

Local Government Fiscal Competition in Developing Countries: The Case of Indonesia¹

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This paper explores the role and significance of spatial fiscal competition among local governments in the developing world. Although there is now a large literature on local fiscal competition in North America and Western Europe, little is known about the extent and significance of fiscal interaction among local governments in the many developing countries that have undergone fiscal decentralization process over the last decade. This paper, in particular, examines whether jurisdictional competition (in the forms of expenditure externalities, tax competition, and yardstick competition) has been present in Indonesia, a country that was strongly decentralized starting in 2001. Our empirical results strongly suggest the relevance of fiscal competition in the case of Indonesia.

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Este artículo explora el papel e importancia del modelo de competencia fiscal espacial entre gobiernos locales en países en vías de desarrollo. A pesar de que existe ahora una literatura significativa sobre competencia fiscal espacial en América del Norte y Europa Occidental, poco se conoce sobre la relevancia del modelo de competencia fiscal espacial en países en vías de desarrollo que han experimentado grandes avances en el proceso de descentralización fiscal durante la última década. En este artículo, en particular, examinamos la presencia de competencia fiscal espacial (en sus formas de externalidades del gasto, competencia impositiva y competencia de marca) en Indonesia, un país que ha estado embarcado en un fuerte proceso de descentralización desde 2001. Nuestros resultados empíricos

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sugieren de una forma significativa la relevancia del modelo de competencia fiscal espacial en Indonesia.

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JEL classification: H71, H72, H75, H77, C21

I. INTRODUCTION

This paper explores the role and significance of spatial fiscal competition among local governments in the developing world. An increasing number of papers in the fiscal competition literature, as reviewed below, have established the importance of spatial interaction among local governments in the United States and several Western European countries. Although over the last two decades many developing and transitional countries have been involved in deep decentralization reforms, providing local governments with different degrees of fiscal autonomy, little is known about the extent and significance of fiscal interaction among local governments in those countries.

Fiscal and other forms of spatial interactions among local governments can help shape important institutional features and outcomes of decentralization. Although the goals of decentralization may not differ that much between industrialized and developing countries, the forms of decentralization and the institutional and budgetary constraints with which local governments operate in those two categories of countries may mean that the role played and the outcomes produced by local fiscal competition may differ considerably between the developing and developed worlds.

However, the potential of fiscal competition, in particular some forms of it such as yardstick competition, can be of much more significance in the developing world because other forms of voice (such as, elections and referenda), and exit (such as, household and firm mobility) are likely to work less effectively in shaping the behavior of local governments in developing countries than in western democracies. The decentralization theorem (Oates, 1972) argues that decentralized governance can improve overall efficiency in public service delivery by bringing greater diversity into the supply of public services, thus enabling government to better serve heterogeneous preferences for public goods. Along with this *efficiency or preference matching* argument for decentralization, it is also argued (Shah, 1999) that decentralization can facilitate political participation of the citizens and improve