Helpdesk Research Report: The impact of decentralisation on economic growth

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Query: What has the impact of democratic decentralisation been on economic development and economic growth? Please provide examples and lessons from various countries.

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1. Overview

Democratic decentralisation is advocated as a means of providing more appropriate, efficient and accessible public services, and of achieving a variety of interrelated socio-economic objectives, including poverty reduction and economic development (Conyers, email communication). Local government’s contribution to economic development comprises policy interventions to ensure the participation of citizens in decision-making at local levels and facilitating partnerships between the public, private and community sectors; creating an enabling environment, including the provision of goods and services, such as critical infrastructure, and for the development of human capital; and raising and managing revenues for investment. These correspond to the political, administrative and fiscal responsibilities of democratically decentralised government, respectively.

However, few studies empirically explore the links between decentralisation and economic development. This is partly because research has shown that it is difficult to arrive at definitive conclusions about the effect of decentralisation on economic development (Scott 2009). Moreover, the (largely econometric) studies that have attempted to identify the relationships arrive at a variety of conclusions. Qualitative studies are limited. Some practical examples do exist, however, focusing mainly on sub-national development strategies. While each of the case study examples discussed in this paper take place in a context of democratic decentralisation, because of the focus on economic development, the fiscal aspects of decentralisation tend to be emphasised. This includes experiences of:

- Local Economic Development (LED) in various African countries
- Rural Economic and Enterprise Development (REED) in South Africa
- The Local Developmental State model in Colombia
- Developing Economies Locally Through Action and Alliance (DELTA) in Kosovo and Albania.
Evidence of a positive impact of decentralisation on economic development is even more limited. The few examples of (expected) impact discussed in the case studies below include (Davis 2006):

- creating an enabling environment for economic growth
- creating adequate mechanisms, processes, and structures which articulate local needs
- promoting active private sector institutions and linkages
- creating effective and functioning infrastructure
- promoting access to integrated and open markets
- promoting access to effective and efficient support services, including resourcing
- promoting the management capacity of emergent entrepreneurs.

This paper supplements the case studies with summaries of some econometric studies. However, these largely focus on the implications of decentralisation for economic growth. This differs from economic development in that while economic development refers to policy processes, economic growth refers to increased market productivity. In keeping with the case study approach, it focuses on a small number of countries (Indonesia, India and China), on which multiple studies have been conducted. These studies raise questions such as whether there is a trade-off between economic growth and social development/service provision.

Key lessons that emerge (summarised in van der Wal and Hilhorst 2007) include:

- An important precondition for pro-poor economic growth is that local governments understand their potential role in supporting private sector development, and are aware of the opportunities and constraints for the private sector: fostering public-private dialogue is an important tool.
- Municipal officials and policymakers may require capacity building to help them manage economic projects and build effective partnerships with other sectors.
- Local governments can contribute in various ways to an enabling environment for pro-poor economic growth, such as by fostering effective and efficient registration and licences for business activities. They need to become more service- and facilitator-oriented, and less controlling.
- Good economic governance means predictable and reliable government action, through the application of accessible, affordable and transparent policies and procedures. Taxes and levies should be collected and used in a transparent way. Moreover, experience shows that taxes are collected more successfully when local government openly demonstrates how the money has been invested.
- Fostering investments in physical infrastructure, such as roads, water, telecommunication services and electricity, is a major determinant of product quality and market access.
- Local governments constitute an important market for the private sector, as buyers of services and goods. Preferring the procurement of local services is therefore important.

Local governments face many challenges in fulfilling their economic development functions (Scott 2009). These include the following:

- Decentralisation can reduce public sector efficiency, particularly when administrative capacity at the local level is constrained as a result of too few staff, inexperienced personnel and/or inadequate financial resources.
- Local economic development is reliant on efficient, reliable service provision, such as of roads, electricity and water. In addition to lack of administrative capacity, lack of clarity around roles and responsibilities and inappropriate focus and investments often constrain the delivery of services that are necessary for local economic development.
- While an important rationale for decentralisation is that it reduces corruption by bringing government closer to the people, hence strengthening accountability, decentralisation
also carries a danger of local elite capture. This can undermine business development when decisions are made to benefit certain individuals rather than to promote general economic growth.

The paper concludes with a section that presents the findings of various empirical studies, which draws conflicting conclusions as to decentralisation’s effectiveness in both facilitating economic development, and contributing to economic growth.

2. Qualitative evidence

This section presents case studies evaluating the contribution of local government to economic growth and development.

Report from Workshop Two: Local Economic Development and Poverty Alleviation, UNCDF symposium on Decentralization and Local Governance in Africa, Cape Town

This report presents a summary of discussion during a conference session attended by African policymakers and practitioners involved in local economic development (LED). Experience in many countries suggests that the role of local government in LED needs to be:

- **facilitative**, including playing a complementary role to the private sector in such activities as co-financing and the provision of start-up costs. Delegates considered that the role of local governments is to co-ordinate investment and to provide information and knowledge about export markets, government regulations, quality standards, and so on to local producers.
- **focused on the provision of public services**, but it was important that such strategies had certain key elements in place, including participatory processes, the existence of a development fund and a bias towards local producers.

A number of challenges were also identified:

- Many successful LED projects were donor-funded, raising the issue of sustainability.
- There was a strong view that local governments could play a successful role in LED only if they were able to make a clear distinction between public sector and private sector activities. A clear line needed to be drawn between a) facilitative roles supporting an enabling environment; and b) income-generating activities.
- Road infrastructure provision was identified as a key to LED. However, often countries tended to only adequately fund urban roads, to the detriment of rural roads, thus slowing down rural development, particularly in generating access to markets for local farmers.
- LED is not only about the provision of infrastructure by local governments: ensuring adequate maintenance is also important.
- Delegates stressed the failure of administrative decentralisation to empower local governments to undertake LED, especially in rural areas, where rural councils had been completely marginalised by the centre.
- The issue of limited resources for local governments was constantly raised, as well as the increasing disparities between urban and marginalised rural local governments.
- External factors also constrain local action, including: the degree to which countries participate in the international economy; the extent to which central governments attend to local government priorities; and arrangements with donors, which were often limited to each country’s (national) – or even donors’ – development priorities.

Lessons from the experiences shared included the following:
• The role of the various actors has to be clearly defined, both within government (central versus local government) and between government and non-governmental actors (business, community-based and non-governmental organisations (NGOs), donors).
• The framework for co-ordinated planning could be expanded to include NGOs and development partners, and such partnerships need to be formalised through contracts.
• The importance of real, effective consultation between central and local governments, between local governments and non-governmental actors and between local governments and communities cannot be over-emphasised. Often, donors overestimate the capacity of local authorities for consultation.
• National frameworks need to be flexible, taking into account the varied scales and complexity of LED initiatives.
• Outsourcing of some ‘traditional’ public sector activities could be effective. However, the role of the public and private sectors have to be clearly defined in both urban areas (where the private sector may be dominant) and rural areas (where local governments and community groups are prominent). Further, partnerships with the private sector must not mean handing over state assets to it, and the creation of private sector monopolies.
• Participatory processes are important for successful LED and poverty alleviation. However, the correct combination of approaches for such participation needs to be identified, including appropriate mechanisms for group decision-making.


This paper assesses the degree to which the components of the Rural Economic and Enterprise Development (REED) framework have been incorporated into integrated development planning (IDP) or into strategic local economic development (LED) plans. It evaluates two local municipal level IDPs in South Africa’s Free State in the post-Apartheid period.

While the national government provides a broad framework and plays a supportive role, the developmental effort is the responsibility of the local government, not only in terms of implementation of the programmes but also in terms of the formulation of plans. Establishing clear roles and responsibilities among different levels of decentralised government has been important in South Africa. The participation of civil society, private enterprise, and donor organisations is also considered to be crucial in the integrated development planning phase.

South Africa has identified seven key interventions it considers critical for securing an enabling environment for local economic development: securing good governance; improved, reformed regulation (including promoting competition and creating regulation appropriate to local realities); developing a realistic tax regime; increasing the capacity of local government to maintain effective business registration and licensing systems; addressing tariff and non-tariff barriers; creating a supportive legal framework; and creating incentives for private investment (including tax cuts, appropriate subsidies, public investment in infrastructure, and credit schemes).

The paper notes, however, that although some success stories do exist in the Free State, the success rate of local economic development has been fairly limited. For instance, despite the fact that the projects financed by means of the LED fund had made a contribution to human development, only a limited number of these projects would actually survive the initial phase, during which funding occurred: lack of sustainability is a significant constraint. Also, with regard to the creation of infrastructure for small business development initiatives in South Africa, the Free State has not performed well. Overall, IDP and LED strategies lack detail when considering the
importance of creating an enabling environment for small and medium enterprise (SME) development. The operationalisation of the concept of an enabling environment is limited.

Bateman, M., Ortiz, J.P.D., Maclean, K., 2011, A post-Washington consensus approach to local economic development in Latin America? An example from Medellín, Colombia, ODI Background Note, London

After more than two decades of very well-publicised narco-industry and paramilitary-driven violence and chaos, Medellín, Colombia has made significant economic and social progress since the late 1990s. This is thanks to local state activism that has proved both popular and effective. The core idea is that sub-national levels of government can, and should, be proactive in building the institutional and organisational infrastructures required for growth-oriented micro-, small and medium enterprises to emerge and succeed. This is termed the Local Developmental State (LDS) model. The process requires public assets, institutions and funding, with public agencies often linked to, and financing, a range of non-state and private organisations.

City ownership and management of the main energy company helped produce significant revenue flow to the city, which has allowed the city to embark on major longer-term programmes of enterprise and community development. Medellín also used public ownership to encourage solidarity and build a new civic culture. For instance, the city used pro-poor transport policies to connect the poorest locations with the metropolitan centre, facilitating important family contact for the poor at a comparatively low price.

Two specific LDS innovations proved highly important. First, was the creation of a network of 14 publicly-funded business support centres, located in the very poorest areas, designed to support business development by the poor. They offer free business support services and technical advice to anyone with a good business idea. Working alongside these centres is the Banco de las Oportunidades, which provides microloans up to US$2,500 at a favourable interest rate (0.91 per cent monthly) to establish microenterprises. The end result of both interventions is an increase in the number and quality of the microenterprises operating in the poorest communities around Medellín.

While the model is considered highly successful, the study makes a number of recommendations for improvement:

- **Greater support to convert microenterprises into small enterprises** is needed: in Medellín, almost none of these microenterprises have evolved into informal small or medium businesses. The promotion of microenterprises needs to be phased out gradually as a development intervention, replaced by an emphasis upon building innovative small and medium enterprises with genuine growth potential, provided with technical support.

- **Gender issues are critical**: the informal sector in Latin America is dominated by women micro-entrepreneurs. Many microfinance institutions target women, and the microenterprises they support have become synonymous with women’s empowerment. However, these interventions may also reinforce women’s positions at the margins of development in informal businesses that do not have the potential to grow beyond the micro level.

- There should be **clearer separation between economic and social objectives**: notably, the business support centres should be freed from their mandate to help all who develop a business idea. Instead, there needs to be more support for sustainable enterprise development, which means identifying and supporting those with the most potential to grow.

- **Greater links** need to be made between the local institutions in Medellín and the wider region to promote and support social enterprises that can operate alongside the regular
commercially-driven business sector. This is especially so in relation to cooperative enterprises, which have real potential to provide additional sustainable employment opportunities, raise incomes, and provide the poor with greater access to important markets.

- **A local industrial policy** is required to provide further structure, content and institutional backup to the measures currently underway, especially for policy tools and programmes that might improve the transfer of technology, innovations and knowledge.


The Developing Enterprises Locally through Alliance and Action (DELTA) programme focuses on building institutions within municipal governments in Kosovo and Albania, providing them with support to improve private sector development. It operates by promoting capacity-building training and technical assistance to local institutions, municipal officials and local business and NGO leaders. Municipal stakeholder groups (of between 40 and 175 people) work with technical support from a local implementing partner to develop their own locally owned three- to eight-year strategies and priorities for improving the enterprise sector. The programme aims to institutionalise public-private partnerships in which the development of goals, objectives, programmes and projects are jointly identified, prioritised and implemented.

This evaluation highlighted the following impacts:

- modification in way cities were run, including greater citizen involvement, partnerships, less political conflict and more long-term planning
- better relationships with the business sector
- the expansion of small and medium enterprises
- a high project completion rate.

Perhaps most important was the change in the way officials think about their duties and ways of governing — including changed approaches to working with citizens and the business community and in general changes in the way that local governments do business.

Its success in achieving its goals was a strong indicator that the DELTA programme should be repeated. However, a few weaknesses were identified, including: lack of coordination for donor support; the need for Offices of Economic Development to be set up in each participating city; the need to extend the time frame, including longer involvement of local and international experts; and the need for the project to include a central government component.
3. Empirical evidence

This section presents evidence from econometric research studies on Indonesia, India and China, whose decentralised processes have been the subject of many studies.

Indonesia

http://www.ids.ac.uk/files/docfile/WPS1720111.pdf

A large literature suggests that countries with better governance have higher growth rates. This paper explores whether this is also true at the sub-national level in Indonesia. The researchers exploit a new dataset of firm perceptions of the quality of economic governance in 243 districts across Indonesia to estimate the impact of nine different dimensions of governance on district growth. Surprisingly, they find relatively little evidence of a robust relationship between the quality of governance and economic performance. However, they do find support for the idea that structural variables, such as economic size, natural resource endowments and population have a direct influence on the quality of local governance as well as on economic growth. This suggests that efforts to improve local governance should pay greater attention to understanding how such structural characteristics shape the local political economy and how this in turn influences economic performance.

http://courses.cit.cornell.edu/tp253/docs/decentralization.pdf

This article studies whether decentralisation has improved economic performance in Indonesia and argues that decentralisation has had no discernable effect on the country’s national-level economic performance. It uses sub-national data to probe two political economy mechanisms – inter-jurisdictional competition and democratic accountability – that underlie all theories linking decentralisation to better economic outcomes. Their findings suggest that extreme heterogeneity in endowments, factor immobility, and the endogenous deterioration of local governance institutions can each undermine the supposed development-enhancing promises of decentralised government in emerging economies such as Indonesia. For decentralisation to foster national development, a country must have relatively homogenous regions, highly mobile labour and capital, and strong accountability for local leaders. Indonesia’s experience demonstrates that the absence of these three requirements can constrain decentralisation’s effectiveness, particularly in the very districts where good governance is most needed.

http://digilib.gmu.edu:8080/bitstream/1920/5684/1/Tirtosuharto_Darius.pdf (saved also)

This paper measures the effect of fiscal decentralisation on state efficiency and economic growth in Indonesia. The efficiency of Indonesia’s 26 states’ government expenditures over a 10-year period (1996-2005) is constructed using Data Envelopment Analysis (DEA) and a Tobit panel data model is used to analyse the determinants of state efficiency. The researcher found that the degree of fiscal decentralisation has a positive association with economic growth if there are insignificant imbalances between regions following a disproportionate growth in labour force and population. To a certain degree, regional imbalances are one of the disincentives to a decentralised system. Another finding is that although decentralisation provides incentives for
states to become more efficient, this does not always lead to robust growth due to the extent of misallocation of fiscal resources and lack of investment in productive spending. The degree of fiscal decentralisation, ratio of productive spending, operating costs and revenue independence are all significant for determining state efficiency, and these factors differ between leading and lagging states.


Indonesia has three levels of decentralised governance: provinces, regencies and municipalities. This study explores the effect of fiscal decentralisation on economic growth (measured as the growth of output per capita) in a sample of 26 (out of 33) provinces, using data from 1992-2002. Fiscal decentralisation is approximated as expenditures (ratio of local government expenditure to total government expenditures), revenues (ratio of local government revenue to total government revenues), production (ratio of local government expenditures to total government expenditures minus the defence and social security expenditures) and autonomy (degree of fiscal independence of a local government in a province).

The researchers’ model shows that:

- The expenditures indicator, particularly non-security and social services spending, positively and significantly influences economic growth both in the short and long term.
- Revenue indicators influence economic growth negatively.
- Investment is negatively related to economic growth. This implies that investment is not efficient or, in the short-term, investment has no multiplier effects and has no value added.

The authors derive several policy implications from their findings:

- Local government should be able to increase their non-tax revenues.
- There is a need to create conducive conditions for capital inflows: the availability of good infrastructure and assurance of security and political stability are among conditions that can be expected to support local economic activities.
- There is a need to develop a clear framework for fiscal decentralisation assignments, such as income redistribution and borrowing.
- Central government should carry the policy responsibility for stabilising income redistribution.
- For local government with limited sources of finance, there is no reason that local government should not take loans to fund their activities.
China and India

NB While it is not a democratic experience, China’s extensive decentralisation process can still offer important lessons for democratic decentralisation.


http://aysps.gsu.edu/ispwp0519.pdf

This paper explores the extent to which decentralisation has been an engine for growth in China and India. Both countries face similar design issues in their intergovernmental systems, such as lack of clear expenditure assignments, high transfer dependency, low revenue autonomy and soft budget constraints. As a result, in both countries, there is a lack of aggregate fiscal discipline among sub-national governments, and the quality of sub-national service delivery is poor. Poor service delivery and lack of fiscal discipline threaten the ability of both countries to sustain high rates of economic growth.

The paper contends that the structure of intergovernmental fiscal transfer (expenditure assignments, revenue assignments, fiscal transfer system and borrowing autonomy) plays a crucial role in shaping conduct and performance of sub-national governments. Public expenditures in India have failed to provide public services, despite states being charged with many responsibilities relating to human and economic development.


http://digitalarchive.gsu.edu/econ_diss/57

This paper provides an empirical test of the effects of fiscal decentralisation and horizontal fiscal equalisation, two major growth policies, on economic growth in both China and India. Expenditure decentralisation reforms are partly meant to empower local governments to pursue economic development that best suits local preferences and comparative advantage. Horizontal fiscal equalization is meant to address concerns about growing interregional disparities in the quality of public services that may result from fiscal decentralisation due to differences in regional attributes and policies. Yet, while both countries are experiencing high economic growth rates, the rural poor in both countries are not fully sharing in the benefits of rapid economic growth. Despite the dangers of widening disparities in terms of inter-regional fiscal resource distribution from further decentralisation, no substantial evidence shows a trade-off between horizontal fiscal equalisation and growth in either country.

Based on the results, it appears that in China, a significant deepening of fiscal decentralisation would have a beneficial effect on the performance of the economy in terms of equalisation and growth. However, equalisation does not appear to influence the growth rate. In India, the researcher finds that fiscal decentralisation has a non-linear effect on growth, and that fiscal decentralisation is having a negative effect on growth in India.

4. Conflicting evidence: decentralisation, economic growth and economic development

Martinez-Vazquez and Rider (2005: 2) summarise the difficulty of drawing conclusions about the effect of decentralisation on economic growth. They argue that although the relationship between the two has received significant attention in the empirical literature, ‘no consistent empirical patterns emerge from these studies. Whether a direct relationship exists between the two therefore remains an unanswered question. However, there are a multiplicity of potential effects through which decentralisation could indirectly affect growth, such as the regional allocation of resources, macroeconomic stability, and corruption.’
Faguet and Channa (2011) also note that the majority of empirical studies (with one exception) demonstrate an insignificant or negative relationship between decentralisation and economic growth. They argue (2011: 26) that, ‘Regarding growth, it is important to note that decentralization’s effect is at best indirect and long-term, via raising the efficiency of public expenditure. Despite the fact that many reform programs cite raising the growth rate as one of their primary goals, there is no reason to expect decentralization to raise growth in the short term or via a more direct path unless it is accompanied by a separate fiscal boost. This is because in terms relevant to economic growth, decentralization is simply a reorganization of existing public expenditure patterns. Altering who undertakes and executes such decisions may in the best case improve the quality and efficiency of government services, and hence of the economy as a whole, and so raise growth as such effects feed through to increased productivity. But such effects will take time to become noticeable. Advocating decentralization as a short-term solution for low economic growth is mistaken’.

Similar difficulties arise in trying to determine the impact of decentralisation on economic development. However, some positive examples can be identified in empirical studies (Faguet and Channa 2011: 26-27):

- In a study of twenty countries’ spending on infrastructure over ten years, Estache and Sinha (1995) find that decentralization increased both total and sub-national spending on public infrastructure. However, they also note that methodological difficulties mean that no conclusions can be drawn from this about whether decentralisation made spending more or less efficient, and that interpreting spending levels in terms of efficiency or welfare is fraught with difficulty.

- Some studies report efficiency increases from decentralisation. Studies of small-scale rural projects in Mexico managed by Comités de Solidaridad (community self-help groups supported by World-Bank-financed projects) find cost savings of up to 50 per cent relative to similar projects managed by state agencies (World Bank 1994). Further, Piriou-Sall finds that decentralization boosted the overall cost-effectiveness of public health services in Chile. Effects in education were mixed, however. In Brazil reform led to increased administrative costs without significant service improvements, while Chile managed to avoid this problem.

- Estache (1995) finds strong evidence that even for services with high technological or coordination requirements, such as paved roads or piped water networks, where central governments have an advantage in building systems, local authorities are almost always able to operate them more cheaply.

- Using panel data to study the cost of road provision in eight countries over 25 years, Humplick and Moini-Araghi (1996) show that concave resource costs are offset by downward-sloping ‘preference costs’, so that initial losses in economies of scale from decentralisation are outweighed by efficiency gains when the locus of roadworks is closer to the people. Hence where road maintenance was decentralised, unit costs were lower and roads were of better quality.

But there are also negative examples from empirical studies. For instance, in a study of rural water supply in central India, Asthana (2003) finds that decentralisation of water provision decreased efficiency.

Faguet and Channa (2011: 27) conclude thus: ‘In summary, while decentralization does seem to increase expenditures on public services, it is unclear whether the efficiency and cost-effectiveness of public resource use rises or falls. And the effects of decentralization on economic growth appear to be either insignificant or negative.’
5. References


http://www.gsdrc.org/docs/open/PO60.pdf

van der Wal, F. and Hilhorst, T., 2007, The role of local government in stimulating pro-poor economic development; what and how?
http://www.businessenvironment.org/dyn/be/docs/156/van%20der%20Wal.pdf

6. Additional information

Selected websites visited
Addressing Poverty through Local Economic and Territorial Devopment, Natural Resources Institute http://www.nri.org/projects/reed/publications.htm

OECD Local Economic and Employment Development Programme (LEED)
http://www.oecd.org/department/0,3355,en_2649_34417_1_1_1_1_1_00.html

OECD LEED Working Papers

United Nations Capital Development Fund Publications and Reports
http://www.uncdf.org/english/publications_and_reports/?_pstart=400

World Bank Local Economic Development Case Studies

World Bank Local Economic Development: Looking at Experience Relevant to Low Income Countries

Experts consulted
Diana Conyers, Institute of Development Studies
Jean-Paul Faguet, London School of Economics
Jorge Luis Martinez-Vazquez, Georgia State University
Zoe Scott, Oxford Policy Management
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