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Fiscal decentralization and regional economic growth: Theory, empirics, and the Russian experience ☆

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Abstract

The article addresses the theoretical and empirical relation between fiscal decentralization and economic growth. An empirical analysis of Russian regions for 2005–2012 shows that excessive expenditure decentralization within the region, which is not accompanied by the respective level of revenue decentralization, is significantly and negatively related to regional economic growth. In contrast, regional dependence on intergovernmental fiscal transfers from the federal center is positively associated with economic growth.

JEL classification: H70, H77, O18, O47.
Keywords: fiscal decentralization, economic growth, Russian regions.

1. Introduction: Fiscal decentralization — theoretical aspects

Fiscal decentralization is one of the key concepts in the public finance theory and a commonly used policy measure in public sector reforms. In federal states, fiscal decentralization means that revenue and expenditure responsibilities (the right to impose and collect tax and independently determine the focus areas of expenses) are transferred from the federal to the regional and local levels.[1]

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[1] Depending on the context, fiscal decentralization can be viewed as a process (transferring budgetary authority) or as a state or result of such a process (scope of authority delegated to lower administrative levels with respect to the total scope of authority of the public sector).

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Fiscal federalism is a more general concept that represents a vertical financial structure of the public sector (Oates, 1999), with revenue and expenditure assignment among different levels of government and a system of intergovernmental transfers. Thus, fiscal decentralization is a mechanism of fiscal federalism and can be considered as a necessary condition of the latter because there is no point in a vertical financial structure of the public sector without a certain level of decentralization (in this case, all resources, authority and responsibilities are concentrated at the federal level).

The classical theory of fiscal federalism considers three key goals of the public sector: economic efficiency, macroeconomic stability, and income redistribution (Musgrave, 1959; Oates, 1972). According to Musgrave, the federal government should be responsible for macroeconomic stabilization and income redistribution, whereas subnational (regional and local) authorities, which are closer to citizens and possess more information on their preferences, should ensure the efficiency of public goods provision within their jurisdictions (Musgrave, 1959).

The key argument in favor of fiscal decentralization is the possibility to increase the allocative and productive efficiency of public goods provision (Martinez-Vacquez and McNab, 2003; Oates, 1999; Thiessen, 2003). The allocative efficiency of the decentralized provision of most public services is higher than that of the centralized provision because lower levels of government can improve the well-being of residents through a more comprehensive satisfaction of their individual needs (*preference-matching argument*). The productive efficiency can also be higher under decentralization because subnational authorities, which have better knowledge of citizens' needs and experience in providing respective public goods, can produce such goods at lower cost.[2] Another advantage of fiscal decentralization is the increased horizontal and vertical fiscal competition, which, in turn, may limit the size of the public sector and its predatory incentives (Brennan, Buchanan, 1980). Moreover, with strong democratic institutions (transparent elections, rule of law, and an effective parliamentary system) fiscal decentralization may encourage a higher accountability of subnational authorities and an improved quality of governance (Lockwood, 2005).

In contrast, fiscal decentralization can be dangerous under particular circumstances (Prud'homme, 1995). Excessive decentralization makes macroeconomic stability and income redistribution nearly unachievable. In times of crises, macroeconomic stabilization becomes problematic because the federal government does not have sufficient resources to stabilize the economy, whereas powerful regional governments may have differing, often contradictory, fiscal policy priorities. Income redistribution also does not work under full decentralization. Resources are usually unevenly distributed among territories (at least in large federal states). Therefore, a lack of a centralized equalization policy can lead to the bankruptcies of poor regions (Thiessen, 2003). Excessive horizontal fiscal competition may lead to greater inequality among regions and horizontal fiscal imbalances. Moreover, the quality of governance is questionable at the regional

[2] This argument has been challenged in the literature (Thiessen, 2003) because centralization (and a uniform level of public goods provision) may lead to significant economies of scale. Conversely, decentralization may lead to lower production efficiency because lower level officials potentially lack the necessary competences to provide high-quality public goods.