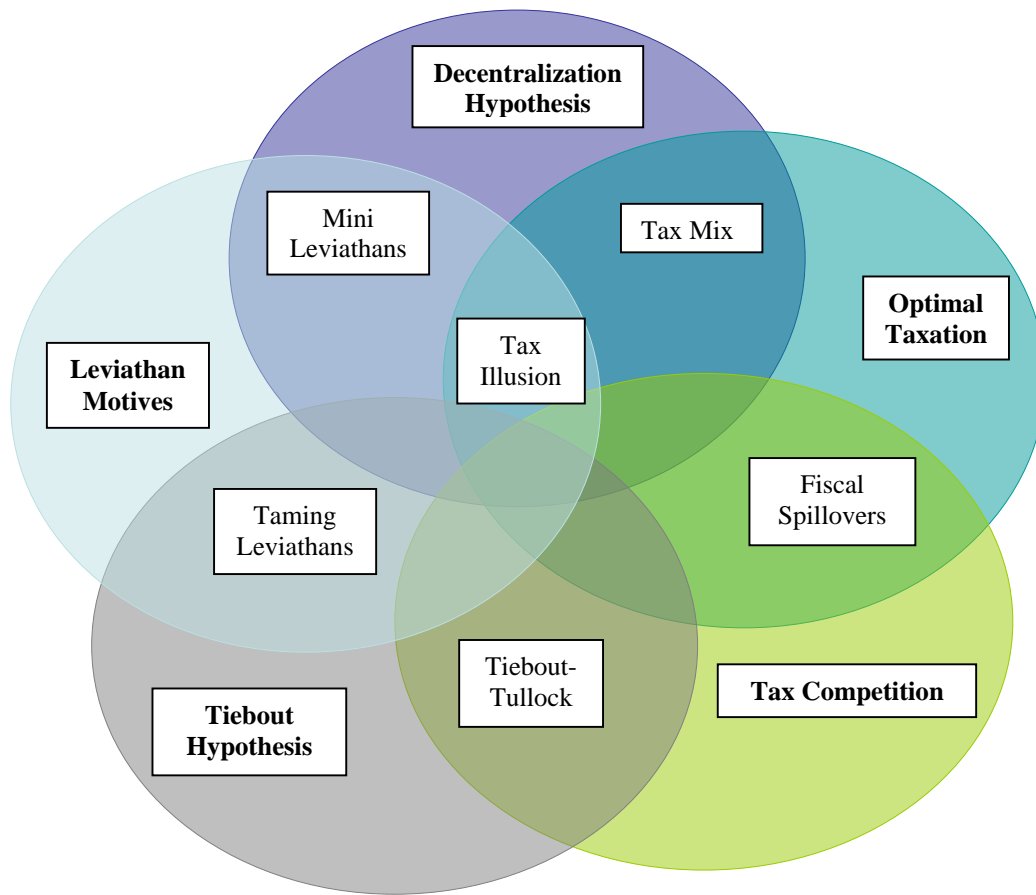


FIGURE 3. Major Themes Related to Decentralization Hypothesis

Moving counterclockwise is the oval representing Leviathan motives.<sup>3</sup> This focuses on government agents as budget maximizing entities. Decentralization is credited as a way to tame leviathan tendencies by engaging local participation and through competitive pressures. Notably, it could also produce mini-leviathans, though this is less noted in the literature.

At the bottom is the oval representing the Tiebout Hypothesis, which allows for individuals to vote with their feet to find the mix of government taxes and amenities that fits their needs (Tiebout 1956). In this way decentralization allows for sorting of residents by preference for local public goods provision and tax mix. In the proper context, such sorting could be efficiency enhancing.

<sup>3</sup> The Leviathan literature follows from the Brennan-Buchanan hypothesis. See for instance Brennan and Buchanan (1977, 1978, 1980)

The oval at the bottom right represents the tax competition literature. It is ambivalent about the impact of fiscal decentralization. Competition pushes local governments to provide services more efficiently and to be more responsive to local demands. On the other hand, such competition can lead to the infamous “race to the bottom” concerns.

The oval at the top-right represents the optimal taxation literature. Although generally broader by nature, this has direct connections to the fiscal decentralization literature, particularly regarding fiscal spillover and tax mix decisions. These are particularly salient with overlapping taxing jurisdictions. Potential, though by no means certain, gains from decentralization have to be balanced against loss of economies of scale.

Although the literature generally focused on a single theme, the themes related to decentralization are interrelated, as represented by the overlap of the main oval themes in Figure 3. For example, Tullock (1971) frames the Tiebout hypothesis so as to stress the consumer-voter’s choice of local public goods and tax liabilities.<sup>4</sup> Thus, the Tiebout-Tullock hypothesis overlaps the tax competition and Tiebout model concepts. Similarly, state and local tax mix decisions can create fiscal illusions and these may be influenced by the extent of fiscal decentralization.

Generally there is no unifying theory of the consequences of fiscal decentralization. The main mechanisms by which fiscal decentralization influences economic outcomes are information and heterogeneity. Information leads to empowerment, competition, and optimal sorting. These are accentuated by heterogeneity in preferences and in local endowments. This leads us to the age-old claim about the importance of “location, location, location!”

Empirical evidence regarding the growth consequences of decentralization is mixed. Table 1 highlights the controversial findings in recent articles published in the *Journal of Urban Economics*. The evidence for cross-countries studies is controversial. Davood and Zou (1998), for example, find a negative association between decentralization and growth for developing countries but not for developed countries. In contrast, Iimi (2005) concludes that fiscal decentralization enhances growth using 51 countries and more recent data.

Similarly, in a study of U.S. aggregate state and local decentralization, Xie, Zou, and Davoodi (1999) conclude that further state and local decentralization could be detrimental to growth. In contrast, Akia and Sakata (2002) and Stansel (2005) find decentralization to be growth enhancing for studies of U.S. states and metro areas, respectively.

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<sup>4</sup> See Cebula (2002) for a discussion of the correspondence between the Tiebout and Tullock frameworks.

TABLE 1

*The Journal of Urban Economics Controversy*

Growth Impacts of Decentralization	
Decentralization is Detrimental to Growth	Decentralization Enhances Growth
<u>Cross-Country Studies</u> Davoodi & Zou (1998) - 46 countries, 1970-89 - Estimated country impacts: <ul style="list-style-type: none"> <li>○ Insignificant for Developed</li> <li>○ Negative for Developing</li> </ul>	Iimi (2005) - 51 countries, 1997-2001
<u>U.S. studies</u> Xie, Zou & Davoodi (1999) - Agg. state & local, 1948-94 - Estimated local impacts <ul style="list-style-type: none"> <li>○ Insignificant for state</li> <li>○ Negative at local level</li> </ul>	Akai & Sakata (2002) U.S. states, 1996 Stansel (2005) U.S. Metro Areas, 1960-99

Such controversial cross-country findings regarding the growth impacts of fiscal decentralization are also evident in a series of papers in the *European Economic Review*.<sup>5</sup> Further, there are numerous studies on China that find ambivalent results.<sup>6</sup>

The controversial findings on decentralization impacts are easily attributed to differences in empirical specifications. Note that articles attributing growth benefits to decentralization use more recent data and more sophisticated econometric techniques. This suggests that the controversy lies in differences in empirical techniques or perhaps structural changes in the growth-decentralization relationship.

A newer line of research focuses on the factors driving differences in decentralization as explanations to the empirical controversies. These highlight the role of preference heterogeneity in the demand for decentralized institutions and in demands for local public goods. One study examines the demand for U.S. state alcohol policy as literally being driven by local tastes (for alcohol).<sup>7</sup> These studies point out the potential endogeneity of *de facto* decentralization to local preferences. As a regional economist at heart, I'm inclined to go farther by pointing to the potential endogeneity with regard to basic location factors.

<sup>5</sup> See for example Folster and Henrekson (2001) and Agell, Ohlsson, and Thoursie (2006).

<sup>6</sup> See for example Zhang and Zou (1998), Lin and Liu (2000), and Feltenstein and Shigeru (2005).

<sup>7</sup> Strumpf and Oberholzer-Gee (2002) investigate the influence of heterogeneity in preferences for alcohol within a state on the determination of state alcohol policy decentralization.

Figure 4 summarizes the state of the empirical literature on fiscal decentralization. The bulk of the literature investigates the growth consequences of decentralization. As indicated by the bottom arrow, these studies look at the relationship between *de facto* decentralization and outcome measures such as income or job growth. They offer no clear conclusions to support or reject policies on the basis of decentralization outcomes.

A much thinner body of literature, indicated by the top arrow, focuses on the causes of decentralization. These range from the early studies on basic socio-economic characteristics to more recent studies of the heterogeneity and institutional decentralization. Empirical evaluations, however, investigate *de facto* decentralization. That is, they combine the process indicated by the top arrow and the arrow on the left.

Few studies investigate the link between institutional decentralization and *de facto* decentralization. Little is understood about the mechanisms by which policies affect *de facto* decentralization. That is, do policies that give local governments more autonomy actually lead to more decentralized decision making? If so, under what conditions is this desirable?

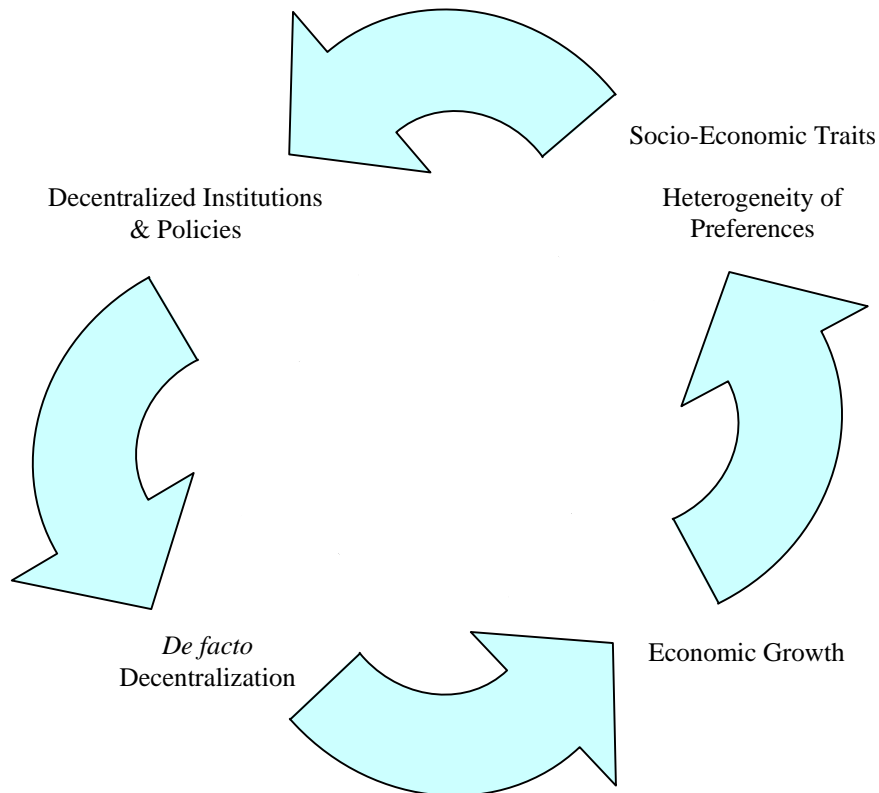


FIGURE 4. Characterization of Empirical Literature on Fiscal Decentralization



Investigating the endogeneity of decentralization to person- and place-specific characteristics is the new frontier for understanding the impact of decentralization. This points back to the importance of location considerations. Lacking an understanding of the underlying mechanisms by which decentralization is related to economic growth, we have little advice to offer to policy makers regarding the impacts of decentralization and policies that might promote it.

Now to address the subtitle of my presentation: What advice can we offer practitioners or policy makers about so-called decentralizing policies?

1. Beware of one-size-fits all policies given the inherent heterogeneity across places.
2. Understand and document your local context. What are your goals? Are you targeting equity, better schools, more jobs, etc? Also understand your comparative advantage.
3. Seek guidance from the experience of others. Make sure you emulate the right role models, however. Oklahoma City, for example, would have little success emulating Houston, given its lack of proximity to the sea—a fact that hasn't escaped an ocean lover like myself. You just can't escape basic location factors.

What are the implications for researchers?

1. Expand the body of knowledge by analyzing a variety of data, methods, and theories.
2. Synthesize research to create a menu of contexts.
3. Evaluate policy options for particular contexts.

Figure 5 presents a graphic to show the role that researchers can play. Expanding the body of knowledge is indicated by adding dots to the funnel. The funnel represents the process of synthesizing a large body of research so as to pick out the relevant features. It highlights that a large body of research is need to create a trickle of knowledge. The globe represents targeting the synthesis and guidance to the context in question.

So the link between practitioners and researchers is vital. Practitioners need to document their contexts so they can read off the menu that researchers create. Researchers need to know what “items/contexts” to offer in their menus. That is, researchers need to digest the diverse and often controversial findings to pull out relevance for a range of realistic contexts. Lots of analyses are needed to provide a large pool of cases from which to draw policy conclusions.

I would like to conclude by offering the following ideas: Not all things are possible. Not all possibilities are desirable. To quote our good colleague, Dan Rickman, perhaps the best we can hope for is to “provide a speed bump in the road to bad ideas.”

And with this, I conclude my duties as the SRSA 2005-06 President.



FIGURE 5. The Role of Researchers in Guiding Policy

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