When is Fiscal Decentralization Good for Governance?

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Many developing countries are seeking to improve governance with fiscal decentralization. It is therefore worth revisiting what we know about political and economic institutions to understand how and under what circumstances decentralization can be beneficial. In an effort to do that, I review past research on the governance implications of devolving power to subnational authorities. Based on this review, I find that the gains from decentralization depend sensitively on how subnational authorities and intergovernmental relations are structured. I therefore conclude the paper by drawing nine lessons from theory and experience to help improve the design of decentralized institutions.

Even a cursory examination of the world’s states reveals a dizzying array of relationships between central and subnational governments. In some states, the central government is clearly dominant and subnational authorities are merely agents of its will. In others, strong regional and local leaders influence the crafting of virtually all domestic policies. Many systems fall somewhere between these two extremes, with central governments setting the direction of national policies and subnational authorities exercising power on the margins. In some states, the strength of subnational governments lies in their influence over the national policymaking process, while in others it rests in their competence over specific policy arenas set aside for them by a federal constitution.

This already diverse mixture of systems has been further enriched by a recent global trend toward decentralization, most strikingly in the developing world. International Monetary Fund data on twenty-nine countries, for example, show that the percent of total public expenditure undertaken by regional and local governments has increased from around 20 percent in the late 1970s to between 30 percent and 40 percent in the mid-1990s (Rodden 2006). There is reason to believe that this trend is continuing and even accelerating as decentralization gains support within the international development community. It has therefore become urgent to understand the impact of decentralization on governance quality, especially in

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poor countries where institutional changes bring the greatest potential for good or ill.

In this article, I draw lessons from theory and experience to shed light on the consequences of empowering subnational governments, especially in the developing country context. My focus, unless otherwise indicated, is on the “region,” “province,” or “state” standing at the highest level of subnational government, although many of the principles discussed will apply to local institutions as well. I begin by mining current research in economics and political science for insights into the potential benefits and pitfalls of decentralization. I then attempt to draw general lessons for designing the most efficient system of intergovernmental relations. In doing so, I seek the political and fiscal institutions best suited for maximizing the benefits of decentralization and avoiding the pitfalls, with the goal of providing the best governance outcomes possible. For the purposes of this article, decentralization provides quality governance when (i) it efficiently and reliably provides citizens with the public goods and services that they desire, (ii) it ameliorates (or at least avoids exacerbating) regional inequality and separatism, and (iii) it protects macroeconomic stability. Throughout the article, I draw on the experiences of a variety of states, centralized and decentralized, rich and poor, to flesh out my broad points with real-world examples.

Is Decentralization Good for Developing Countries?
The State of the Debate

Do the benefits of decentralization for developing countries outweigh the potential drawbacks? Most of the first-generation literature in economics views decentralization in a very positive light, emphasizing, among other things, its potential to improve efficiency (Oates 2005). More recently, a number of studies have called into question the belief that decentralization is a uniformly good policy choice. In this section, I will review the current state of the debate over decentralization’s impact on three policy outcomes: (i) the targeting and efficient provision of public goods, (ii) inequality and regionalism, and (iii) macroeconomic stability.

Decentralization, Targeting, and the Allocation of Public Goods

Tiebout (1956) pioneered the idea that decentralization, especially fiscal decentralization, can improve the efficiency of public goods provision by making it less uniform. His argument was that, in countries where taxation and spending powers are delegated to subnational governments, citizens can sort themselves geographically according to their preferred combination of government services. Two decades later, Oates (1972) took Tiebout’s simple but powerful idea as a starting point in developing a more comprehensive theory about the optimal level
of decentralization (see Lockwood 2002). He identified a trade-off between the responsiveness of government to subnational preferences and its ability to internalize externalities and achieve economies of scale. When regional governments enjoy significant fiscal autonomy, the resulting diversity of tax and spend policies enhances the efficiency and responsiveness of government. On the other hand, Oates argued, it is inefficient for governments to provide public goods whose effects may spillover into adjoining constituencies. Such public goods would be underprovided because the regional government in question would only consider the beneficial effects of the good in its own territory when deciding how much to generate. As a result, Oates argued, there exists for every case an efficient level of decentralization where the benefits of policy diversity are balanced by the drawbacks of non-internalization.

A possible implication of Oates’s argument is that, in most cases, public services should be provided at a subnational level. National governments should concern themselves with macroeconomic stabilization and with equalizing the regions and encouraging spending that generates positive externalities (Bird et al. 2003). Not all scholars agree, however, that decentralization is a necessary precondition for the targeting of public goods. For example, some critics, pointing out that moving from region to region tends to be costly, argue that citizens are unlikely to sort themselves geographically by tax and spending preference (Manor 1999; Bardhan 2002). This relative immobility of citizens should be especially true, they contend, in developing countries.

A second reservation that many scholars have about the Tiebout and Oates models is that they assume that central governments are unable to target different bundles of public goods to different regions (Breton 2002; Treisman 2007). If central governments can in fact accommodate the heterogeneous preferences of their citizens with targeted fiscal policies, subnational governments become superfluous.

While there is probably some truth to these critiques, a number of points can be adduced to defend the first-generation theories. First, political impediments may make it difficult for central governments to tax different regions or groups differently or to provide more public goods in one place than another. Clever approaches may be found to do so (such as imposing excise duties only on products made in regions that prefer more government), but it is unlikely that central authorities will be as efficient in targeting their fiscal behavior as sub-national governments. Moreover, central governments, which respond to the aggregate national preferences of voters, may lack the incentives to provide such targeted policies. Finally, even if they are willing to vary their taxation and spending, such governments are unlikely to be the most effective judges of regional preferences. While it may be true that citizens rarely sort themselves geographically by fiscal policy preference, subnational governments in a decentralized system can at least provide the policies preferred by most current residents of their constituency.
Targeting diverse regions with their preferred taxation and spending policies is not the only important aspect of quality governance. Perhaps more fundamentally, it is important that subnational governments have an incentive to provide public over particularistic goods in the first place. Many scholars argue that decentralization encourages such positive incentives by increasing the democratic accountability of the state. The basic intuition here is that government is more accountable when it is closer to the people. First, citizens can better oversee the behavior of public officials when they live in the same region than when the officials operate from a distant national capital (see von Braun and Grote 2002). This improved transparency results in better public service outcomes. Indeed, some studies have found that political participation tends to improve with decentralization (Manor 1999; Crook 2003). Second, subnational government officials are in a better position to judge what citizens want if they represent small constituencies.

A number of empirical studies have examined the relationship between decentralization and governance (and more specifically public service delivery). Excellent summaries of this literature can be found in Smoke (2006), Treisman (1999), and Azfar et al. (2004). To take some examples, Lewis (1998) has found that, in Kenya, local water services are superior to water services administered by the central government. By contrast, Parry (1997) does not find clear evidence for improvement in educational services after decentralization in Chile. More broadly, Davoodi and Zou (1998) conclude that fiscally decentralized states tend to experience slower economic growth, but Yilmaz (1999), criticizing their use of subnational expenditure percentages to measure decentralization, finds evidence for the opposite relationship. Von Braun and Grote (2002) conclude that decentralization reduces poverty.

There is currently a debate in the literature between those who credit decentralization with promoting transparency and accountability (i.e. Manor 1999; Gurgur and Shah 2002; Crook 2003; Huther and Shah 1998) and those who believe it exacerbates, or at best has no impact on, corruption (i.e. Treisman 2000, 2007; Tanzi 2002). Experts in the first camp argue that citizens can better supervise leaders at the regional level. Those in the second contend that more levels of government provide more opportunities for abuse of office, particularly as subnational government leaders may be less professional.

A related argument is that decentralization can place more responsibilities in the hands of regional governments than they can effectively handle (Manor 1999; Shah 2003). Even if subnational authorities have sufficient revenue streams, they may not possess the administrative resources necessary for effective governance. Many regional governments lack sufficient numbers of trained civil servants to carry out their policies, and this problem is especially acute in developing countries.

Finally, some scholars have highlighted the danger that decentralization, far from enhancing accountability, may simply serve as a vehicle for strengthening the...
powers of regional elites (Smoke 2006; Azfar et al. 2004; Bardhan and Mookherjee 2001; von Braun and Grote 2002). Such individuals may highjack regional and especially local governments to enhance their own positions. For subnational democracy and accountability to exist care must be taken that lower-tier governments truly represent all of their constituents.

**Decentralization, Inequality, and Regionalism**

A different strand of the literature, associated most closely with Barry Weingast (for example, Weingast 1995), argues that decentralization is beneficial because of the intergovernmental competition that it generates. Because, as Tiebout argued, citizens, and especially investors, can easily move from one region to another if they prefer lower taxes or better governance, decentralization puts subnational authorities in direct competition with one another. In other words, it generates an incentive to provide the maximum quality of government services at the lowest cost (see Qian and Roland 1998). Regional leaders who fail to provide such high-quality governance may find that their tax base shrivels and their economic development slows. Decentralization also has the important benefit of preventing the central government from engaging in harmful economic intervention. For all of these reasons, according to Weingast and others working in this strand of the literature, decentralization should discourage corruption, promote responsiveness, and check the growth of government.

Other scholars question this optimistic view by pointing out that, under certain circumstances, decentralization may weaken the economic and social cohesion of a nation. If regional authorities fund themselves primarily with their own tax revenues, it is inevitable that wealthy regions will enjoy more public services than poorer regions, exacerbating inequality (Manor 1999; Prud’Homme 1995; and see Aznar et al. 2004). West and Wong (1995), for example, have found that the availability of education and medical services has grown more unequal in China since decentralization. Such concerns are less relevant in systems that rely entirely on central transfers to fund subnational governments.

Furthermore, some scholars have argued that subnational authorities, if not carefully regulated by the central government, may enact policies that interfere with the free flow of commerce within a country (Tanzi 2002). The United States constitution provides the federal government with powers over interstate commerce to prevent such an eventuality, and central governments around the world typically work to protect internal markets. Nevertheless, in some decentralized countries (such as India), regional governments have used their taxation and regulation powers to interfere with cross-regional trade (Rao 2002).

A final concern is that, in highly divided societies, decentralization may contribute to the strengthening of regional identities and even, in extreme cases,
the development of separatist movements. Research on the consequences of decentralization for national cohesiveness is inconclusive and indeed contradictory. Some scholars fear that decentralization will undermine the unity of diverse countries (i.e. Treisman 1999; von Braun and Grote 2002), while others make the opposite point, contending that decentralization can save divided states from disintegration (i.e. Haysom 2003; Lijphart 1977). A number of states around the world have relied on decentralization to maintain national cohesiveness, from the creation of federal systems in Belgium and Switzerland to the recent devolution of power in the United Kingdom to the current Iraqi constitution. Others, for example France and the Soviet Union, have used a rigorously centralized state to promote national unity. The specific impact of decentralization on cohesiveness is probably only an issue in highly divided societies and is likely to vary on a case-by-case basis (Crook 2003).

Decentralization and Macroeconomic Stability

A final strand of the literature critiques decentralization for the risks that it may pose to macroeconomic stability (i.e. Prud’Homme 1995; Tanzi 2002; and see Smoke 2006 and Wibbels 2000 for reviews of the literature). The danger is that subnational governments may undermine the macroeconomic environment of countries by engaging in profligate spending. Bearing out this fear empirically, Treisman (2000) and Wibbels (2000) have found evidence linking federal systems with higher inflation.

Other scholars have emphasized that decentralization need not pose significant challenges for the macroeconomy if central governments either restrict the freedom of subnational authorities to borrow on private capital markets or credibly commit to a “no-bailout” policy (see Rodden 2006). If regional governments can borrow beyond their capacity to pay and then turn to central authorities to finance their debt, they have no incentive to behave responsibly. With the right mix of policy tools, however, central governments can incentivize regional leaders to engage in responsible financial practices.

Nine Lessons for the Design of Decentralized Institutions

What are we to conclude from these contrasting arguments about decentralization’s impact on governance? If there is an overarching theme in the literature, it is that the impact of strengthening subnational institutions, whether positive or negative, depends sensitively on case-specific details. Most scholars would probably agree that decentralized institutions, when designed correctly, can improve governance and avoid most of the potential drawbacks that plague poorly structured systems. The consequences can be dire, however, when decentralization is done poorly. In this section, I cull from theory and experience a series of nine lessons for designing
well-functioning decentralized institutions. I group these lessons into three categories—those that ensure that decentralization is genuine and effective, those that promote better subnational representation and governance practices, and those that strengthen national public goods and political stability. Obviously, political economy is by no means an exact science, but countries that take note of these lessons are likely to experience smoother intergovernmental relations and better performance outcomes.

Making Decentralization Genuine and Effective

1. Subnational governments should be delegated specific and important responsibilities.

Only when central authorities delegate significant responsibilities to regional governments can the benefits of decentralization be realized (Manor 1999; Burki et al. 1999). What sorts of responsibilities should they delegate? There is no absolute rule here, and the answer will depend on a country’s priorities, its population size, and the administrative capacity of its subnational units. Generally speaking, however, subnational governments should provide goods that generate few cross-constituency spillover affects, especially when there may be significant geographical differences in the quality of goods demanded. For example, the United States constitution provides Congress with such powers as raising an army, regulating commerce with foreign nations, setting naturalization policies, and coining money, activities that would clearly be impossible for subnational authorities to undertake efficiently. Residual powers are left to the states. In India, perhaps the developing world’s most established democratic federation, an annex to the constitution assigns certain very specific powers to the center, others to the states, and still others concurrently. The national list of powers includes everything from foreign affairs to railways to the regulation of insurance and stock markets. States, on the other hand, are responsible for public order, policing, fisheries, agriculture, and many other items. Concurrent powers include education and economic planning.

Specific powers may also be allocated to the local level under the same principle. In a comparison of local governments in the established democracies of western Europe, for example, Norton (1991) found that virtually all governments delegated responsibilities such as water provision, tourism, roads, building permits, sewage, trash, and libraries to the local level, and some went on to delegate electricity, hospitals, and disaster response. It is also possible for certain policy areas to be shared among different levels of government; in education policy, for example, national or regional authorities often control curriculum and teacher certification, and local authorities oversee school buildings. This more cooperative approach can bring to bear the contrasting strengths of different levels of government on a single public policy issue.
It is important to note, however, that many observers prefer the enumeration of clear policy areas that are under the purview of subnational authorities to more cooperative forms of intergovernmental relations. Clearly separated powers, they argue, may avoid conflicts between levels of government and improve the ability of voters to reward and punish politicians for their performance. Countries such as the United States and India have rules that delineate the separate responsibilities of national and subnational governments, although the reality is certainly much more complicated. By contrast, France and Germany provide interesting examples of countries where intergovernmental responsibilities are much more muddled. In France, the regions have responsibility for economic development, infrastructure, and transport, whereas the smaller departments exercise authority over social affairs and roads, and the communes over planning, building permits, and the like. However, the precise responsibilities and powers of each level of French government remain somewhat contested in a number of policy areas, and policy-making frequently involves multiple levels of authority (Cole 2006). In the more decentralized case of Germany, states derive most of their authority from their representation in the upper house of the national parliament, the Bundesrat, rather than from independent powers over specific policy areas. Policy formation and implementation (as well as taxation and spending) are shared, cooperative activities between the center and the states. Rodden (2003) argues that this more cooperative approach has impeded the ability of voters to impose fiscal discipline on the states and has contributed to cases of dangerous fiscal indiscipline.

2. **Subnational governments should enjoy sufficient expenditure freedom and administrative capacity to perform their responsibilities.**

For reasons already noted, achieving the benefits of decentralization is likely to depend on the creation of genuinely independent subnational authorities. Along with significant policy responsibility, the most important characteristic of such institutions is that they have control over their expenditures. Only then can regional governments adjust their behavior to the preferences of the citizens they represent. An alternative approach is to provide subnational governments with an important voice in the creation of the national budget, generally through an upper legislative chamber.

Of course, even responsive and fiscally independent subnational governments will be unable to function properly if they lack administrative capacity (Manor 1999). A number of ideas have been floated for resolving this common problem, including an administrative sharing program with the central government (as in India and South Africa) or among regional governments themselves (see Momoniat 2002). Private sector expertise can also be brought to bear in an effort to improve subnational governance (Shah 2003). In any case, the building of strong administrative structures is vital for decentralization to be effective.

3. **Subnational governments should have the ability to tax or should receive steady and unconditional transfers.**
Most experts emphasize the benefits of devolving taxation powers to regional
governments. Such an approach will maximize the accountability benefits of
decentralization by allowing subnational authorities to alter both the distribution of
government policies and the size of government itself. Further, efficiency is
maximized when governments raise their revenues from the same citizens who will
enjoy the benefits of the public goods they provide (see von Hagen 2003). In such
circumstances, regional authorities will not have the incentive to overspend that
they would if their funds came from central transfers made up primarily of revenue
generated outside their constituencies (Oates 1972; Hines and Thaler 1995;
Rodden 2002).

What resources should subnational governments tax? Economic theory points to
the importance of assigning regional authorities the right to tax relatively immobile
assets such as real estate, water and sewer services, etc. (von Hagen 2003; Shah
2003). Such a tax policy will reduce the danger that holders of mobile assets
will flee to the constituency with the lowest tax burden, leading to a race to the
bottom.

In the absence of significant regional taxing authority, steady and unconditional
central transfers are necessary to ensure that subnational governments can set their
own budgetary priorities (Manor 1999). There is a large literature on how best to
structure these transfers, but a common choice is to provide regional governments
with the portion of revenues collected in their constituencies (along with an
equalization grant). Whatever the approach, it is important that subnational
governments enjoy the fiscal resources necessary to carry out their policy
responsibilities.

India and Canada provide contrasting examples of sub-national finance. India
is currently struggling with the negative consequences of fiscal imbalance. While
India’s states are allocated certain taxation powers, the most remunerative sources
of finance are reserved by the center. As a result, states collect only about 35
percent of public revenues, generating a center–state fiscal imbalance (McCarten
2003). This imbalance is corrected with sizable transfers from the central
government disbursed through the finance commission, the planning commission,
and the central ministries (see Hankla Forthcoming). The finance commission,
which is at least nominally independent, oversees tax sharing programs with the
states. Revenues are disbursed based on objective criteria, but the commission does
not use clear formulae, so some discretion is possible. Revenues from the planning
commission, which fund India’s economic development plans, are determined by
bargaining among state and central officials. State officials are represented on a
powerful advisory board called the National Development Council, and there is
evidence that political considerations have entered into disbursement decisions, at
least in the past (see Hankla Forthcoming). Further, the fact that planning
commission funding dries up five years after a project begins poses serious
budgetary problems for a number of states, as they must budget for recurring costs (McCarten 2003).

By contrast, Canada is characterized by ten powerful provinces which have virtually complete revenue and borrowing powers (Simeon and Papillon 2006; Bird and Tassonyi 2003). The provinces have virtually a free hand in imposing taxes, and indeed they generate fully 83 percent of their financial resources from their own revenues (Simeon and Papillon 2003). Interestingly, the provincial governments tap many of the same revenue sources as the center, and they often rely on federal authorities to collect their taxes (Bird and Tassonyi 2003). Other sources of provincial finance include large unconditional block grants that Ottawa distributes to correct the country’s vertical fiscal imbalance.

### Ensuring that Subnational Institutions are Representative and Efficient

4. **Subnational institutions should be democratically elected.**

Most of the benefits that accrue from decentralization are related in some way to the improved accountability and transparency of regional government. Forms of decentralization that eschew elections (such as a purely administrative reorganization of the central government) may achieve modest improvements by locating decision-makers closer to the citizenry. Without the incentives for responsiveness that come with election, however, subnational leaders are less likely to provide citizens with the quality and level of government that they desire (Manor 1999; Bird and Vaillancourt 1998). Bearing out this argument empirically, Enikolopov and Zhuravskaya (2007) have found no relationship between administrative decentralization alone and improved service delivery or reduced corruption.

On a related issue, there is substantial evidence that increased electoral competitiveness encourages quality governance and especially fiscal responsibility. The reason is likely that, when elections are more strongly contested, incumbents must worry more about the consequences at the ballot box of poor governance. Hallerberg (2004), for example, has linked electoral competitiveness with fiscal solvency in Western Europe, while Wibbels (2003) has made a similar argument for US states. In a close examination of Mexico, Hecock (2006) has found that greater competitiveness in subnational elections was associated with increased education spending. It should be noted, however, that a stable party system at the subnational level is also an important component of governance quality. A significant body of research points to the negative impact of rapid legislative turnover on budget deficits, arguing that it reduces the time horizons of elected officials (Roubini and Sachs 1989; Grilli, Masciandaro, and Tabellini 1991; Franzese 2002).

India provides a useful example. In the past, the partisan make-up of governments at both the state and federal levels in India was highly stable. As a result, strong chief ministers dominated budgetary decisions at the state level, with
legislatures largely quiescent due to strong party discipline. More recent years, however, have brought a dizzying array of new parties to the fore, resulting in cabinet instability at all levels of government. This cabinet instability has weakened chief ministers and strengthened the role of minority parties in expenditure decisions. There is also reason to believe that this growth in coalitions is increasing the fiscal profligacy of state governments (McCarten 2003). After all, each influential party will have supporters that it wants to reward using the public till. Furthermore, the unstable support bases that plague many of India’s key parties (most notably the governing Congress Party) may discourage further deregulation of the economy (see Hankla 2006).

5. Subnational political institutions should be designed to encourage the provision of public goods.

An important factor that separates successful from unsuccessful examples of decentralization is the quality of institutional design at the subnational level. The literature provides us with a wide array of lessons for how to structure institutions to maximize governance quality, most of which derive from research at the national level. I will briefly summarize those lessons here; for a more in-depth discussion, please see Hankla (2008).

Most researchers would agree on the value of combining a strong, unified executive with robust legislative oversight to encourage the provision of public over particularistic goods. Strong, unified executives, whether directly elected (as in presidential systems) or chosen by the legislature (as in parliamentary systems), are responsible to broader constituencies than any single legislator. Furthermore, they are an easily identifiable focal point of responsibility for the consequences of policy decisions. As a result, unified executives have a strong incentive to provide public over particularistic goods and to ensure that government is run efficiently (e.g. Mukherjee 2003; Blair 1991; Roubini and Sachs 1989; Baldez and Carey 1999; Hallerberg and Marier 2004). To take an example, in Canada the strong provincial premiers, who generally control legislative majorities in their provincial capitals, are probably better able to resist the temptation to overspend than are weaker executives in other systems. If a province gets embroiled in a debt crisis, voters can easily blame the governing party and punish it in elections (Bird and Tassonyi 2003).

Of course, the importance of legislative oversight of executive power cannot be overstated, and regional legislatures must possess the physical and administrative resources necessary to ensure quality government (see, for example, Nijzink et al. 2006). A strong committee system and access to policy expertise and advice are usually necessary for legislatures to function well.

Some observers recommend non-partisan elections at the regional and especially local levels as protection from the animosities of national politics. Many municipal elections in the United States, for example, are like this. Much research in political
science, however, emphasizes the benefits of partisan elections, especially when the national party system is reproduced at the subnational level. The existence of parties allows citizens to quickly identify the likely policy positions of any given candidate and encourages issue driven rather than personality driven politics (Manor 1999). Furthermore, some scholars have found that when subnational leaders belong to the same political parties as the national leadership, they may be less likely to engage in profligate spending and more likely to provide quality governance (for example, Rodden 2006). The logic is that, if such individuals aspire to a career in national politics, they must prove themselves competent at the subnational level. It should be noted, however, that other researchers have begun to question the link between co-partisanship and fiscal responsibility, arguing that it reduces salutary fiscal competition among regions (see Khemani 2007).

Protecting National Priorities and Preserving National Unity

6. The central government should use transfers to ensure regional equality.

To promote national cohesion and prevent animosity among regions (in addition to more normative reasons), central governments should consider using transfer payments to ensure equality of resources among subnational governments (Oates 1972; Bird et al. 2003). To take an example, the federal government of Canada distributes equalization funds so that the revenues of the poorer provinces are brought up to an average level based on their population size. In addition, a special arrangement with Quebec has been made to allow that French-speaking province, which is sensitive about its independence, even more autonomy over its receipts (Bird and Tassonyi 2003).

7. The central government should use targeted and matching grants to promote core national objectives and to encourage the provision of public goods with positive spillovers at the subnational level.

Some observers are justifiably concerned that fiscally independent subnational authorities could neglect to finance objectives seen as vital to the national government (Bird et al. 2003). Central governments worried about this problem frequently mandate that regional and local authorities must provide certain key services at specific minimum levels. Such is the case, for example, with public education in the United Kingdom (Davey 1983). Other central governments use conditional or matching grants to encourage certain behaviors at the regional level (Shah 2003). Medicaid, a medical insurance program for the poor in the United States, works in this fashion. Likewise, the government of South Africa has used matching grants to encourage the provision of public goods by subnational authorities (Shah 2003). Among the most important uses for conditional and matching grants is to encourage subnational authorities to provide public goods whose benefits spillover outside their constituencies. Public goods of this sort might
include the construction of hospitals and universities and the subsidization of research and development. As noted above, such goods will be underprovided if the central government does not take action.

8. Reformers should design subnational political institutions to maximize national unity and protect minorities.

By carefully designing subnational political institutions, reformers can go a long way toward realizing the benefits of decentralization for national unity and minority protection and avoiding its pitfalls (see Hankla 2008 for a more detailed treatment). Two institutional choices are particularly important here—electoral system design and the role of national parties. The impact of electoral system design on protecting minorities is the subject of a wide-ranging debate between “consociationalists” and “centripetalists”. Consociationalists (e.g. Lijphardt 1977) advocate list proportional representation for its ability to ensure that all social interests are represented by parties in government. Centripetalists (e.g. Horowitz 2003), by contrast, prefer the alternative vote and single transferable vote systems for the incentives they give candidates to make broad appeals across social groups. By allowing voters to rank-order their preferences, these systems reward moderate candidates who win the second preferences of voters outside their social group. The best approach is likely to depend on national context, with proportional representation generally preferred when (i) society is divided into a small number of groups, (ii) these group divisions are fixed, and (iii) elites are more moderate than voters (see, for example, Reilly 2002). There is very little support in the literature for traditional first-past-the-post electoral systems as used in the United States, the United Kingdom, and many other countries.

One useful approach to reducing the risk of decentralization for national political unity is to encourage the replication of the central party system at the regional level (see Weaver 2002; Filippov et al. 2004). This can be done in two ways—by holding regional elections at the same time as national elections and by using the same electoral system at both levels. When national parties also compete at the regional level, subnational politicians are much less likely to pursue separatist agendas. The participation of national parties should reduce the chances that regional parties with particularistic agendas will take power. Moreover, regional politicians, when they owe their political fortunes to national parties, will need to follow the national party line if they aspire to higher office in the future. Of course, when national party leaders are too strong, there is a risk that regional variation will be suppressed (Yilmaz et al. 2008), but the need to win subnational local elections should serve as a corrective.

9. The central government should protect macroeconomic stability.

The central government, of course, is ultimately responsible for the stability of the macroeconomy. Central governments must therefore use the policies under their control to promote exchange rate stability, control inflation, and ensure a
common internal market. Most of the macroeconomic risks of decentralization, however, can be overcome if central governments either limit borrowing by subnational authorities or impose a credible no-bailout policy. It is probably counterproductive for national leaders to ban all regional borrowing, especially when the money is intended to finance investment, but controls on total debt are probably wise (see Shah 2003). An alternative and perhaps superior approach is for the central government to impose a credible no-bailout policy (Rodden 2006; Bird et al. 2003). With such a policy, all debt that subnational governments acquire will be solely their responsibility to pay down. As a result, regional leaders will have an incentive to borrow only as much as they can repay, and private lenders will be able to set interest rates according to the credit profiles of the subnational governments. This approach maximizes the autonomy of subnational authorities while minimizing the threat of macroeconomic difficulties.

There is much debate about when central governments can credibly follow a policy of no-bailout, since it may be difficult to take no action to aid a subnational government embroiled in a debt crisis. The evidence indicates that central governments will be less able to commit to a no-bailout policy when they fund subnational authorities with transfers (Rodden 2006).

French and Canadian fiscal relations provide an instructive example of how a no-bailout policy can work in practice. All three levels of subnational government in France have the freedom to borrow from the private market, although French law stipulates that borrowed money should be used only to finance investment. Furthermore, subnational governments are required to keep their accounts in annual balance, and may be audited by the center if they fail to do so (Gilbert and Guengant 2002). As a result, recent decentralization reforms in France have increased the risk that subnational governments may default on their loans, but only slightly. Continuing central oversight has helped to mitigate any macroeconomic problems, and the fiscal performance of regional and local governments in France is generally good (Gilbert and Guengant 2002).

Like France, Canada imposes few central regulations over provincial borrowing, relying instead on an informal policy of no-bailout. This system may have contributed to some indebtedness during the tight 1990s, but provincial finances are overall in very good shape (Bird and Tassonyi 2003). As a result of the no bailout-policy, private capital markets are free to adjust their lending practices based on the credit records of individual provinces, providing an incentive for responsible behavior.

By contrast, efforts to limit subnational borrowing in India have been much less successful than the no-bailout approach used in France and Canada. State governments, under pressure to attract foreign direct investment and coping with the declining importance of central planning transfers, have been more and more attracted to borrowing as a means for financing their current accounts (McCarten 2003). They have been able to bypass central regulations in a number of ways,
including by floating corporations and borrowing through them, borrowing from public enterprises and special public accounts, and even over-drafting from the Reserve Bank of India (Rajaraman 2000). Even worse, the central government (including the finance commission) has a history of bailing-out profligate federal states, reducing any incentive for fiscal discipline. As a result, several states have begun to develop serious debt burdens (McCarten 2003). India, therefore, serves as a cautionary tale for relying too heavily on central regulation to prevent overspending at the state level. Subnational governments can often find ways around such regulations, especially when central authorities cannot commit to a credible no-bailout policy.

Some Final Thoughts

More and more, national leaders in the developing world are seeking to improve governance with decentralization. It is worth revisiting what we know about political and economic institutions to understand how and under what circumstances decentralization has been beneficial. This paper has sought to do that by reviewing past research on the governance implications of devolving power to subnational authorities and by drawing lessons from theory and experience for designing better decentralized institutions. The nine lessons presented here, while by no means set in stone, are intended to synthesize what is known about structuring intergovernmental relations, with a focus on deriving practical lessons for those policy-makers in the developing world considering decentralization for their citizens.

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