Fiscal decentralization and the size of government: a European country empirical analysis

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Abstract This article is an original contribution to the understanding of the relationship between fiscal decentralization and government size. Using a panel data set of the EU-15 countries, we analyse the effect of decentralization on aggregate, national and subnational government sizes by separating the long run effects of decentralization from its short run dynamics. In the long run, tax autonomy reduces central expenditure but increases—and to a greater extent—subnational public expenditure, leading to higher aggregate public expenditure. We find also that vertical imbalances tend to increase the sizes of subnational, national and aggregate governments.

Keywords Fiscal decentralization · Government size · Dynamic panel · Cointegration · Error-correction model · European countries

JEL Classification H5 · H7 · C23

1 Introduction

Since the end of the 1980s, decentralization—that is the transfer of political, fiscal and administrative powers to subnational governments—has emerged as one of the most important trends in development policy. Thus, the design of fiscal relations across levels of governments in the European Union member countries has attracted increased interest as competencies and tax-raising powers are transferred to local government level. Supranational institutions, such as the World Bank (2000) or the OECD (2002a, 2002b), support fiscal
decentralization in the East European countries, arguing that a move towards more decentralization would promote economic development as well as the efficiency of the public sector. The World Bank Report on *Entering the 21st Century* notes that the desire for self-determination and the devolution of power is the main force “shaping the world in which development will be defined and implemented”\(^1\) in the first decade of the present century.

Several alternative theories of government behavior proposed in the public finance literature advance the hypothesis that fiscal decentralization might restrict the size of the public sector. Oates (1972) argues that local governments are better informed about citizens’ preferences than federal or central governments, meaning that decentralized provision of public goods should be more efficient than centralized provision. However, he also notes that while public goods better match the needs of citizens (in line with Tiebout 1956), increased local demand for public services might increase the size of the public sector (Oates 1985).

In introducing their famous Leviathan hypothesis, Brennan and Buchanan (1980, p. 185) posited that “total government intrusion in the economy should be smaller, ceteris paribus, the greater the extent to which taxes and expenditures are decentralized”. Depicting governments as revenue-maximizers, these authors, and the subsequent literature on public choice, argue that, as long as tax bases are mobile, fiscal decentralization forces governments to engage in tax competition, thus restricting the Leviathan’s monopoly on taxation. However, models show that when several levels of government independently set their tax rates, on a common tax base (i.e., tax base sharing), the combined (aggregate) equilibrium tax rate of two overlapping revenue-maximizing governments is higher than a single revenue-maximizing government tax rate (Flowers 1988; Shughart and Tollison 1991; Keen 1995; Wrede 1996; Keen and Kotsogiannis 2004). Indeed, there is no theoretical consensus on the relationship between fiscal decentralization and the size of public sector since those who question the Leviathan model also outline arguments showing that decentralization may not lead to a leaner public sector, that is the well-known fly-paper effect and the problem of the commons (for more detail, see Jin and Zou 2002, pp. 273–274).

Following Oates’s (1972, 1985) seminal empirical studies, many papers have attempted to test the impact of decentralization on the size of government. However, the results are inconclusive (see Feld et al. 2003, for an exhaustive literature review). This strand of the literature sees government size typically measured in terms of tax revenues or government spending, while most indicators of fiscal decentralization—derived from the Government Finance Statistics (GFS) issued by the International Monetary Fund (IMF)—are defined on the basis of a single aspect of decentralization, that is, the subnational share of aggregate government revenue or expenditure. However, these common fiscal indicators considerably overestimate the degree of fiscal decentralization or fiscal autonomy in most countries as they take no account of the control wielded by subnational governments over tax bases and rates (Stegarescu 2004). Decentralizing expenditure without corresponding local taxation powers may not produce the tax competition that constrains Leviathan behavior. Decentralization funded by common sources, such as grants or shared revenues that are controlled by the center (i.e., vertical imbalance), may have the opposite effect, by breaking the link between taxes and benefits. Decentralization could restrain or intensify government growth, depending on the nature of the decentralization (Rodden 2003). A few papers based on information from the OECD (2001), take account of subnational government control over tax bases or rates in European transition countries (Ebel and Yilmaz 2002) and in some OECD countries (Rodden 2003;  