

Decentralization of Governance and Development: the Role of Political Institutions

Lecture No. 12

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Road map of the lecture

- Theory and evidence of the effects of fiscal decentralization
- Tests of Riker's (1964) theory
 - Case studies
 - Enikolopov and Zhuravskaya (2004)
 - Gennaioli and Rainer (2005)

Main question

- Does fiscal decentralization result in more efficient governance, higher economic growth, and better public goods?
 - Decentralization defined as devolution of taxing authority and expenditure responsibilities to the lower levels of government
- There is no doubt in modern economic literature about **WHETHER** decentralization matters
- There is a lot of debate on **HOW** it matters

Decentralization has positive effect:

Better economic incentives

- Inter-jurisdictional competition – Tiebout (1956)
 - Apart from “voting with your feet”
 - Competition for fiscal transfers and capital hardens budget constraints of firms (Qian and Roland, 1998)
 - Yardstick competition and experimentation (Maskin, Qian, and Xu, 1999)

Better information & smaller heterogeneity of preferences

- Hayek (1939); Oates (1972); Alesina and Spolaore (2003)

Decentralization may have a negative effect:

Poor economic incentives:

- **State Capture**
 - Federalism often leads to local tyranny (Bardhan and Mookherjee, 2003; Sonin, 2003; Slinko et al., 2003)
- **Externalities**
 - Musgrave, 1969; Oates, 1972:
 - ⇒ trade barriers (Young 2001, Yakovlev and Zhuravskaya 2005)
 - ⇒ local politicians have no stabilization incentives (Tanzi, 1996)
- **Competition for capital**
 - “Race to the bottom”: tax competition may lead to underprovision of public goods
 - Tax competition may corrode the state:
 - Local governments offer protection from paying federal taxes and, thus, weaken the central government’s ability to enforce (Cai and Treisman 2004; Ponomareva and Zhuravskaya 2004)

Empirical evidence is inconclusive

Results vary with samples and time periods

Effect of decentralization on

Growth:

- (-): Zhang and Zou, 1998 (Chinese provinces); Davoodi and Zou, 1998 (developing countries)
- (0): Woller and Phillips, 1998 (developing countries);
- (+): Jin et al., 1999 and Lin and Liu, 2000 (Chinese provinces);

Corruption:

- (-): Fisman and Gatti, 2002; de Mello and Barenstein, 2001 (X-country)
- (0): Treisman, 2000 (X-country)

These papers overlooked importance of political institutions

Riker (1964) "Federalism: Origins, Operation, and Significance"

For fiscal decentralization to function (i.e., produce benefits from better information), need to align incentives of local governments with "national" objectives

- reduce both "local capture" and "externalities"
- *Political centralization* jointly with *Fiscal decentralization*:
 - If local politicians have career concerns about promotion to the national politics, they
 1. internalize externalities of their policies to a larger extent
 2. will be less influenced by local elites

Riker (1964) "Federalism: Origins, Operation, and Significance" (2)

Solutions:

1. Strong national political parties
 - Local officials need financial and political support of national parties during elections
2. Administrative centralization
 - Let central authorities appoint local politicians and promote only "well-behaved" local politicians
 - Riker's view: administrative centralization will not be effective because it undermines the benefits of decentralization in the first place
 - Politicians will stop caring for the preferences of local population

Russia vs. China

Blanchard and Shleifer (2001):

- Fiscal decentralization occurred in both countries during transition
- Decentralization was a major growth-promoting factor in China and an obstacle to growth in Russia
 - Jin, Qian, Weingast (2005) on China
 - Zhuravskaya (2000) on Russia
- The reason is the difference in the level of political centralization:
 - China - tight administrative and political control of the communist party
 - Yeltsin's Russia - large-scale political decentralization

Argentina vs. Chile

E&Z 2005:

Fiscal decentralization in the 80s and 90s:

- Chile - improved provision of public health and education
- Argentina - macroeconomic destabilization and a large-scale economic crisis
- Chile - strong party system with national parties and strong career concerns
 - Mayors of Santiago
- Argentina - national political parties are weak; provincial parties dominate political arena at the national and provincial level
- Career concerns work the other way:
 - Those national politicians who managed to produce more benefits to their provincial constituencies (possibly at expense of other regions) can return back home after serving in the national government

Two attempts to test the Riker's theory

Decentralization and Political Institutions

Enikolopov and Zhuravskaya (2005)

Measures of Political Centralization

1. Age of main parties
 - Intuition: career concerns
 - Control for: the age of democracy and time since independence
2. Fractionalization of governing parties
 - Intuition: career concerns
 - Control for:
 - majoritarian vs. proportional electoral rule
 - presidential vs. parliamentary regime
 - secessionist tendencies
 - segregation of voting patterns at the local level
 - presence of contiguous autonomous regions
3. Subordination
 - Are municipal executives appointed?
 - Are province-level executives appointed?

Measures of decentralization and outcomes

Fiscal Decentralization

- Subnational revenue share
- Subnational expenditure share

Quality of government

- Corruption indices
- Control over corruption
- Government effectiveness
- Regulatory quality
- Rule of law

Growth

- GDP per capita growth rate, PPP

Public goods provision

- Infant mortality
- DPT Immunization
- Illiteracy rate
- Pupil to teacher ratio

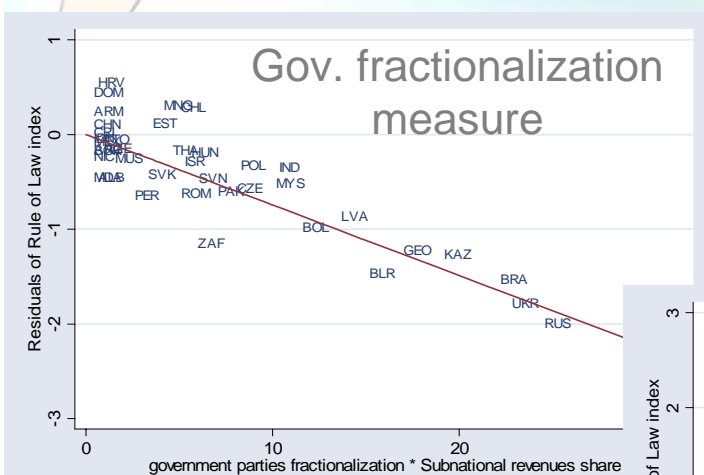
Methodology

- Standard methodology for growth and the quality of governance regressions
 - Treisman, 2000; La Porta et al., 1999; Barro and Sala-i-Martin, 1995; Sala-i-Martin, 1997
- Add decentralization and political institutions measures and their interaction
- Sample of *developing and transition countries* (73 countries)
 - In OECD, measures poorly reflect career concerns
- Cross-section regressions (check robustness with panel regressions that have a problem of low overtime variation)
- Use geographical area of countries as an instrument for decentralization
- Initial levels of political institutions for current political institutions (?)

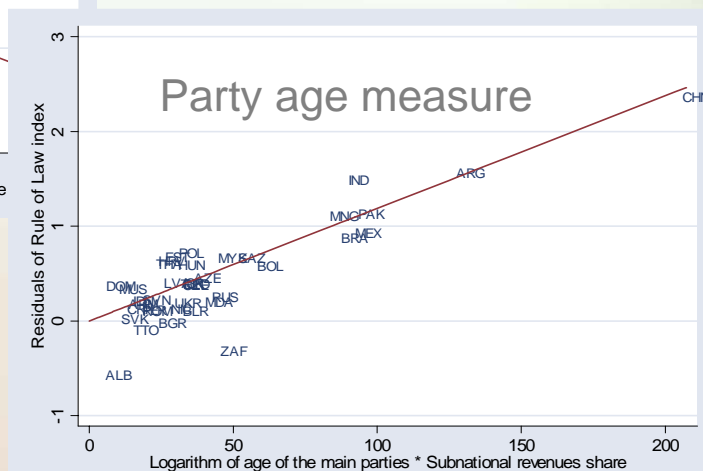
Standard control variables

- Fixed investments
- Population
- Openness
- Fertility
- Current level of democracy
- Democratic tradition
- Ethno-linguistic fractionalization
- Protestants share
- Latitude
- Legal origin

Residual partial plots – party strength



80% of the developing countries have parties younger than needed for decentralization to have a positive effect on indices of government quality

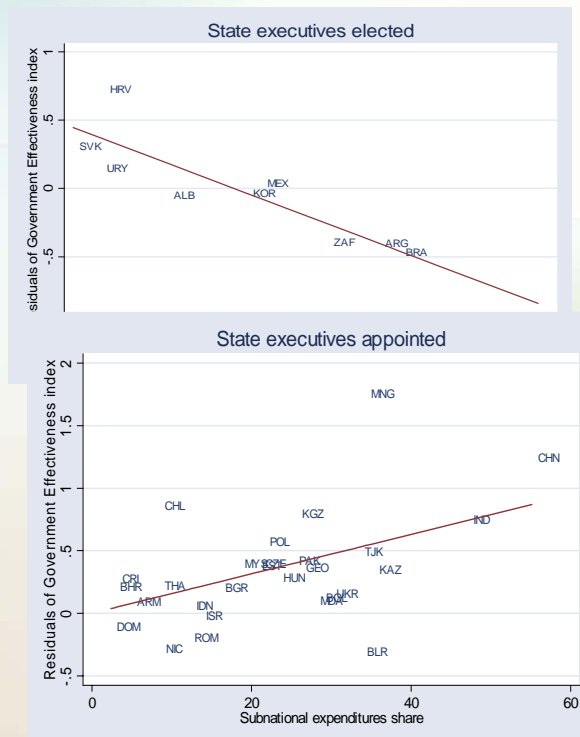


More or less robust to controlling for FE

Residual partial plots – state elections

The overall effect of elections, is positive for almost one half of the developing countries (which have sufficiently low decentralization)

Not robust to controlling for FE



Results - Solid support Riker's theory:

1. Strong parties (low government fractionalization and high party age) make decentralization more efficient: improve quality of government, growth, public goods

	TI - Cor	Gov_Effect	Reg_Quality	Cont_Cor	Rule_Law	GDP_grwth	Immun	Neg_Inf_Mort	Neg_Illiter	Neg_P_to_T
party_age* rev_dec	0	+	+	+	+	+	+	+	+	+
gov_frac* rev_dec	-	-	-	-	-	-	-	-	-	-

2. No robust evidence for the effect of administrative centralization
 - Results depend on the set of controls and particular samples
 - Perhaps, only for elections at the subnational level

Economic significance - example

A 10% \uparrow in decentralization:

- at a level of party age **lower** than the mean by 1/2 of its SD
 - \Rightarrow \downarrow in government quality indices of 1/2 of their SDs
- at a level of party age **higher** than the mean by 1/2 of its SD
 - \Rightarrow zero change on government quality

Sensitivity analysis

- **Influential observations**
 - China is influential; without China results go through
- **Controlled for other possible driving forces for results**
 - Transition
- **Additional controls**
 - Initial GDP per capita squared, federation dummy, regional dummies, colonial dummies, etc.
- **Results are stable**

Endogeneity of political centralization variables

An increase in economic performance can have different effect on political centralization in fiscally centralized and decentralized states

1. Government fractionalization:
 - In countries with low level of decentralization, better performance leads to relative strengthening of the national governing parties (and as a result, lower fractionalization) because the success is attributed to national policies
 - In highly decentralized countries, voters may attribute economic success to regional policies that may lead to a relative increase in fractionalization of national government parties due to strengthening of local political organizations
 2. Administrative centralization:
 - An increase in economically centralized countries coupled with good economic performance may allow the central authorities to get public support to switch from elected to appointed subnational governments
 - With decentralization, this may be harder (?)
- ⇒ OLS - an upward bias in the coefficient of the interaction term
- Story for party age?

Conclusions from E&Z

- Key finding: political institutions play an important role in determining the results of fiscal decentralization (provided we buy causality)
- Solid support for Riker: strong national party system is an effective way of securing political accountability needed for efficient fiscal decentralization, whereas administrative control is not
- If we do not buy causality, an interesting empirical association: ***countries that make decentralization work also manage to have stronger national political parties***
- In any case, this **does not** necessarily mean that elections do not matter
 - Subnational elections may have direct effect on outcomes not just through their influence on the results of decentralization
 - a necessary prerequisite to developing democratic tradition, civil society, and other components civic capital accumulation

The Modern Impact of Pre-Colonial Centralization in Africa

Gennaioli and Rainer (2005)

This paper eliminates concerns about reverse causality

A measure of centralization

- Used data from *Ethnographic Atlas* (by the Yale anthropologist, George P. Murdock) on the number of jurisdictional levels of ethnic group in Sub-Saharan Africa in pre-colonial times
 - Groups:
 - **FRAGMENTED**: lacking any form of centralized political organization
 - **CENTRALIZED**: small states, large states
- Classified more than 300 African ethnic groups
- Used Miklukho-Maklai's "*Atlas Narodov Mira*" for data on countries' ethnic composition to calculate the share of each country's non-European population belonging to the centralized ethnic groups
- X-country: 42 countries in Sub-Saharan Africa

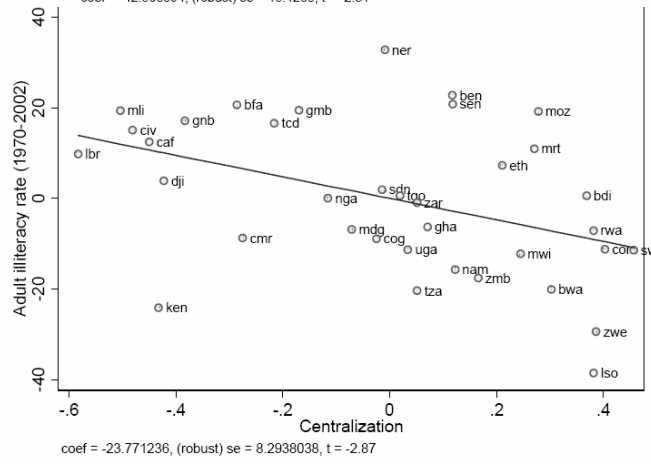
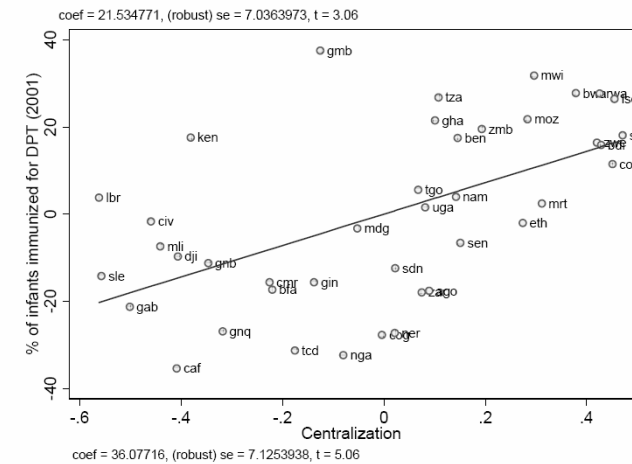
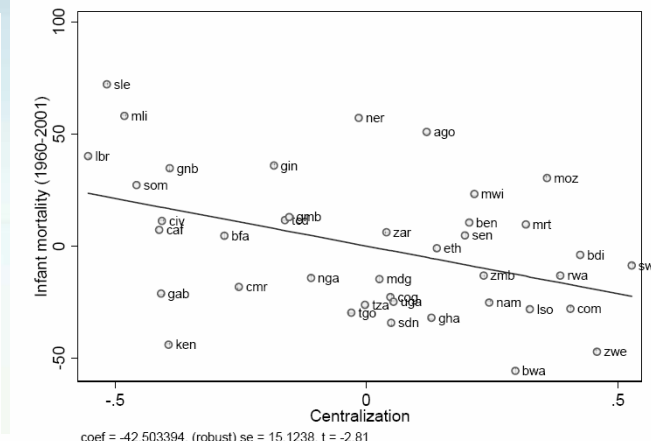
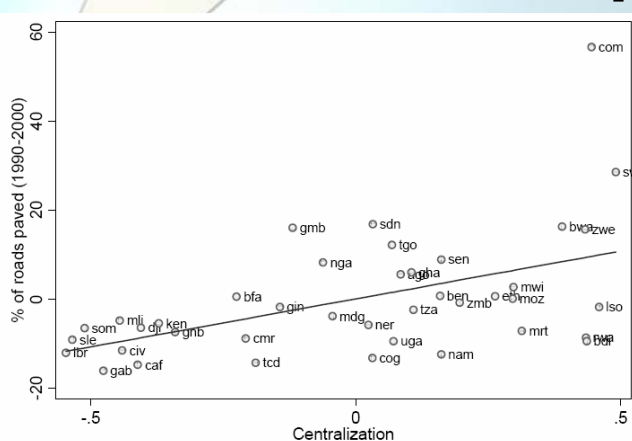
Measures of outcomes and methodology

Country-level provision of local public goods

- **Healthcare:** infant mortality, percent of infants immunized against DPT
- **Education:** adult illiteracy rate, average school attainment
- **Infrastructure:** % of paved roads (as a share of total roads)

X-country regressions of outcomes on the centralization measure and initial GDP per capita

Residual partial plots



“Externalities” vs. “Local Capture” effect

- Different predictions for different public goods in environments with high/low (potential) local capture:
 - If the good imposes high externality on neighboring jurisdictions and elites and masses have the same preference over it (“low conflict”):
 - centralization is good irrespective of local capture
 - If “low externality” and “high conflict” good:
 - centralization is beneficial only where local capture is (potentially) high
- Use “*Class Stratification*” from Murdock’s *Ethnographic Atlas*
 - codes class differentiation at the local level for each indigenous society
 - groups that have and have no class distinctions (stratified and egalitarian)
 - construct shares of indigenous population that fall into four categories: (centralized/not centralized; stratified/egalitarian)
 - compare public goods provision among these groups

Predictions: “Externalities” vs. “Local Capture”

Compared to fragmented and egalitarian:

1. For “High Externality” and “Low Conflict” goods

	Stratified	Egalitarian
Centralized	+	+
Fragmented	0	

2. For “Low Externality” and “High Conflict” goods

	Stratified	Egalitarian
Centralized	+	0
Fragmented	-	

Results

“Low Externality”
and “High Conflict”

		% of roads paved in 1990-2000 (1)	immunized for DPT in 2001 (2)	Infant mortality in 1960-2001 (3)	Adult illiteracy rate in 1970-2002 (4)	School attainment in 1960-1990 (5)
Centr	Strat	22.89**** (7.72)	22** (8.4)	37.18**** (8.56)	-37.2** (14.31)	10.4 (28.55)
	Egalit	22** (8.4)	42.11** (21.86)	-37.2** (14.31)	10.4 (28.55)	-21.27** (8.58)
Fragm	β_2	10.03 (10.88)	0	74** (34.27)	36.39* (20.31)	-2.89 (16.95)
	0	10.03 (10.88)	0	74** (34.27)	36.39* (20.31)	-2.17** (0.9)
$\beta_1 - \beta_2$		12.86 (14.61)	24.48 (22.83)	-111.2*** (31.57)	-57.65*** (18.74)	3.18*** (0.78)
$\beta_1 - \beta_3$		0.88 (11.7)	-4.94 (19.93)	-47.6* (27.58)	-18.38 (15.94)	1.55 (1.06)
$\beta_1 - \beta_2 - \beta_3$		-9.15 (18.15)	-17.63 (36.69)	-121.6*** (44.66)	-54.76** (26.85)	3.72** (1.48)
Obs		40	41	40	36	26
Rsq		0.28	0.32	0.39	0.37	0.29

Notes:

(1) β_1 , β_2 and β_3 refer to the OLS estimations of $Y_i = \beta_0 + \beta_1 \text{Centr-}\& \text{-Strat}_i + \beta_2 \text{Fragm-}\& \text{-Strat}_i + \beta_3 \text{Centr-}\& \text{-Egalit}_i + X_i' \gamma + \varepsilon_i$

“Low Conflict” and
“High Externality”

Alternative Interpretations

- Reverse causality: not a concern
 - Ethnic groups' political organization was predetermined when colonization began
 - Improve on the existing x-country literature
- Omitted variables:
 - Pre-colonial institutions did not matter: centralized groups are just more advanced
 - Pre-colonial institutions improved national political outcomes, not relations between the center and periphery
- The level of decentralization

Control for possible omitted factors

For “advanced”, consider three potential covariates of pre-colonial centralization:

- a) Geographic factors
- b) Cultural factors
- c) Demographic factors

For national political effects - look at two channels:

- a) National Strategies of colonizers
- b) Post-Colonial National level political outcomes

My concern is that:

- Centralization/fractionalization of groups may be related to at what level the local public goods are provided (perhaps, the goods are centrally provided in centralized societies, and locally, in fragmented)
- Then, the finding is about the direct effect of fiscal centralization, not political
- While Riker’s concern was not whether to fiscally centralize or not, but how to make fiscal decentralization work
- **However, the different effects for egalitarian and stratified groups give us a very important result that decentralization works better when there is lower conflict between the elites and the masses**

Summary of G&R’s main results

- Pre-Colonial institutions mattered for quality of government in Africa
- Centralization can be important to solve the problem of local capture (for both externality and local tyranny)
 - G&R build a model that formalizes how centralization can both internalize spillovers and reduce local tyranny by inducing political competition among local elites
 - Provide case study evidence from Uganda about the channel – career concerns, and wider political competition with centralization

Conclusions from G&R

- 1) Document the importance of the pre-colonial institutions in Africa
- 2) Pre-colonial centralization is conducive to better education, health and infrastructure today
- 3) When regressive local Elite capture economic and political power, centralization helps
 - By inducing political competition it may solve both the externalities problem and local capture

Conclusions from the lecture

- Political centralization, indeed, may help fiscal decentralization to function properly.
- But one should not forget that career concerns may be achieved in different ways, some of which may have independent adverse effect on outcomes
 - i.e., decrease of accountability due to bundling of different policies in situation with no elections