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*How does the fiscal decentralization of government affect government effectiveness as measured by the World Bank?*

**Introduction:**

This paper identifies the effects of fiscal decentralization on the effectiveness of government, a field of public sector economics that has been relatively neglected. The existing literature already finds that decentralization tends to have substantially varying effects on specific aspects of the public sector market. In the case of education, research shows that among developed countries students who attend school in more decentralized systems tend to get a better education (Barankay & Lockwood, 2007) while students in a less developed country tend to be disadvantaged by decentralization (Parry, 1997). Conversely, a great deal of research has been done on the effects of decentralization on corruption. Unfortunately, in this case the results are highly conflicted; because there are multiple measures for decentralization it is reasonable that mixed conclusions could be made about the effects of decentralization (Lessmann & Markwardt, 2009) (Dincer, 2010) (Goel & Nelson, 2010).

Researchers in both economics and political theory have difficulty explaining why decentralization in a country may change over time as it is a contradiction by development (United Nations Population Fund, 2000) (Carrion-i-Silvestre, Espasa, & Mora, 2008). If a government is becoming more decentralized it would imply that a higher level of government is relinquishing some of its own power to give it to the lower tier (Escobar-Lemmon, 2006).

Some of the benefits of decentralization include: i. Local knowledge insures that the knowledge of the particular circumstances will be promptly and properly used (Treisman, 2002).

ii. Greater accountability; if local politicians are locally elected, voters are better able to monitor and direct them (Treisman, 2002).

Ambiguous effects: i. Interjourisdictional competition; neighboring localities compete for mobile resources and facilitating the satisfaction of local tastes. But this can also impede coordination when it is needed. Local governments may also seek to attract capital in efficiency decreasing ways (e.g. giving businesses incentives that don’t lead to efficient market outcomes) (Treisman, 2002). ii. Checks and balances; there is conflicting data on the effect or decentralization on corruption (Dincer, 2010) (Lessmann & Markwardt, 2009). iii. Vertical competition-the more tiers of government there are, the higher the aggregate burden of any corruption or inefficiency.

Potential problems: i. Duplication of services; there are fixed administrative costs in each jurisdiction. ii. Corruption and incompetence – At lower levels, the intimacy and frequency of interaction between private individuals and officials are greater, rendering corrupt collusion less risky (Treisman, 2002). It can be argued that local representatives may be less competent than central government officials because if they were actually good politicians they would be in a better paying, more powerful position.

Government effectiveness as defined by the World Bank is essentially the government’s ability to conduct itself in an efficient manner. The details of how it is calculated can be found in the appendix and in the methodology report for the WGI by the World Bank.

**Data and Economic Model:**

Data comes from three primary sources: the World Bank, the International Money Fund and the US Census Bureau. The proxies typically used for fiscal decentralization are typically the breakdown between either revenue or expenditure between the subnational governments in a country (Yeung, 2009) (Neyapti, 2010). See appendix for specific calculations of both types of fiscal decentralization. Data is presented in a panel format; the project is not intended to be time-series but the lag effect of action to reaction is tested.

Literature shows the best measure for decentralization is a combination of fiscal decentralization, income per capita and country size (Panizza, 2004); PPP and population are generally good measures for these auxiliary variables (Letelier, 2005). There are several types and measures of decentralization but fiscal tends to be the standard because it is the easiest to quantify in a standard way for cross-country analysis.

Within these models there are something like 3-4 different iterations that include certain interaction terms, Booleans to separate clumps of data based on things like geography and completeness in the data. I haven’t figured all the SAS out. Some study also sites using some of the other WGI variables as dependents but literature that has done this didn’t find any significance.

Using these models the best fit has an adjusted r-sq of about .12

PPP is very significant

**Methodology:**

Preliminary models show that EFD compared to RFD does not only tell a more economically sound story, it is also statistically the better choice.

**Interpretations:**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | Model I | Model II | Model III | Model IV | Model V | Model VI |
| Constatnt |  |  |  |  |  |  |
|  |  |  |  |  |  |  |
| EFC |  |  |  |  |  |  |
|  |  |  |  |  |  |  |
| RFC |  |  |  |  |  |  |
|  |  |  |  |  |  |  |
| PPP |  |  |  |  |  |  |
|  |  |  |  |  |  |  |
| Pop |  |  |  |  |  |  |
|  |  |  |  |  |  |  |
| EFC\*PPP |  |  |  |  |  |  |
|  |  |  |  |  |  |  |
| EFC\*Pop |  |  |  |  |  |  |
|  |  |  |  |  |  |  |
| EFC t-1 |  |  |  |  |  |  |
|  |  |  |  |  |  |  |
| PPP t-1 |  |  |  |  |  |  |
|  |  |  |  |  |  |  |
| Pop t-1 |  |  |  |  |  |  |
|  |  |  |  |  |  |  |
| Adj. R-sq. |  |  |  |  |  |  |
| SSE |  |  |  |  |  |  |

**Conclusions and Limitations:**

Initial regression shows a definite positive correlation between EFD and GE.

Only used fiscal decentralization, try PSE.

Did not adjust for SS-type programs; most lit doesn’t and would be a massive pain.

Did not adjust for grants; apparently doing so does not have a significant impact on results in most cases.

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Appendix

From the World Bank on what factors create the index for Government Effectiveness:

Code Concept Measured

Representative Sources

DRI Government instability

Government ineffectiveness

Institutional failure

EIU Quality of bureaucracy / institutional effectiveness

Excessive bureaucracy / red tape

GCS Quality of general infrastructure

Quality of public schools

Time spent by senior management dealing with government officials

GWP Satisfaction with public transportation system

Satisfaction with roads and highways

Satisfaction with education system

IPD Quality of the supply of public goods: education and basic health

Capacity of political authorities to implement reforms PRS Bureaucratic Quality

WMO Bureaucracy: An assessment of the quality of the country’s bureaucracy. The better the bureaucracy the quicker decisions are made and the more easily foreign investors can go about their business.

Policy consistency and forward planning How confident businesses can be of the continuity of economic policy stance - whether a change of government will entail major policy disruption, and whether the current government has pursued a coherent strategy. This factor also looks at the extent to which policy-making is far-sighted, or conversely aimed at short-term economic advantage

Methodology for how the data was collected is available on the IMF website under GPS statistics section.