



Exploring the Causes and Effects of Revenue Decentralization:

Does Revenue Decentralization Increase or Reduce Economic Growth?

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Exploring the Causes and Effects of Revenue Decentralization: Does Revenue Decentralization Increase or Reduce Economic Growth?

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Abstract

Although many developing and transition countries are pursuing fiscal decentralization reforms, the debate surrounding the relationship between revenue decentralization and economic growth has not yet been fully resolved. While proponents of decentralization suggest that local own source revenue collections are generally evidence of an effective local public sector, a contrasting view holds that revenues collected by weak and non-responsive local governments tend to negatively affect economic growth. Our analysis suggests that the relationship between revenue decentralization and economic growth differs considerably for different groups of countries, but does not find any evidence for the hypothesis that revenue decentralization suppresses economic growth.

1. Introduction

Although many developing and transition countries are pursuing fiscal decentralization and the reform of local government finances, there is an ongoing debate about the role that local revenues and revenue decentralization should play in such reforms. The policy debate surrounding own source revenue collections offers two contradictory views.

The first view emphasizes the importance of local governments in the public sector, where sub-national governments are considered to be important partners of central governments in providing efficient public services (UCLG, 2010). In contrast to the distant and unresponsive central government, local governments are closer to the people, which forces local governments to compete with each other and allows residents to “vote with their feet” in selecting their preferred mix of local expenditures and local revenues (Tiebout, 1956). In this context, higher local revenues reflect a higher willingness to pay for local public services as a result of more efficient and responsive local government jurisdictions (Oates, 1993). Higher local revenues are thus associated with higher economic growth.

An opposing argument seems to have gained more traction in recent years, notably that local revenues may detract from economic growth more than what they contribute (see, for instance, Prud’homme, 1995, and Tanzi, 2004). The basic argument made by this camp is that outside the United States and Europe, few countries have the local governance institutions necessary to ensure responsiveness and efficiency at the local level. It is argued that in the absence of appropriate institutions and accountability mechanisms, the encouragement of greater local government revenue collections would simply result in the expansion of the predatory tax powers of the public sector, where local elites are expected to capture the benefits of local taxation without a corresponding increase in marginal social benefits from own-source-funded local expenditures.

The relationship between fiscal decentralization and economic growth has been analyzed by a number of economists during the last three decades.¹ Many of these empirical analyses, however, focus on the impact of expenditure decentralization on economic growth, and are therefore of limited relevance for our current purpose. The empirical research analyzing the impact of revenue decentralization on economic growth is not only considerably smaller, but also inconclusive (Breuss and Eller, 2004). As such, which view of the local taxation and economic growth debate ultimately carries the day is unclear from the available academic research.

It appears that policy practice within the global development community is similarly divided. On one hand, USAID and other bilateral donors frequently encourage local governments to increase revenue collections as part of projects intended to strengthen democratic local governance. The same is true for many (urban) local government support projects supported by the World Bank. These projects assume that increased local revenues will translate into improved local services, and therefore, will improve conditions at the local level in terms of service delivery and local economic development. However, if this assumption is wrong, then

¹ Empirical analyses studying the link between fiscal decentralization and economic growth include Davoodi and Zou (1998), Dabla-Norris (2006); Thiessen (2000), Martinez-Vazquez and Nab (2001); Iimi, (2005), Martinez-Vazquez and Rider (2006); and Rodriguez-Pose and Kroijer (2009). See Breuss and Eller (2004) for an overview of much of the relevant literature.

the interventions that these development organizations support may actually result in a net loss to social welfare and could result in slower economic growth.

In contrast, the concern that local revenues form an obstacle to economic growth has led central government officials in some developing countries—along with their supporters in selected international financial institutions—to support the elimination of local taxes and other local own revenue sources. This viewpoint has received considerable attention in the literature and analysis of business climates. Concerns that higher local revenues will limit the potential for business growth, investment and job creation are used as an argument to actively advocate for reducing local taxes, licenses and fees (Corthay, 2009; Investment Climate Advisory Services of the World Bank Group, 2011).

The contrasting opinions on how own source revenues might impact economic growth are pitting different international development actors against each other in providing policy advice to partner country governments. It is this confusion that has inspired the current effort to uncover further evidence with regard to the potential effects (and causes) of revenue decentralization.

2. The Research Question: Does Revenue Decentralization Increase or Reduce Economic Growth?

Informed by the policy dilemma noted above, the main purpose of this paper is to investigate the relationship between revenue collections at the local level and the rate of domestic economic growth. In particular, are higher local revenue collections consistently associated with either higher or lower economic growth?

In particular, this paper analyzes the relationship between revenue collections at the local level and the rate of economic growth for different groups of countries for the period from 2003 to 2008. In doing so, we recognize that the relationship between economic growth and local revenue collections is likely to be different for different groups of countries.

2.1 Fiscal Decentralization Patterns among Different Groups of Countries

It is widely recognized that high-income, industrialized countries are more decentralized than developing or transition economies (Bahl and Linn, 1992). Table 1 presents the average shares that local governments contribute to general government expenditures and revenues, respectively, for selected OECD, transitional and developing countries. Consistent with previous findings in the literature, the results reveal that industrialized countries have a higher degree of decentralization, both with regard to expenditure decentralization as well as revenue decentralization. Previous analysis of fiscal decentralization patterns over time suggests that the overall trends with regard to fiscal decentralization have remained almost unchanged for the past three decades (Bahl and Wallace, 2005).

Table 1. Local government expenditure and revenues (as a percent of general government), 2008

	Expenditures	Revenue collections
OECD countries	23.39	14.69
Transitional countries	22.82	12.43
Developing countries	10.8	5.94

Source: Computed by authors based on IMF Government Finance Statistics, 2010. See table 2 for country sample.

Although the statistics in table 1 indicate that more economically developed economies collect a greater share of public finances at the local level, few analysts would argue that this correlation is evidence that higher revenue decentralization is actually the cause of faster economic development. In fact, if anything, it is likely that the main line of causality runs in the opposite direction.

Economic development stimulates demand for services provided by local governments in addition to increasing the local tax base (Bahl and Linn, 1992, p.393). The wealthier a country (and the more formal its economy), the higher the demand for public services, the higher people's ability to pay local taxes, and the stronger the local government level's "tax handle" over the local economic base.² Following these arguments, higher levels of economic development and income might thus be a *cause* (rather than an *effect*) of greater revenue decentralization.

Of course, to the extent that a higher level of revenue decentralization might fund improved local public services and growth-enhancing local public investments, it is in fact possible that revenue decentralization might also simultaneously contribute to economic growth.

In addition, there might be a secondary relationship that causes higher levels of country income to be associated with higher levels of (expenditure and revenue) decentralization, as higher per capita income growth might have an impact on the quality of the governance system or on the degree of democracy. Collier (2009) suggests that democracies get safer as income rises, and that democracy will lead to better governance outcomes in countries with levels of GDP above a threshold of \$2,700 per person. If local governments become similarly more responsive and accountable as income levels rise, then, when all else is held equal, we would expect higher income levels to cause greater revenue decentralization merely based on the income effect on good local governance.

These arguments suggest that a positive and possibly bi-directional relationship is likely to exist—especially in more advanced economies with responsive governance systems—between revenue decentralization (the share of public revenues collected at the local level) and income and economic growth. These arguments notwithstanding, it is quite possible that among poorer countries (especially if these countries have weak local governance systems), higher revenue decentralization could have a negative impact on domestic economic growth

² A similar set of arguments can be made that a higher degree of fiscal *centralization* in low-income, developing countries is driven by lower income levels: low-income countries typically start from a point of scarce investment capital; regional disparities in income and wealth; and superior administration abilities of central governments (Bahl and Linn, 1992: p.388).

if local accountability is poor and corruption is prevalent. In the context of weak local governance, increased revenue decentralization could act as a tax on economic activity without a corresponding Wicksellian benefit being provided in terms of better local public services or local public infrastructure investment.

Given that the quality of governance and public sector accountability are highly correlated with a country's income level, it is unlikely that we can take patterns or lessons from one set of countries (e.g., high-income industrialized economies) and expect these same relationships to hold for low-income countries (presumably with weaker local accountability relationships).

2.2 Research Methodology

Unlike some of the previous empirical research, the current analysis separately considers countries by grouping them into three broad groups based on their level of economic development: industrialized OECD countries; transition economies in eastern Europe and the former Soviet Union; and developing countries (in Latin America, Africa and Asia). The quantitative analysis will explore the relationship between revenue decentralization and economic growth for each of these groups of countries using a relatively simple bivariate framework by correlating economic growth in each country over a five-year period (2003-2008) with the country's degree of revenue decentralization.

The remainder of the paper is organized as follows. Section 3 discusses the research methodology and explains the measurement of economic growth and revenue decentralization in some detail. Section 4 analyzes the relationship between revenue decentralization and economic growth. Next, Section 5 discusses the impact of political decentralization on local revenue collections in transition countries. Finally, Section 6 provides concluding remarks.

3. Data Sources and Measures

3.1 Data Sources and Country Sample

This study relies on three different data sources. First, data on public revenues were extracted from the International Monetary Fund's Government Finance Statistics (IMF, *various years*). Second, economic growth was computed based on GDP figures from the World Bank's World Development Indicators data set. Finally, this study draws on global indicators of political, administrative and fiscal decentralization prepared by Ivanyna and Shah (2012).

Table 2 presents the countries that are included in the analysis in this working paper. The choice of countries included in the study was mainly determined by data availability.

Table 2. Countries Included in the Analysis

Industrialized countries (OECD)	Transitional countries (FSU & EE)	Developing countries
Australia	Armenia	Argentina
Austria	Belarus	Bolivia
Belgium	Bosnia and Herzegovina	Chile
Canada	Bulgaria	Colombia
Denmark	Croatia	Costa Rica
Finland	Czech Republic	El Salvador
France	Estonia	Honduras
Germany	Georgia	I.R. of Iran
Greece	Hungary	Lesotho
Iceland	Kazakhstan	Mauritius
Ireland	Latvia	Mongolia
Italy	Lithuania	Morocco
Luxembourg	Macedonia, FYR	Paraguay
Netherlands	Moldova	Peru
New Zealand	Poland	South Africa
Norway	Romania	Thailand
Portugal	Russian Federation	
Spain	Serbia	
Sweden	Slovak Republic	
Switzerland	Slovenia	
United Kingdom	Tajikistan	
	Ukraine	

3.2 The Definition of Local Governments and Local Government Revenues

An important methodological issue concerns the definition of what constitutes a “local government” and, in turn, what composes local government revenues. Although this point may seem trivial, an inaccurate understanding or definition of local government revenues can have major policy consequences. For instance, it would clearly be unwise to consider the revenue collections of a deconcentrated local administrative entity (which it deposits into the national treasury) on equal footing with the collection of own source revenues by a devolved local government (which it gets to retain in its own accounts).

Since the fiscal data for the current analysis is drawn from the IMF’s Government Finance Statistics, the classification of local governments and local government revenue follows the definition set forth by the IMF. According to the IMF’s definitions, state and local governments are subnational government entities which are, first, entitled to own assets, raise funds and incur liabilities by borrowing on their own account, and, second, have some discretion over how such funds are spent and are able to appoint their own officers independently of external administrative control (IMF, 2001: 14).

Unfortunately, the IMF does not adhere strictly to its own definitions as it collects and prepares Government Finance Statistics, as the “State and Local Government Subsector” sometimes includes entities that do not meet all the criteria described above. The concern is

especially acute in transition countries. For instance, according to the IMF's definitions, local governments in Kazakhstan (and therefore, local government revenues) consist of 16 local administrative bodies, including two cities (Almaty and Astana) and 14 oblast bodies (Dziobek, Gutierrez Mangas, and Kufa, 2011). Although oblasts in Kazakhstan have some features of local governments (e.g., there are regionally-elected councils), in practice these regional bodies are deconcentrated organs of the state without substantive own budget decision-making authority (UCLG, 2010).³

Although consideration of the definition of local government is not the main purpose of this research study, it cannot be ignored that the IMF's Government Finance Statistics simply fail to distinguish (especially in transition countries) between "real" local government revenues in devolved countries and deconcentrated "local" revenues in other countries. Therefore, after the initial analysis of global trends in local revenue collection and economic growth, this issue is explored further below.

3.3 Measures of Own Source Revenue Collections, Economic Growth and Decentralization

Three different variables are used in analyzing the relationship between local government revenues and economic growth. Most obviously, the analysis requires measuring the level of local (own source) revenue collections in different countries as well as the rate of economic growth. In order to further explore patterns of revenue collections in different countries, the analysis drew on country-level indicators of political, administrative and fiscal decentralization.

Own source revenue collections. Despite the concerns noted above, the classification of local government revenue follows the definitions described in the IMF's Government Finance Statistics Manual (2001). Thus, the main sources of revenue for local governments are taxes and other compulsory payments imposed on households and businesses by government units; property income derived from the ownership of assets and the sales of goods and services; and other revenues such as fines and penalties.

In the analysis below, own source revenues are defined as local government revenue collections expressed as a percentage of general (central plus subnational) government revenues. In order for the analysis not to be impacted by the global recession, the analysis relies on revenue data for the year 2008.

Economic growth variables. A sustained increase in per capita income is considered to be one of the main policy objectives pursued by governments through decentralization (Davoodi and Zou, 1998). The growth rate of GDP (or per capita GDP) is a widely used indicator of economic growth and is widely used in studies of the relationship between fiscal decentralization and economic growth (Breuss and Markus, 2004).

For the purpose of the current study, economic growth is measured as the average annual GDP growth rate (in constant prices) for the five-year period from 2003 to 2008. The real growth rate (in constant prices) was used rather than the growth in nominal GDP in order to

³ The same problem was noted by Ivanyina and Shah (2012: p. 6), who suggest that the IMF's definitions are quite vague, resulting in countries deciding for themselves what levels or tiers represent "local government" and reporting their data correspondingly.

eliminate the impact of inflation. The average growth rate over a five-year period was used (rather than the annual growth rate for 2008) in order to prevent any one-off economic events from driving the relationship.

Decentralization indicators. Decentralization is a complex process, and there are different dimensions of decentralization that may each (alone or together) have a different impact on economic growth (Imi, 2005). Usually, decentralization and intergovernmental fiscal relations are assessed along three dimensions: political, fiscal and administrative (Ivanyna and Shah, 2012; Shah, Thompson and Zou, 2004). In fact, it is impossible to capture the degree of decentralization in a country by any single empirical measure.

When considering the impact of a particular element of fiscal decentralization (revenue decentralization) on economic growth, it is useful to consider whether this relationship may be impacted by other aspects of decentralization reforms. This study tests the relationship between local revenue collections and indicators of all other dimensions of decentralization based on indexes prepared by Ivanyna and Shah (2012).⁴

The political decentralization index prepared by Ivanyna and Shah (2012) measures the degree of local self-governance. Political decentralization is assessed by three criteria: (i) legislative and executive elections; (ii) direct democracy provisions, such as the presence of recall provisions for elected officials and citizen participation in local elections; and (iii) local decision making processes. As further discussed in Section 5, the relationship between local revenue collections and this political decentralization index for transition countries is found to be downward sloping.

4. The Relationship between Own Source Revenue Collections and Economic Growth

The first attempt to determine whether there is a relationship between the degree of revenue decentralization and average economic growth presents the correlation between these two variables for all available countries (figure 1). Next, the analysis plots the degree of revenue decentralization against per capita GDP for 2008 (figure 2), where per capita GDP is a measure of long-term cumulative economic growth. In either case, proponents of decentralization would expect to find—under the right circumstances—a positive relationship between these two variables. On the other hand, those who are concerned with the pitfalls of decentralization would expect to find a negative relationship.

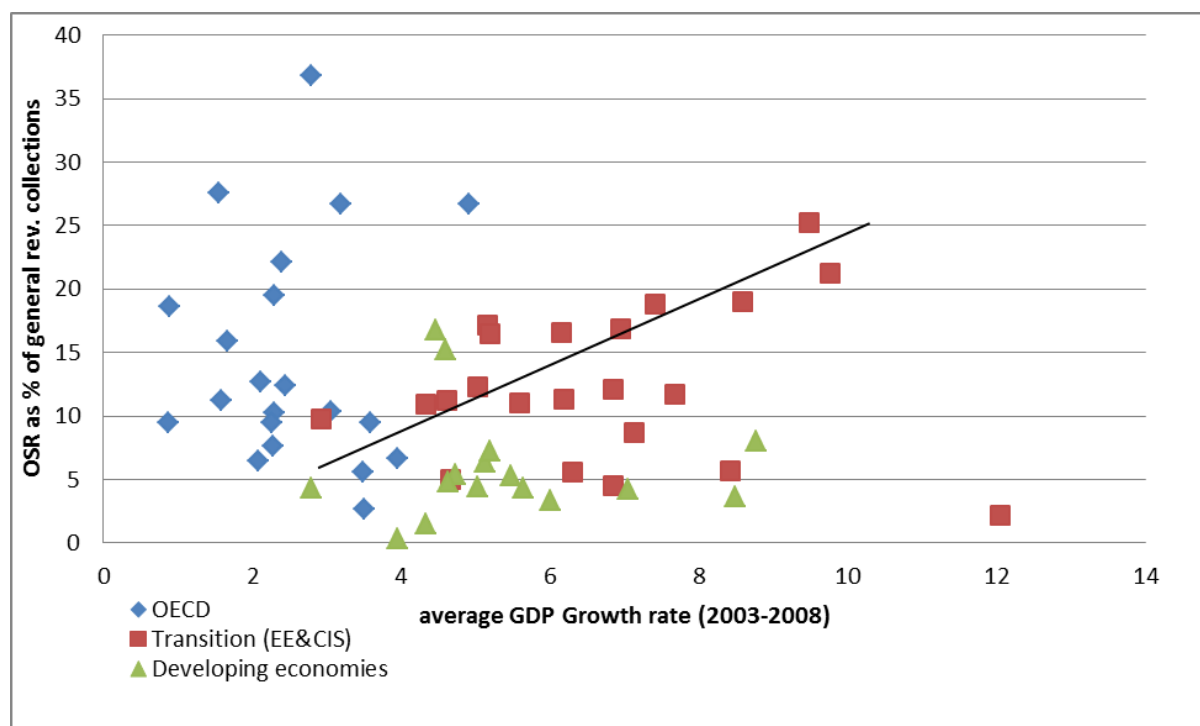
Although the analytical approach being used is rudimentary, one would expect to find either a detectable positive or negative correlation between the two variables. The underlying relationship is as consistent and robust as either of the two hypotheses suggests.

⁴ The measure of fiscal decentralization focuses on measuring the degree of local governments' fiscal autonomy, including the range of local expenditure functions; autonomy in rate and base settings for local taxes; the degree of self-financing of local expenditures; and others. The measure of administrative decentralization is focused on measuring local governments' regulatory control over own functions, as well as the authority to hire, fire and set terms of employment for local employees. The relationship between local revenue collections and fiscal and administrative decentralization indices tested in this research work does not show any explicit linear trend for transitional countries. Investigation of the relationship for other OECD and developing countries begs further study.

4.1 Results

The overall relationship between revenue decentralization (local revenue collections as a share of public sector revenues) and economic growth as presented in figure 1 provides little evidence that own source revenue collections have an overall negative impact on economic growth. The Pearson correlation coefficient for the overall correlation is -0.08. This is insufficient to reject the null hypothesis that there is no significant correlation between the two variables.

Figure 1. Local Revenue Collections and Average GDP Growth Rate

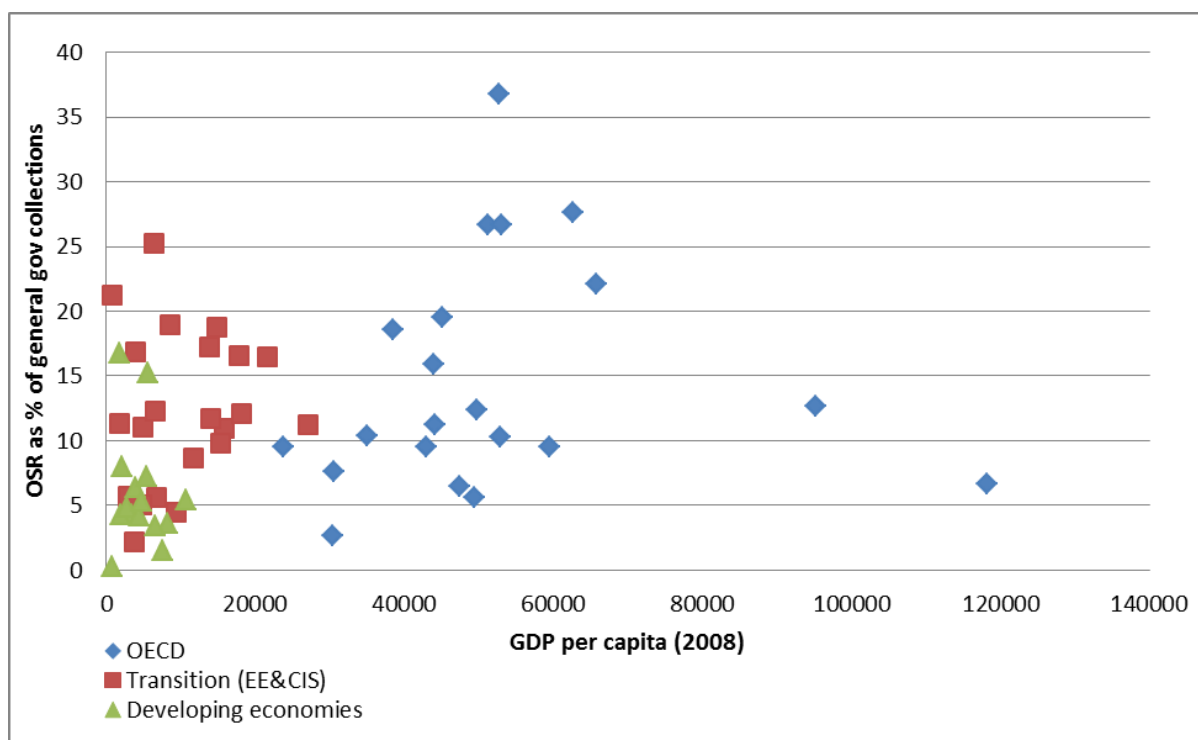


However, figure 1 reveals distinct patterns for each of the three groups of countries (OECD, transition countries and developing countries). The most obvious pattern is that OECD countries generally appear to have a lower GDP growth rate than transitional and developing countries. A second pattern revealed by the figure is that OECD countries and transition economies appear to have a higher degree of revenue decentralization, all else equal, than developing economies. Among the three groups of countries, there is no perceivable relationship between revenue decentralization and economic growth for either OECD countries or developing countries; for transitional economies, there appears to be a positive (albeit not statistically significant) relationship ($r=0.12$). Section 4.2 presents a further discussion of the trends revealed for each of the three groups of countries.

The underlying patterns by country type may suggest that it is not the rate of economic growth, *per se*, but rather, the level of economic productivity that may be more directly related to revenue decentralization. Therefore, figure 2 analyzes the relationship between own source revenue collection and GDP per capita (in US dollars) for 2008.

Figure 2 confirms that despite the lower economic growth rates in OECD countries from 2003 to 2008, OECD countries have considerably higher levels of GDP. The lower overall growth rate of OECD countries is not likely to be due to higher revenue decentralization, but rather, due to macroeconomic patterns and the concept of diminishing returns. When looking at the overall relationship between revenue decentralization and per capita GDP (across all three groups of countries), the figure shows a general positive pattern ($r=0.32$). When the two right-hand-side outliers (Luxembourg and Norway) are excluded, the Pearson correlation coefficient increases to 0.46.

Figure 2. Local Revenue Collections and GDP Per Capita for 2008.



These initial findings support earlier empirical findings that the level of revenue decentralization is positively correlated with the level of economic development (e.g., Martinez-Vazquez and Nab, 2001). These findings, however, do not support the conclusion that greater revenue decentralization leads to predatory local taxation in a way that negatively impacts economic growth or per capita GDP.

4.2 Discussion of Trends by Country Grouping

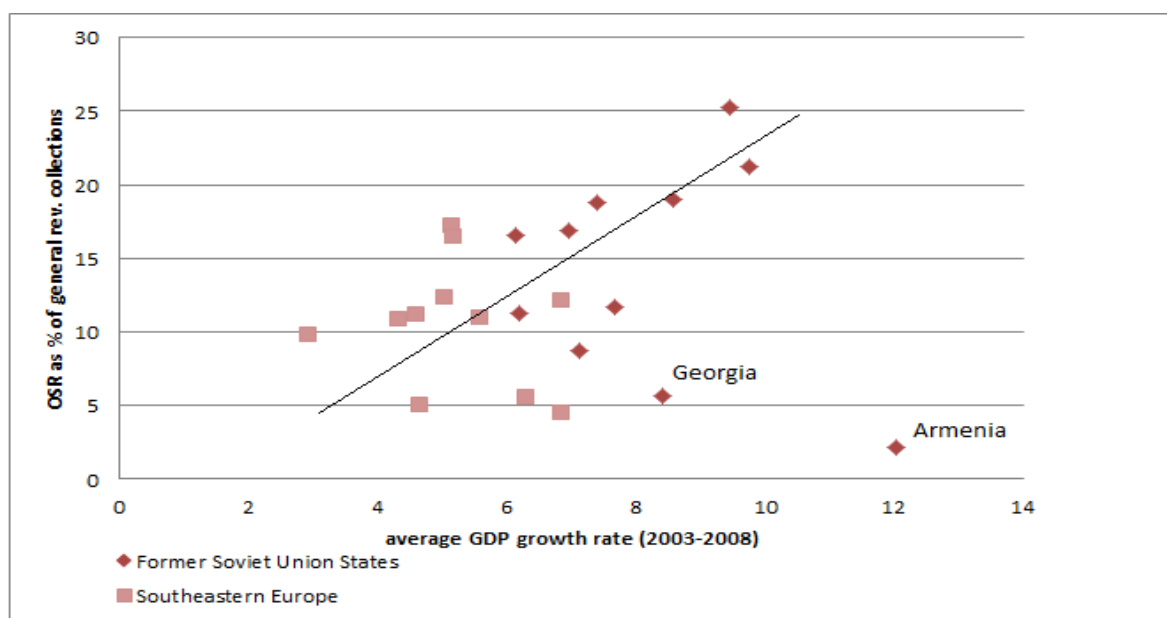
OECD countries. A large number of existing studies investigate the correlation between fiscal decentralization and economic growth among OECD countries. Many of these studies either find a positive relationship or a “hump-shaped” relationship, where economic growth first excels with fiscal decentralization, but slows down when a country decentralizes beyond a certain threshold (Bodman, 2008; Eller, 2004; Thiessen, 2000; Thiessen, 2001). In contrast, Rodriguez-Pose and Ezcurra (2010) detect a negative and significant association between

fiscal decentralization and economic growth, while Thornton (2006) finds no relationship for OECD countries. However, most of these results are based on an analysis of expenditure decentralization, rather than on an analysis of revenue decentralization.

Considering the pattern of OECD countries in figures 1 and 2 contributes little to the existing state of knowledge, as revenue decentralization does not appear to have a significant impact (positive or negative) on economic growth rates ($r=0.01$). It is notable, however, that when Luxembourg and Norway are excluded, the bivariate analysis finds a strong and positive relationship between revenue decentralization and per capita GDP ($r=0.36$).

Transitional countries. Figure 1 (as well as figure 2) reveals a more consistent story when considering transition economies: there appears to be a slight but positive correlation between the level of own-source revenue collections and domestic economic growth for transitional countries ($r=0.12$). When two outliers (Georgia and Armenia) are excluded, the Pearson correlation coefficient increases to 0.57.

Figure 3. Relationship for Transitional Economies.



To further understand this relationship, it is helpful to group the transition countries into states of the former Soviet Union and countries in southeastern Europe (figure 3). The figure suggests that these two country groups have distinct patterns, with transition countries in eastern Europe generally showing lower revenue decentralization and lower economic growth, compared to higher revenue decentralization and higher economic growth in states of the former Soviet Union.

It is unclear from the bivariate correlation presented in figure 3 whether there is indeed a positive relationship between higher economic growth and revenue decentralization, or whether the figure simply compares two sets of different countries that have different approaches to decentralization (in which case the correlation is spurious).

The finding that decentralization is greater in the states of the former Soviet Union when compared to eastern Europe contradicts the popular perception that eastern Europe is more decentralized than many former Soviet republics. However, as we already noted, the IMF Government Finance Statistics do not always properly distinguish between local government revenues and “local” revenues collected by local administrations. This issue is further investigated in Section 5.

Developing Countries. The relationship between own-source revenue collections and average GDP growth rate for developing countries is highly dispersed, showing no meaningful correlation between the two variables. However, the total number of developing countries included in this study is quite limited due to the absence of necessary data. As such, the sample of developing countries represents various (potentially very different) regional experiences. Further study is needed to isolate potentially different regional patterns among developing economies.

Overall conclusions of the analyses by country grouping. There appear to be some subtle differences in the relationship between revenue decentralization and economic growth across the three groups of countries considered in this study.

On one end of the spectrum, when considered in isolation, it does not appear that revenue decentralization is either positively or negatively correlated with economic growth in developing economies. On the other end of the spectrum, it does appear that for OECD countries a positive relationship exists between revenue decentralization and per capita GDP. The results for transition economies are less clear: there may be a mild positive relationship between revenue decentralization and economic growth, but there are suggestions that this relationship may (or may not) be spurious.

5. The Relationship between Own Source Revenue Collections and Economic Growth: Does Subnational Structure and Political Economy Matter?

The fact that different relationships between revenue decentralization and economic growth are found for different groups of countries is not surprising. After all, decentralization is a multi-dimensional process and we would expect revenue decentralization to impact economic growth differently in different institutional contexts. For instance, whereas we may expect a positive relationship between revenue decentralization and economic growth under certain conditions, if more revenues are assigned to a local government level at which jurisdictions are inefficiently small, we would expect there to be a negative relationship between revenue decentralization and growth. In addition, the measures of revenue decentralization that are available from different sources may sometimes inadvertently lead us to compare “apples with oranges” (as in the case of transition economies). Furthermore, it is possible that the decision to decentralize revenue sources is driven more by political economy considerations than by policy considerations (e.g., economic growth).

Indeed, there is a high likelihood that the structure of the local public sector and the degree of political decentralization in a country have an important impact on the degree (and efficacy) of revenue decentralization. It might be the case that in more (politically and administratively) decentralized countries, local governments have earned greater trust from the central government and therefore, are assigned more robust own revenue sources. At

same time, however, in countries which are institutionally and politically more decentralized, central governments may not have much of an incentive to give public revenue sources away to relatively autonomous local authorities (over which central officials have little or no control) and thus, local authorities may end up collecting less own source revenues in countries that are more politically decentralized. In contrast, central government officials might be less resistant to decentralizing revenue sources when there is a strong vertical power structure that allows central officials a greater degree of control over subnational government entities.

In order to test the importance of political decentralization on revenue decentralization, the relationships between local revenue collections and the political decentralization index (prepared by Ivanyna and Shah, 2012) were analyzed for three groups of countries—OECD countries, transitional countries and developing countries. While no consistent relationship was found for developing and OECD countries (and is therefore not shown or further explored here), for transitional economies the correlation between revenue decentralization and economic growth was clearly found to be negative (figure 4).⁵

Figure 4. Local Revenue Collections and Political Decentralization in Transition Countries

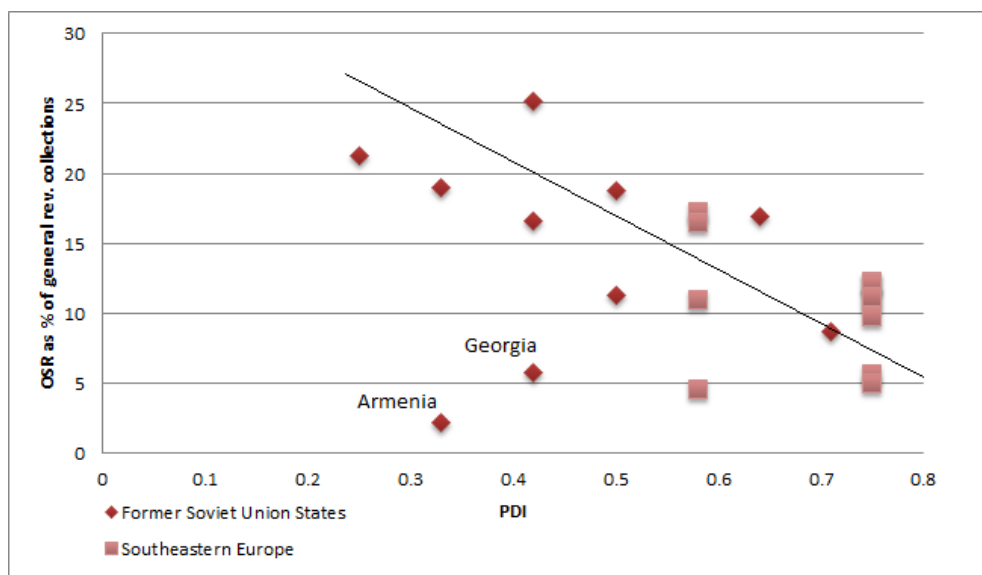


Figure 4 shows an inverse (downward sloping) relationship between local revenue collections and political decentralization for transition countries (including both eastern Europe and former Soviet republics), with Armenia and Georgia being notable outliers. The graph further shows that countries in southeastern Europe tend to have a higher degree of political decentralization than former Soviet republics. Perhaps surprisingly, the graph indicates that many former Soviet states have a higher degree of revenue decentralization than their regional neighbors in eastern Europe.

⁵ We initially investigated the relationship between revenue decentralization and all three dimensions of decentralization (political, fiscal and administrative). Using the indicators prepared by Ivanyna and Shah (2012), however, we did not find strong relationships between revenue decentralization and the other dimensions of decentralization as measured by Ivanyna and Shah.

It is unlikely that the observed patterns of revenue decentralization and political decentralization are unrelated. As already noted in Section 3.2, despite their relatively high degree of revenue decentralization (as indicated by the IMF), local governments in many former Soviet republics are more akin to deconcentrated entities than to semi-autonomous local governments. Indeed, subnational autonomy over revenues in many FSU countries is virtually nonexistent. In the Russian Federation, Ukraine and the Central Asian republics, subnational authorities are allocated a specific share of collections in their jurisdiction from the major tax instruments (e.g. VAT, PIT, enterprise profits tax and excise taxes) (Dunn and Wetzel, 1998). Although these shared revenues are counted as “own source revenues,” central governments determine the tax bases, the tax rates and the sharing rates for these shared taxes.⁶ Indeed, revenues from taxes shared on a derivation basis account over half of regional and local revenue receipts in Russia, Ukraine and Kazakhstan, and their structures can be changed only at the central level (Dabla-Norris, Martinez-Vazquez and Norregaard, 2000). Furthermore, the spending of these “subnational” resources is controlled extensively by centrally-issued budget guidelines and administrative norms.

Thus, what appears to be a high degree of local revenue autonomy in former Soviet republics (typically an indicator of a high degree of fiscal decentralization) is in fact constrained and ‘captured’ by the central government through vertical political, administrative and fiscal controls.

In fact, the results of figure 4 match the findings of the study done across the same group of countries by Rodriguez-Pose and Kroijer (2009). This study finds that higher shares of transfers from other levels of government and subnational taxation negatively correlate to economic growth. However, further investigations suggest that locally imposed taxation is in fact positively correlated to economic growth in the long run (Rodriguez-Pose and Kroijer, 2009).

6. Concluding Remarks

The primary aim of the paper has been to tackle the question of whether local revenue collections are beneficial for economic growth or not. We have concentrated our analysis on three groups of countries—OECD, transitional and developing countries for the period of 2003 to 2008. Overall, there is no evidence to suggest that local revenue collections have a negative impact on economic growth in each of the three groups of countries covered in the research.

Second, we introduced measures of political, fiscal and administrative decentralization indices into the analysis. When considering the transitional countries of eastern Europe and the former Soviet Union, this analysis uncovered a clear inverse relationship between subnational political autonomy and revenue decentralization, and clear differences between the experiences of eastern European countries and former Soviet states.

⁶ In some countries, such as Ukraine, Russia and others, local agents of the central tax authority collect the taxes, give local authorities their approved shares and pass the rest up the administrative chain. In other countries, tax collection is centralized, and subnational tax shares are passed down from central authorities (e.g. Croatia, Hungary and Poland) (Dunn & Wetzel, 1998).

Our results are inconsistent with the argument that revenue decentralization hinders sustainable business growth or private sector development. This does not mean that some degree of predatory local taxation never takes place when revenue powers are decentralized to local authorities. Consistent with anecdotal country experiences, however, our results seem to suggest that countries with ineffective or unaccountable local governments possibly ‘self-correct’ by not decentralizing major revenue sources.

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