# FISCAL DECENTRALIZATION, ECONOMIC GROWTH AND DEMOCRATIC GOVERNANCE

Jorge Martinez-Vazquez

Robert M. McNab

Economics Department and
Policy Research Center
Georgia State University

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## I. Introduction

The goal of this paper is to review the state of our knowledge in the economics literature on the causal relationship between fiscal decentralization and economic growth and democratic governance, whether these relationships are uni-directional or bi-directional, and to what extent there appear to exist synergies or pre-conditions between fiscal decentralization, on the one hand, and economic growth and democratic governance, on the other.[1]

Given the unquestionable importance of economic growth and democratic governance for the welfare of nations, the study of the potential impact of fiscal decentralization on these objectives is timely. Most developing and transitional economies are embarking or have embarked upon fiscal decentralization initiatives.[2] Fiscal federalism issues have also been on the policy agendas of most OECD countries. This renewed interest in fiscal decentralization appears to be fueled by the widespread belief that fiscal decentralization is an effective tool for increasing the efficiency of public expenditures, even though it may carry some risks vis-a-vis other desirable objectives for government policy, such as income redistribution and macro-economic stability.[3] The rush to decentralize can also be seen as a reaction to the failures over the past decades of large centralized bureaucracies under very different political regimes. As Taillant (1994) puts it, the issue in many of these countries has become not “whether to?” but “how best to?” decentralize.[4]

Another reason that decentralization appears to be so widespread is that there is often confusion in terminology. Actually, what many governments call decentralization is nothing but the

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[1] The paper does not examine the question of the relationship between democratic governance and growth. Our focus is on decentralization. It is not our intention either to review the now vast and still fast growing literature on fiscal decentralization. For reviews of the literature see Wildasin (1986), Rubinfeld (1987), Oates (1990, 1991), Shah (1994), Rondinelli et al.(1989), Prud’homme (1991) and Bird and Vaillancourt (1997).

[2] See, for example, Dillinger (1994).

[3] See, for example, Oates (1972), Bahl and Linn (1992), and Guess, Loehr, and Martinez-Vazquez (1997).

[4] A similar point is made by Oates (1993) who argues that fiscal decentralization is now widely seen as a way to break the “grip” that central planning and mismanagement (at the central government level) has imposed on poorer nations.

geographical deconcentration of central government bureaucracy and service delivery.[5] This "deconcentration" has general value in streamlining and making more relevant to taxpayers central government services, but it has nothing to do with fiscal decentralization. Although there are many ways to describe the process of fiscal decentralization, it is useful to focus on two related processes, "delegation" and "devolution" of fiscal authority.[6]

One way to describe "decentralization by delegation" is as a "top down" process by which the state gives subnational governments the power to perform functions and to raise resources according to explicit norms and rules with the understanding that these powers can be changed or revoked by the central authorities. The degree of discretion in service provision is often constrained by central government rules and often the authority or discretion to raise taxes is quite limited. It is clear that in the case of delegation, the power remains within the central government. Thus decentralization by delegation may be identified with unitary forms of government.

On the other hand, "decentralization by devolution" can be better described as a "bottom up" process in which subnational governments have a more permanent right, such as a constitutional right, to govern their own affairs, including the ability to raise taxes and formulate their expenditure budgets, with little meddling by the central authorities. In a devolved system, local governments have their own-source revenues as well as discretion to determine the mix of services. This approach to decentralization may be better identified with federalist forms of government.

At the end of the spectrum there is deconcentration which, properly speaking, is not a form of decentralization. Instead, it is a process followed by centralized systems of government to increase effectiveness and flexibility in the delivery of central government services by providing services through regional or local offices of the central government. Under deconcentration, decision-makers respond to central authorities and not to local constituencies.

Both true approaches to fiscal decentralization, delegation and devolution, may produce the same results in efficiency gains in the allocation of resources, but the balance of national and

[5] Actual deconcentration efforts in the guise of decentralization is a common process in countries in transition such as the Central Asia republics, Ukraine or even Vietnam (McLure et al. forthcoming, Martinez-Vazquez et al. 1995, and McLure and Martinez-Vazquez, 1997).

[6] These terms have been used in the literature with slightly different meanings. See, for example, Bird and Vaillancourt (1997) or Rondinelli et al. (1989).

subnational interests may differ (Bird 1993, and Bird and Vaillancourt 1997). In delegated systems there may be a sense that national interest always prevails over subnational interests. On the other hand, in devolved systems, there may a sense and an acceptance of the fact that subnational interests may diverge in some cases from national ones, and that, because the decisions are made democratically, they must be respected. In devolved systems, in short, subnational governments have some (limited) degree of sovereignty in both decisions and consequences that is less present in delegated systems.[7]

Regardless of the form it takes, fiscal decentralization is currently encouraged perhaps because of the increased importance among developing and transitional countries of the two issues that are the focus of this conference: economic growth and democratic governance. There has been in recent years an increased interest in the potential role of fiscal decentralization on economic growth. Traditionally, the objective of economic growth had played no role in the normative design of fiscal decentralization or in the analysis of how decentralized systems actually perform. The recent empirical research has provided certain evidence that fiscal decentralization may affect economic growth. However, this literature is at an early stage and the avenues by which fiscal decentralization may affect economic growth are not clearly understood. There is, on the other hand, a wide-spread belief that fiscal decentralization fosters the broadening and strengthening of democratic institutions. However, this issue has been given only indirect attention in the fiscal decentralization literature, perhaps because this literature has been dominated by narrower concerns relating to the economic aspects of fiscal decentralization such as tax and expenditure assignments or the design of transfers.

These are the two sets of issues to which we now turn our attention. The rest of the paper is organized as follows. The first half of the paper, Section Two, addresses fiscal decentralization and growth. The second half of the paper, Section Three, addresses fiscal decentralization and democratic

[7] Although Bird (1993) and Bird and Vaillancourt (1997) do not directly make this inference, it may be useful to associate delegation systems with what they call "fiscal federalism," and devolution systems with what they call "federal finance". Although the labels may be disputed, under "fiscal federalism" the decentralization perspective is one that helps achieve the goals of the central government (or increase national welfare as a whole). The central government is a benevolent principal, knows best, and the subnational governments act as agents of the central government. Under "federal finance" the perspective is one that frees subnational governments from central dictates or objectives (or improves local welfare the most). Under this perspective decentralization is a bargaining process between principals who are not necessarily equal. Neither system is categorically better or worse than the other. Each might be more or less appropriate to individual national circumstances.

governance. Although there are obvious linkages between economic growth and democratic governance, the paper focuses exclusively as fiscal decentralization and its separate impact on growth and governance.

## II. Fiscal Decentralization and Economic Growth

This section addresses the relationship between fiscal decentralization and economic growth and is organized around four main themes. First we discuss the lack of attention to economic growth in the public finance literature in general and in the fiscal decentralization literature in particular. Next we discuss the empirical findings so far about the potential relationship between fiscal decentralization and growth. The following subsection discusses the theoretical elements of the relationship between fiscal decentralization and growth and proposes an empirical methodology to improve in the future our understanding of the relationship between fiscal decentralization and growth. The last subsection offers a summary and addresses policy issues including what guidelines are suggested by our present knowledge of the issues.

### (i) Economic growth has not been a traditional concern in the theory of fiscal decentralization.

The theory and practice of fiscal decentralization traditionally has had little overlap with the objective of economic growth. Only very recently have normative discussions of fiscal decentralization added economic growth to the traditional list of public finance objectives: efficiency in the allocation of resources, equity in the distribution of income, and economic stabilization.[8] The empirical studies that have attempted to estimate possible effects of fiscal decentralization on economic growth, reviewed below, have only appeared in the past few years.

The basic economic argument for fiscal decentralization is that it can provide greater economic efficiency in the allocation of resources in the public sector.[9] Under the assumption that

[8] See, for example, Bird and Vaillancourt (1997). The lack of preoccupation in the fiscal decentralization literature with economic growth is evidenced by the fact that there is no discussion of this objective in textbooks on the subject; for example, Fisher (1988).

[9] See, for example, Oates (1972) and Boadway and Wildasin (1984).

public officials respond to the desires of their constituents, subnational governments are better able to match these preferences, especially when these preferences differ across jurisdictions. These gains in efficiency are enhanced if taxpayers are mobile because they can migrate or sort themselves out among the jurisdictions that best match their preferred tax-expenditure package, as first discussed in Tiebout's (1956) seminal piece.[10] In short, if preferences for public goods differ across regions or individuals, the level of welfare achieved through a uniform provision of public goods by a central government is inferior to that which can be attained by a decentralized provision which allows for differences across jurisdictions. Thus fiscal decentralization is concerned with the assignment of expenditure functions and tax revenue sources among different levels of government (federal or central, state or provincial, and local or municipal) to best achieve an efficient allocation of resources.[11]

Efficiency is one of the three objectives, the other two being income redistribution and macroeconomic stability, initially stated by Musgrave (1959) and widely accepted as guiding government policy. But if decentralized governments can play an important role in efficiency, there is wide consensus that the objectives of income redistribution and macroeconomic stability are better pursued by the central or federal governments. Even though subnational governments may differ in their preferences for income redistribution, the mobility of households and businesses will tend to make differences in redistributional policies self-defeating because the rich would move out of and the poor would move into the jurisdiction.[12] Attempts to implement macroeconomic stabilization by subnational governments will also be ineffective because of the considerable economic "leakages" associated with local expenditures.

[10] Using Hirshman's well-known terminology, Oates (1993) describes the two systems for conveying preferences for public goods to local government officials through "voice" (voting elections and responsiveness to the local electorate) and "exit" (fiscal mobility or taxpayers voting with their feet by moving across jurisdictions).

[11] More generally, the theory of fiscal decentralization is a part of public economics which studies the role of government in a market economy. Government activity in a market economy is primarily justified by private market failures in the presence of public goods and externalities; and the provision of public goods, within the public sector, generally can be improved through fiscal decentralization.

[12] However, subnational governments do engage in redistribution policies. See, for example, Bahl, Martinez-Vazquez and Wallace (1997). In addition, mobility is constrained in many developing and transition countries, which mitigates the validity of this argument (Prud'homme, 1995 and Tanzi, 1995)

Thus the lack of direct concern with the objective of economic growth in the theory and practice of fiscal decentralization has its roots in the lack of direct concern in public sector economics with this objective.[13] Public sector economics has paid indirect attention to the objective of economic growth by focusing on issues such as how taxation may distort economic incentives toward savings and investment, how to evaluate the relative worthiness of public investment projects (as for example in the theory of cost-benefit analysis) or how to improve the performance of private markets through better education and health systems or investments in basic infrastructure. The general implicit assumption in public sector economics has been that economic growth is fueled by the growth in the quantity and quality of economic inputs (labor, capital and natural resources) and by technological change in the private sector. The role of the public sector is to facilitate, or not to impede, this process.

**(ii) What do we know about the empirical effect of decentralization on economic growth?**

A significant feature of the current state of the fiscal decentralization literature is the paucity of empirical information regarding the effects of decentralization, not only on economic growth, but also on the traditional objectives of economic efficiency, income redistribution, and macroeconomic stability. As we discussed below, only recently have there been several studies that analyze the direct role of the public sector in economic growth and even more recently, a series of studies have investigated the role of decentralization on economic growth. Without empirical findings, the debate over the desirability of fiscal decentralization in developing and transitional economies has mainly focused on theoretical and normative analysis and on case studies. In the following paragraphs we discuss the existing empirical evidence on the potential relationship between fiscal decentralization and growth.

*From economic growth to fiscal decentralization*: Even though there has been little research on the causation line from decentralization to growth, interestingly, there has been extensive empirical analysis of the reverse question: to what extent is the level of decentralization a function of the level of economic development?

[13] Of course, other fields of economics have been directly concerned with economic growth and development.

It is well documented that most measures of fiscal decentralization across countries, such as share of expenditures or revenues of subnational governments in the general government budget, are positively correlated with the level of economic development, generally measured by per capita income (Oates 1972 and 1985, Pommerehne 1977, Kee 1977, Bahl and Nath 1986, and Wasylenko 1987).[14] There is less agreement in the literature about how to interpret the fact that decentralization is a more common and deeper phenomenon in industrialized countries.[15] One possible explanation is that decentralization is like a superior good. It is only at relatively high levels of per capita income that decentralization is demanded or becomes "attractive" to taxpayers in the sense that its benefits can be more fully exploited without the problems or disadvantages that tend to be more present in countries at lower levels of development (Bahl and Linn, 1992). This correlation between economic development and the depth of decentralization may also be due to the fact that many developing countries inherited quite centralized systems at the time of their independence from their colonial powers (Conyers, 1990).[16] However, there should be wide agreement with Oates (1993) that the empirical correlation between the level of development and the presence of fiscal decentralization should not be interpreted to say that there is a monotonic relationship between the two such that decentralization intensifies without bound with per capita income,[17] or that a decentralized system of public finances will not offer advantages to countries at lower levels of economic development.

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[14] These studies have been criticized for performing inter-country comparisons using aggregate measures of fiscal decentralization, such as the share of subnational government in overall expenditure or revenues of the general government (Bird 1986). The more recent studies on the causal connection between fiscal decentralization and economic growth are also subject to the same criticisms, so we postpone the discussion of this issue until we discuss these studies below.

[15] Other variables that have been found to be positively related to the level of decentralization across countries include: population size (Oates 1972, Pommerehne 1977, Bahl and Nath 1986)); a federalist constitution (Oates 1972, Kee 1977, Bahl and Nath 1986, and Wasylenko 1987); more urbanized population (Kee 1977, and Bahl and Nath 1986); less open economies (Kee 1977, and Wasylenko 1987); more equal distribution of income (Pommerehne 1977); and greater geographical sectionalism (Oates 1972).

[16] Conyers' (1990) conjecture would suggest that, other things equal, the level of decentralization across developing countries should vary directly with the time period they have been independent and with some proxy of how centralized the colonial administration systems were. These control variables have not been introduced so far in the empirical literature.

[17] The ups and downs of the extent of decentralization in the United States (Wallis and Oates 1988, and Shannon 1997) are clear witnesses that no such monotonic relationship does exist.

*From fiscal decentralization to economic growth:* Only recently have economists attempted to quantify the role of government expenditures on economic growth. Aschauer (1989) and Barro (1990) find that an increasing share of central government consumption in GDP is negatively associated with growth in per capita income. Devarajan, Swaroop and Zou (1996) examine the impact of the composition of public expenditures on economic growth and find that while an increase in the share of current central government expenditure has a positive and statistically significant effect on growth, the capital component of public expenditure has a negative impact on per capita growth. This finding by Devarajan et al. (1996) conclude that developing country governments may have been allocating too many resources to capital investments at the cost of more productive current expenditures. Other researchers have found that public infrastructure spending has a positive significant impact on growth (Aschauer, 1989; Easterly and Rebelo, 1993; and Ford and Poret, 1991).

However, none of the studies above was concerned with the potential impact of the degree of decentralization (or intergovernmental composition of public expenditure) on economic growth. A series of studies conducted by Heng-fu Zou and his associates at the World Bank has attempted to test the presence of a direct link between fiscal decentralization and economic growth with mixed results. Zhang and Zou (1997) find that different measures of fiscal decentralization seem to have a positive and sometimes significant effect on regional economic growth in India. This contrasts with the opposite general finding that fiscal decentralization is associated with slower growth for the case of China also by Zhang and Zou (forthcoming), for the United States by Davoodi, Xie, and Zou (1995), and for a full sample of both developing and developed countries by Davoodi and Zou (1996).[18]

Although the theoretical underpinnings of this literature still need to be further developed, as discussed below, these studies at the World Bank have not only provided the first empirical estimates of the potential effect of decentralization on economic growth but have also contributed valuable insight into different aspects of this relationship. For example, if fiscal decentralization could be measured, as is done in this literature, in a single dimension (for example the share of expenditures

[18] These studies use different levels of disaggregation of expenditures and revenues at different levels of government. For example, Davoodi, Xie and Zou (1995) concentrated on the role of aggregate spending of different levels of government while Zhang and Zou (1997 and forthcoming) carry this analysis further by looking at the impact of the sectoral composition of public expenditures at different levels of government on economic growth.

or revenues of subnational governments in the general government) then we should not expect a monotonic relationship between decentralization and growth (Davoodi and Zou, 1996). That is, it will not be necessarily true that the more decentralized a country's fiscal system becomes, the faster its economy will grow, but rather, we should expect that there exists an optimal degree of fiscal decentralization which is less than complete decentralization. The bounds are imposed by the fact that there are some public goods, those with nation-wide benefits, that can be more efficiently provided at the national level. However, with a more complex definition of decentralization, which as discussed below may include degree of discretion for expenditure composition or level of revenue autonomy, it would be possible to find multiple optima, and we could also find monotonic relationships between some measures of decentralization and economic growth. This recent literature on the empirical relationship between decentralization and growth also raises several estimation issues for future work.

*Empirical issues in the estimation of a relationship*: Several issues will need to be clarified in the future to strengthen our confidence in the results. First, there is the issue of *possible misspecification* of the empirical estimation models. The literature on economic growth suggests that long-term growth may be a function of many variables such as economic freedom and basic legal structure, savings rates, investment behavior and general capital accumulation, human capital, technological development and change and so on. Excluding some of the necessary control variables across countries or over time may result in a misspecified model leading to the false conclusion that a statistically significant relationship exists between growth and fiscal decentralization. In short, there is a need to verify that the estimated relationships between decentralization and growth are robust under alternative specifications of the estimation model. The lack of robustness was the general critique addressed by Levine and Renelt (1992) to the empirical growth literature that has tried to identify the impact of diverse government policies on growth. Levine and Renelt (1992) using cross-country time series data find that the results found in many previous studies of a significant correlation between measures of economic policy and economic growth are fragile. In particular, Levine and Renelt (1992) find that the statistical significance for those explanatory variables is lost by small alterations in which other explanatory variables are included in the equation. This is the fate of a wide array of fiscal-expenditure variables, monetary policy indicators, and political stability indices. The only robust correlations they find are for the share of investment in GDP and for the share of international trade in GDP and economic growth. Typically Zou and his associates employ a model based on Barro's (1990) endogenous growth, where the production function for the economy has multiple inputs including private capital and multiple public spending by the three levels of government. While Davoodi and Zou (1996) use the Levine-Renelt conditioning variables (investment, population growth, human capital) to test the fragility of the estimate for fiscal decentralization, they do not control for the impact of the external sector.[19]

Second, the *measurement of fiscal decentralization* used by Zou and his associates as an explanatory variable is, at least, problematic. The issue is that there is no single or best measure of decentralization. In all fairness, these empirical studies have evolved significantly in the precision with which the explanatory variable for fiscal decentralization is measured. Initially public expenditures were disaggregated into recurrent or consumption and capital expenditures, then into different levels of government, and finally into types of expenditures by sector at different levels of government. However, all these measures of fiscal decentralization are defined on the basis of a single aspect of decentralization, expenditures going through the subnational budgets. We are sure to misrepresent decentralization when we use a single dimension, no matter how detailed or disaggregated. Clearly, fiscal decentralization is multidimensional. There are many aspects of a country's fiscal affairs that can be more or less decentralized.[20] Even if one country has a greater share of subnational governments in expenditures or tax revenues, it can be the case that a second country may be overall more decentralized because its subnational governments have more significant autonomous sources of revenue or discretion over tax rates, or greater freedom in how to make expenditure decisions on education, health or other services provided at the subnational level. Even worse, one country may have a high share of general government expenditures going through subnational budgets, but de facto the level of decentralization may be small because regional and/or local officials are not democratically elected.

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[19] Feder (1992) and McNab and Moore (1997) show that increases in exports are significantly and robustly associated with economic growth. This may be an important omission especially for developing and transitional countries, where external trade plays a critical role.

[20] See Guess at al. (1997).

It would be desirable in future empirical research to attempt to capture in the right-hand side of the equation estimating the impact of fiscal decentralization on economic growth the multidimensionality of fiscal decentralization. A possible point of departure could come from the minimum conditions for effective fiscal decentralization such as discretion in the margin to raise own revenues or democratic elections that have been suggested in the literature.[21]

Third, given that our understanding of how decentralization may affect growth is not well developed, there is a danger of accepting too willingly the product of *spurious correlations.* This is a difficult problem to control, but a serious one given that decentralization and growth are broad concepts which themselves are correlated with many other variables. Consider the following: Mauro (1995) finds that corruption lowers investment, thereby lowering economic growth. But Mauro (1995) also finds that corruption is highly correlated with ethnolinguistic fractionalization (which measures the probability that two persons drawn at random in the country will not belong to the same ethnolinguistic group).[22] In general, we should expect decentralization to be highly correlated with ethnolinguistic fractionalization because the tensions associated with diversity in population are often addressed through more decentralization. In these circumstances it would not be the case that decentralization slows growth, but that there may be more corruption with fractionalization and therefore less growth.

### (iii) Theoretical linkages between fiscal decentralization and economic growth: What should we be testing?

The review of the empirical literature shows clearly that we may be far from understanding and therefore properly testing the relationship between decentralization and economic growth. The empirical work on the potential impact of fiscal decentralization on economic growth has offered thus far little detailed discussion of why we should expect this relationship to exist. Answering this question should allow us to construct empirical tests that go beyond the “black box” approaches used

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[21] See, for example, Bird (1986).

[22] Mauro conjectures that more fractionalization may lead to more corruption because bureaucrats may favor members of their same group. Shleifer and Vishny (1993) also suggest that more heterogeneous societies may be subject to more corruption than homogeneous societies.

in the literature. The lack of a theoretical framework has hampered the statistical work. However, it is widely acknowledged that economic theory provides no straightforward guide for what the relationships are between fiscal decentralization and economic growth and development.[23] There is also wide agreement on the desirability of developing such a theoretical framework. In this section we examine in some detail the avenues through which fiscal decentralization may affect economic growth. This may provide the basis for a theoretical framework.

*Is there a direct linkage*? The first question is whether we can expect a direct linkage to exist between decentralization and growth. Oates (1993) argues that, intuitively, the static proposition that fiscal decentralization enhances economic efficiency should have a parallel or a validity in the dynamic setting of economic growth. Thus according to Oates, expenditures for infrastructure and the social sector that respond to regional or local differences are likely to be more effective in enhancing economic development than central policies that may ignore those differences.[24] However, Oates (1993) is not very explicit about what this means. The basic question is why, for example, $1 million spent on roads or education at the subnational level should be more growth-enhancing than the same amount of money spent at the national level. The direct effect, pointed out by Oates, indicates that if subnational governments have an advantage in making public expenditures more efficient (by better satisfying the needs and preferences of local taxpayers based on better knowledge of these preferences), then this "static" advantage can also be present in a "dynamic" sense by having subnational government expenditures be more growth enhancing. On a closer look, Oates's argument still would seem to need further development.

*Indirect linkages between fiscal decentralization and economic growth:* Even if there is no direct linkage between fiscal decentralization and growth derived from Oates's argument, there would appear to be several potential indirect linkages between the two.

[23] Oates (1993), Bird (1993), Peterson (1996), and Prud'homme (1995), among others, have recently remarked upon the lack of a formalized theory of fiscal decentralization and economic growth

[24] Of course, the direct linkage between decentralization and growth can be derailed if fiscal decentralization does not function effectively. The same is true for the greater efficiency of decentralization in a static sense. Oates (1993) and many researchers have questioned whether or not voting mechanisms, mobility, or competition, for example, function well enough in developing and transitional economies to allow the realization of the gains in efficiency associated with decentralization. Governance issues are discussed in the next section.

*(a) The nature of efficiency and its measurement:* What is well understood in the theory and practice of fiscal decentralization is that, given certain conditions, subnational governments can be more efficient. This can mean two kinds of things. First, it can mean that the same amount of funds spent at the subnational level rather than at the national level can result in increased individual welfare. This is true because local and regional governments are better at discerning the preferences and needs of their constituencies and can more easily adapt their expenditure policies to fulfill them. This increase in welfare through decentralized expenditures can be termed the greater *"consumer efficiency"* of decentralized expenditures.

Second, it is also possible, but by no means a foregone conclusion, that spending the funds through subnational governments can lead to greater *"producer efficiency."* That is, the same services or infrastructure can be put in place at a lower cost, or a particular budget can yield larger quantities or better quality of services and infrastructure when the funds are spent at the subnational level.

In general, there would be little dispute with the contention that fiscal decentralization can result in greater *consumer efficiency*. The lack of disagreement is not because there have been measurements of these effects. In fact, tests of this nature have been few and far between.[25] This is because of the a priori belief that a decentralized system can be more responsive to differences in demands among taxpayers and to their basic needs. It can be argued that differences in preferences are not likely to be that important in developing and transitional economies (Prud'homme, 1995) but, in fact, subnational governments can be more efficient than the central government even if all individuals have identical preferences. The central government may have a greater tendency to spend funds on, for example, national defense when the priorities of taxpayers may be better reflected, for example, by greater expenditures on education and sanitation. To summarize, the argument of greater *consumer efficiency* by decentralized government may still be valid in the presence of identical preferences across taxpayers and/or lack of mobility because subnational governments may be more responsive to the needs and priorities of taxpayers.

[25] The public finance literature has concentrated on testing how well local budgets may satisfy the demand for public services from representative taxpayers based on statistical tests and surveys. There are no quantitative studies comparing the relative (consumer) efficiency of decentralized versus centralized fiscal systems.

The assertion that fiscal decentralization can result in greater *producer efficiency* would be disputed by many. What kind of evidence is there on differences in producer efficiency? The question put forward by Prud'homme (1995) and others is whether or not local governments operate on the same production frontier as the central government and whether or not this question would receive the same answer in developed and developing and transitional economies.[26] On the other hand, decentralization may lead to greater producer efficiency in that it fosters experimentation and innovation in the provision of goods and services, and subnational governments in many countries have been in the vanguard of privatization of public services. To summarize, there is little evidence one way or another about whether local governments are more or less producer efficient than central governments.

But for the sake of argument, let us assume that at least in some cases decentralization leads to greater consumer and producer efficiency. It is very significant that neither of these two potential effects of decentralization, greater consumer efficiency and greater producer efficiency, is recorded in the national income accounts.[27] Greater consumer efficiency translates into greater individual welfare but no independent measures of this exist. Public expenditures with different levels of consumer efficiency are recorded the same in the income accounts: by the level of expenditures at the national or subnational level. Similarly, equal expenditure programs with very different levels of producer efficiency will provide the same reading in the national income and product accounts.[28]

[26] Prud'homme (1995) argues that there are reasons, such as better paying jobs and career prospects, to believe that central government bureaucracies are likely to operate closer to the technical production frontier, even though both central and local bureaucracies probably operate quite far from this frontier. For a dissenting view see Sewell (1996), who argues that well-functioning subnational bureaucracies exist in many countries.

[27] Other benefits generally associated with fiscal decentralization, such as grassroots democracy and better representation are not directly measurable in the national income accounts.

[28] Somewhat ironically, the regressions of measures of fiscal decentralization on growth are viewed in the recent empirical literature as a test of the "efficiency proposition" of fiscal decentralization. See, for example, Zhang and Zou (1997). The truth, however, is that the efficiency gains associated with decentralization are not captured in measures of economic growth. The theoretical approach in this literature is also inadequate especially if there is a desire to put emphasis on the efficiency gains associated with decentralization. Typically, this literature assumes the presence of a simple representative agent with utility as a function of private consumption, and government expenditures at all levels. Consequently, this theoretical framework omits by force the consideration of consumer efficiency gains associated with decentralization which require the presence of several agents with different preferences or tastes for public goods. There is no attempt in this literature either to try to capture any differences in "producer efficiency". A dollar of expenditure in these models produces the same level of public good at all levels of government.

To recapitulate, the widely acknowledged greater efficiency associated with fiscal decentralization is not directly accounted for in the conventional measures of output and economic growth. So an important question that needs to be addressed at both the theoretical level and at an empirical level is this: if not measured directly, how is it that greater efficiency may affect measured growth? A better understanding of this linkage between efficiency and measured growth should help us better understand the findings so far in the empirical literature and perhaps design improved empirical tests. We turn now to a preliminary investigation of this question.

*(b) What is the nature of the linkage between greater efficiency and measured economic growth?* If fiscal decentralization leads to greater producer efficiency, then the indirect link between fiscal decentralization and growth is quite intuitive. National accounts measure public output by the level of expenditures, regardless of which level of government spends the funds. But if decentralized governments can produce more output (or better quality output) than the central government, with the same level of expenditures, then greater producer efficiency at the subnational level is occurring. Eventually the higher quantity or quality of the locally-provided public services, the true output, will result in increased income and, therefore, in measured growth.

In the case of consumer efficiency, the relationship is less clear. Several complex elements are at play. On the positive side, by better matching the preferences of citizens and increasing their individual welfare, there may be secondary effects on work effort, savings and private investment all of which would have a positive impact on measured economic growth at a later date. It is also possible that if public resources are "more efficiently spent" at the subnational level, this would mean, for example, that a better educated and healthier labor force or faster, less costly, transportation will result in greater (measured) economic growth in the future also.

In this sense, tighter empirical tests of the impact of decentralization on economic growth should focus on whether or not fiscal decentralization, other things being equal (such as expenditure levels, per capita income and so on), results in improved test scores or other measures of education, or better health status indices. In short, we should test the presence of direct impacts of fiscal decentralization on the basic components of the growth equation (better quantity and quality of inputs) rather than directly on economic growth per se. However, the intermediate effect of decentralization on the quantity or quality of some public services, such as roads built by subnational governments, is likely to be more difficult or even impossible to quantify.

On the negative side, it is conceivable that the mix of recurrent and capital expenditures and the sectoral composition of these expenditures (into roads, education, sewerage, parks and so on) that maximize the welfare of local residents may not be the mix that maximizes *measured* economic growth over time. The issue is whether or not there are other mixes of public expenditures that will have a greater positive impact on measured economic growth and whether some of these mixes may be more easily achieved through a centralized system of public finances. The underlying premise of socialist planned economies and central management and planning in many market economies in past decades was that centralized systems were superior in this respect. The poor performance of centralized systems has put into question their alleged superiority.[29] However, in general, there is no reason to expect that the allocation of resources that maximizes voters' welfare as manifested through a democratically representative process is the one that maximizes growth of measured output. In practical terms what this means is that empirically it would be possible to find that decentralization and measured economic growth are not positively correlated.

*(c) Other indirect effects on growth through additional consequences of decentralization*: The theory of design of fiscal decentralization emphasizes a number of tradeoffs between efficiency and other objectives such as balanced income distribution or macroeconomic stability (Guess et al., 1997). The issue is whether or not changes in income distribution and in macroeconomic stability resulting from fiscal decentralization will also have an indirect but measurable impact on economic growth.

Empirically, estimating the indirect impact on fiscal decentralization through income distribution and macroeconomic stability will require two sets of estimations. First, is fiscal decentralization actually associated with, or does it result in, a more unequal distribution of resources across regions and a more unstable macroeconomic environment? Second, what are the quantitative tradeoffs between macroeconomic stability (assuming that it comes from decentralization) and economic growth? That is, how much does macroeconomic instability retard economic growth? And,

[29] See, for example, Rondinelli and Nellis (1986).

how much does the unequal distribution of income across regions affect the rate of economic growth?

Let us take first the issue of macroeconomic stability. There is considerable controversy in the fiscal decentralization literature as to whether or not fiscal decentralization works against macroeconomic stability. Prud'homme (1995) and Tanzi (1995) are among those that have issued warnings on these negative potential effects of decentralization but McLure (1995) and Sewell (1996), among others, have questioned the validity of this link. So far, there has been no empirical test of the link between decentralization and macroeconomic stability. But even if there is no inexorable link between fiscal decentralization and macroeconomic instability, there is wide consensus that poorly designed systems, (for example, allowing subnational governments to borrow without controls with central governments covering any defaults) lead to instability. In these cases, fiscal decentralization could lead to less growth because there is some evidence that macroeconomic instability retards growth (Fischer, 1993).

Let us now take on the issue in income distribution. The first issue is whether or not decentralization causes a more unequal distribution of resources. Again, there has been no empirical test of this proposition. However, a priori, there should be wide agreement with Prud'homme's (1995) argument that, all else being equal, unfettered fiscal decentralization is likely to lead to a concentration of resources in a few geographical locations. The general presumption is that more centralized public sectors will attempt to produce a geographically more balanced distribution by channeling resources from richer areas to poorer ones. However, neither of these two propositions, that unfettered decentralization leads to the geographical concentration of resources and that centralized public sectors yield more geographically balanced distributions, has been empirically tested.

A different issue is how the distribution of resources actually affects economic growth. Economists have given considerable attention to understanding the links between income distribution and economic growth. However, most of this research has concentrated on income inequality across the population and much less with income disparities across regions. There is now considerable evidence that countries with relatively low levels of income inequality tend to grow faster.[30] There

[30] See Persson and Tabellini (1994), Birdsall et al. (1996), and Deininger and Squire (1996).

is little evidence, however, on how inequality across regions affects long-term economic growth.[31] This is another area that awaits testing.

*(d) Subnational government competition and economic development.* A quite different perspective on the impact of fiscal decentralization on economic growth is that fiscal decentralization for better or worse can provide subnational officials with the ability to actively pursue economic development policies. Often, subnational governments' development policies include several forms of competition among regional and local governments. These may include granting tax privileges and offering other forms of assistance to businesses willing to locate in a particular jurisdiction. This is an issue surrounded by considerable controversy in North America and in Western Europe.[32] Less research and discussion has been addressed to these issues in developing and transitional countries, but it would appear that similar policies are at play there as well. At stake is whether interjurisdictional competition can actually help promote economic growth in a country or whether it is actually a zero-sum or even a negative-sum game among local and regional governments for a fixed set of resources or economic activity.[33] On the positive side, there is the possibility that interjurisdictional competition (of whatever form) forces government officials to deliver services at minimum feasible cost, thus enhancing producer efficiency at the subnational level. The lack of competition at the central government level may mean that costs of public services are higher than they ought to be. On the negative side, competition may lead subnational governments to underprovide public services and basic infrastructure (Break 1967). This, of course, would retard growth.

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[31] We do not understand well either how growth may affect regional disparities. Prud'homme (1995) cites a number of studies showing that regional disparities do not disappear with economic development. On the other hand, there is evidence of a substantial narrowing of regional income differentials in the long run in the United States (Barro and Sala-i-Martin, 1992).

[32] In the United States early research found that this type of competition would appear to have little effect on business location. However, more recent research (for example, Bartik 1985, and Wasylenko and McGuire 1985) finds that there is some effect.

[33] The fostering of competition by fiscal decentralization is seen by public choice economists as a way to enhance democratic governance by creating a check on central and local government authorities. This angle is discussed in the next section.

**(iv) Summary of issues and guidance for policy advice**.

The impact of fiscal decentralization on growth is more than an academic question. The impact of decentralization on growth has become an important policy issue for developing and transition countries. This is an issue of importance both for large countries like China and India and also for small countries like the Baltics or those in Central America.

International donors and multi-lateral agencies including the World Bank, the IMF and USAID have responded to the wave of interest in decentralization in developing and transitional economies with technical assistance and advice for how to implement good decentralization strategies. But is helping these countries to devise decentralized systems of government working against the objective of economic growth? What ought to be done and how should economic aid be directed? Perhaps this is too vast a question to be answered in this paper given the current uncertainty about the general impact of international aid (not only for decentralization) on economic growth.[34]

In general, our knowledge of how decentralization affects economic growth is too limited to allow us to proffer advice. We have seen that the empirical evidence of the correlation between the extent of decentralization and economic growth is mixed, and that this empirical evidence may not be entirely reliable because of several potential problems with the methodological approaches followed to derive those tests. At a theoretical or a priori level we have also seen that the overall impact of fiscal decentralization on economic growth is uncertain. In terms of a direct impact, if Oates' (1993) argument is correct, we should expect higher growth associated with decentralization. But this dynamic superiority of decentralized over centralized public expenditures is by no means obvious. We have also seen that there are potentially a multiplicity of indirect effects of decentralization on growth including those through consumer efficiency, producer efficiency, the geographical distribution of resources, and macroeconomic stability. Through these indirect effects there are forces at work that will link decentralization to higher economic growth but there are others that work in the opposite direction. It is also unfortunate that we are not in a position to capitalize

[34] For example, Boone (1994, 1996) finds that international aid had no effect on investment or growth in a sample of developing countries. A more recent paper by Burnside and Dollar (1997) finds that international aid has a positive effect on growth in the presence of good policies, but international aid does not seem to affect what policies are adopted by developing countries. These findings contrast significantly with more optimistic ones in the earlier literature on the impact of aid, e.g., Heller (1975).

on what we know with more certainty is a significant determinant of economic growth: capital investment.[35] At the present time, we have no knowledge about whether or not decentralized fiscal systems dedicate fewer resources to public investment than centralized ones; nor do we know about differences in the effectiveness or quality of public investment undertaken by different levels of government.[36]

In light of the lack of consistent knowledge on the impact of decentralization on growth, it would seem safe to argue that policy advice and international aid must still focus on improving the design of fiscal decentralization in developing and the transitional economies. Even if we were to find at some later date that decentralization retards economic growth, this effect would need to be weighed against the positive impact of decentralization on the efficient allocation of economic resources and democratic governance. Policy makers and international aid providers need to have a balanced view of the importance of growth vis-a-vis other economic policy objectives. The concern of policy makers in developing countries and economies in transition is probably wider than economic growth per se. The wider concerns are about economic development which includes growth in per capita income, of course, but it also includes other things such as preservation of the economic environment, a balanced distribution of resources, higher individual welfare as provided by a more efficient provision of public services, democratic governance and so on.

## III. Fiscal Decentralization and Democratic Governance

### (i) Introduction

Unlike the case of fiscal decentralization and growth, there is an explicitly clear link between fiscal decentralization and democratic governance. This link is perhaps best described as a symbiotic relationship. Fiscal decentralization reinforces democratic institutions by bringing government closer to the people and by giving communities the means to make decisions that affect their daily lives.

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[35] Capital investment also seems to be a decisive factor in helping the poor (Deininger and Squire, 1997).

[36] To complicate things further, it is not entirely clear that greater public investment (as opposed to public consumption expenditures) has led to higher economic growth (Devarajan et al., 1996). There is clearly the possibility of too much of a good thing. See also Rioja (1997).

Democratic institutions provide the basic mechanism for the realization of efficiency gains associated with fiscal decentralization. It is through the election of public officials and through other democratic institutions, such as referenda or polls, that taxpayers reveal their preferences for goods and services and their willingness to pay for them. Democratic governance also guarantees some degree of responsiveness and accountability of regional and local officials to taxpayers and voters. As Putman (1993) has put it, decentralization promotes democracy and fiscal decentralization needs democratic governance to deliver the advantages associated with a more efficient provision of public services.

Despite the strong link between fiscal decentralization and democratic governance, the latter has received little explicit attention in the economics literature other than at the theoretical level.[37] For example, democratic governance is hardly ever mentioned by economists as part of the normative set of goals for the design of fiscal decentralization or as a condition that must be satisfied for effective decentralization in developing and transitional countries. But, as has been the case for economic growth, recently there has been increasing awareness in both field work, and in studies, of the importance of governance issues in fiscal decentralization.[38]

Political reforms in wide areas of the world including Africa, Eastern Europe and the former Soviet Union, and Latin America have provided an impetus for decentralization through the democratization of the political systems in many of these countries.[39] The political impetus for decentralization has been reinforced by the failure of centralized political systems to provide basic services, the general disenchantment of the public with political authorities, and the abuses, patronage and bossism historically associated with centralized political regimes in these areas of the world.[40] The dynamics of change have also worked in the other direction. The impetus of fiscal reform toward more decentralized systems has been instrumental in implementing more meaningful democratic

[37] The theoretical tradition in voting models and the like is discussed in the next section.

[38] See for example Campbell et al. (1991), Campbell (1993), Guess et al. (1997), World Bank (1997), and Bird and Vaillancourt (1997).

[39] See Taillant (1994) and Rondinelli and Nellis (1986).

[40] See for example Bird, Ebel and Wallich (1995) for the former socialist states, Hommes (1995) for Latin America and Wunsch and Olowu (1990) for Africa.

governance at the subnational level in developing and transitional countries.[41] Fiscal decentralization provides the means, but does not guarantee, effective democratic governance.

Of course, democratic governance at all levels of society has critical value independently of the degree of fiscal decentralization. Citizens place direct value on being able to elect their representatives, quite independently of efficiency gains or other benefits associated with fiscal decentralization. Fiscal decentralization should be interpreted as supporting or fortifying democratic institutions at the subnational level and thus as another check to the power of central governments.

Fiscal decentralization or attempts at fiscal decentralization are also being carried out under authoritarian political regimes.[42] Although in these countries public officials are appointed rather than elected, regional and local governments are delegated power to raise some of their revenues through own taxes and granted some autonomy for the composition of budget expenditures. Given the absence of democratic governance institutions in these countries, it could be said that these reforms are some form of deconcentration. This is an arguable point, but, because regional and local governments have separate status from the central government, they are typically termed decentralization reforms. What is less arguable is that many of the benefits associated with decentralization, especially increased efficiency, are very limited or not present in these countries.

The rest of this section of the paper is organized as follows. We first briefly review the theoretical models of democratic representation that economists have developed to understand the links between fiscal decentralization and democratic institutions and how applicable they may be to developing and transitional countries. Next, we examine several potential institutional failings, such as control by local elites or corruption, that may compromise the exercise of democratic governance in developing and transitional countries and therefore the value or attractiveness of fiscal decentralization in those countries. We next review the very limited evidence of the two-way relationship between fiscal decentralization and democratic governance in developing countries. We conclude with a brief summary and a discussion of policy guidance issues.

[41] See, for example, Peterson's (1996) discussion for Latin America.

[42] See, for example, Ahmad et al. (1993) and Bahl and Wallich (1992) for China and McLure and Martinez-Vazquez (1997) for Vietnam.

**(ii) Theoretical linkages between decentralization and democratic governance.** [43]

The economic essence of subnational governments is the provision of public goods and services. Public goods are characterized by joint consumption (adding additional individuals may not detract from the amount consumed by others) and nonexclusion (once the good is provided it may be too expensive to withhold it from any one individual). The nonexclusion feature makes it very expensive or impossible to provide these goods through private markets since individuals will tend to free-ride rather than to contribute voluntarily to the financing of the costs of provision. The feature of joint consumption makes it efficient not to exclude additional consumers since the additional cost may be close to zero.

In the real world, public goods are provided by governments which finance public good provision by coercing individuals to pay taxes. Under democratic governance institutions, individuals express their preferences for the level and mix of public goods through the political process by voting for elected representatives and tax-public service packages. The analysis of how these decisions are made and the outcomes they produce is known in economics as the "theory of public choice." Two main types of public choice models have been developed. The first type, voting models, link majority rule or other forms of voting to an implicit demand for public goods. The most popular of these models is the "median voter model" which postulates that, under certain conditions, the quantity of the public good provided by government is that demanded by voters with the median income.[44]

The main insight from these voting models is that even when politicians or elected representatives are honest and follow the will of the voters, government provision of public services is likely to be inefficient; generally, too much or too little of the public good will be provided and most taxpayers will be dissatisfied with that amount because they have different preferences and income but only one level can be provided by government. The decentralization of government can therefore enhance the efficiency of public good provision because decentralized governments can more closely tailor tax-public good packages to the preferences and incomes of voters. If there are

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[43] The standard public finance book has a good discussion of these issues. See, for example, Boadway and Wildasin (1984) or Fisher (1988).

[44] See the classic papers by Bowen (1943) and Black (1948), and Bergstrom and Goodman (1973) for a more modern application.

many subnational governments, taxpayers can also migrate or "vote with their feet" to those jurisdictions that better match their preferences, as initially stated by Tiebout (1956).

A second type of public choice model emphasizes the monopoly power and ability of government officials in the real world to deviate from the preferences of voters. Invariably, these models assume that bureaucrats attempt to maximize the size of government budgets such as in the Leviathan view of the state by Brennan and Buchanan (1980) or Niskanen's (1971) theory of bureaucracy.[45] The major insight of these models is that even in democratic governance settings it may be possible for governments not to be responsive or fully accountable to taxpayers.[46]

Summarizing, what we learn from the theory of public choice is that efficiency in the allocation of public resources may be enhanced (although hardly ever completely achieved) by decentralized governance when there is a democratic conveyance of taxpayer\citizen preferences and when public officials closely follow those preferences. But it will not always be the case that public officials represent the interests of taxpayers. If these problems (lack of complete efficiency and deviation by bureaucrats and officials from citizens' wishes) can exist in perfectly democratic settings, clearly they can be expected to be more acute in non-democratic settings.

Given these difficulties, it is easy to understand the skepticism shown by some observers about the relevance or potential benefits of fiscal decentralization to many developing and transitional countries where democratic governance institutions are much less developed than those assumed in public choice models (which pretend to represent those in place in Western industrialized countries).[47] A more balanced interpretation of the message contained in the theory of public choice is that the relevance of or achievements from fiscal decentralization are along a continuum, that democratic governance institutions are a necessary but not a sufficient condition for fiscal decentralization to deliver enhanced efficiency, and that the more developed and effective democratic governance institutions are, the higher the benefits to be expected from fiscal decentralization.

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[45] See also Romer and Rosenthal (1979).

[46] Interestingly, Buchanan and Brennan (1980) see fiscal decentralization as a means to break the monopoly power of government and therefore as a means to enhance democratic governance.

[47] See, for example, Prud'homme (1995).

The theory of public choice makes it quite clear, however, that in those developing and transitional countries in which local and regional authorities are appointed by the central government or otherwise are significantly restrained from taking autonomous decisions, there may be little justification for fiscal decentralization. In those developing and transitional countries where democratic governance institutions do exist, there is the potential for realizing gains from fiscal decentralization. In practice, however, these gains can be compromised by additional obstacles to democratic governance often peculiar but not exclusive to developing and transitional countries. We turn now to examine some of the most important obstacles.

**(iii) Obstacles to good governance in decentralized systems**.

In reality, the effectiveness of democratic governance varies from country to country and it should be expected to work less well in those countries that have only recently transitioned from authoritarian regimes. Several arguments have been advanced in the fiscal decentralization literature about behavioral and institutional problems in decentralized governments which may make it necessary to rethink whether or not the default system - a centralized system - could be a better alternative for the delivery of services in many developing and transitional countries.

*(a) Domination by local elites*: One danger of fiscal decentralization in developing countries is that local governments may become controlled by local elites.[48] Such elites may be presumed to pursue their own narrow interests to the detriment of the majority of voters. In these cases, citizens may be presumed to be better off with a centralized system of government if it can be assumed that the central government is more benevolent or if it has the public interest more in mind. On the other hand, centralized systems of government can also produce local governance in the interest of narrow elites through patronage and clientelism.

How real or serious is the control by local elites in fiscally decentralized governments? How powerful or dominant are local elites in decentralized versus centralized systems of government? As in other areas of fiscal decentralization there is still very little empirical knowledge about the

[48] See, for example, Tanzi (1995), Oates (1993), and Conyers (1990).

likelihood of dominance by elites in democratic centralized versus democratic and decentralized systems of government.

In reality, it is quite possible that greater participation by individuals and social groups invited by fiscal decentralization will work as an effective weapon against "local capture" or control of resources and rents by a local elite.[49] In addition, as appears to have been the case in Latin American and African countries, national centralized systems can give more power and rank to local officials in a way that can be converted to an even more significant and unchallenged source of "capture" by local elites.[50] Domination by small local political elites can be controlled by open and frequent elections, a free press and mass media communications, and a better educated and informed public. It is not clear that a more centralized system of government would provide an advantage on any of these elements.

The argument of fear of control by local elites takes other forms. For example, it may be argued that decentralization can lead to a loss of political control of the hinterland or even to political separatism. However, the international experience shows that, politically, national parties do quite well in decentralized countries when they allow for more input from the grassroots. In addition, effective decentralization has been used by many countries to diffuse separatist movements and to accommodate autonomic feelings of some regions without leading to secession.[51]

In summary, even though fiscal decentralization is less attractive or desirable given that local elites may capture local governance, there is no good a priori presumption (nor hard empirical evidence) that this problem would be more serious under fiscal decentralization than under a centralized system of government.

*(b) Is corruption enhanced by decentralized governance*? Earlier benign or even positive views of the impact of corruption have given way to empirical evidence showing that corruption is damaging to investment and the growth potential of a country.[52] One question of importance to

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[49] See Carroll (1992) and Campbell (1993).

[50] See Rondinelli (1981) Hommes (1995) and Campbell (1993).

[51] See Litvack (1994).

[52] See Shliefer and Vishny (1993) and Mauro (1996).

democratic governance is to what extent fiscally decentralized systems may promote corruption to a greater scale relative to more centralized systems. If fiscal decentralization results in increased corruption, the advantages of decentralization will be diminished or even neutralized. On the other hand, fiscal decentralization may effectively control the overall level of corruption in a country.

Casual evidence shows that there is corruption at the central government level, but there is little dispute that decentralized governments are also subject to corruption.[53] In some developing countries there is a widespread belief that corruption is deeply ingrained in local government institutions.[54] However, there has been no systematic empirical study of the extent of corruption at different levels of government in decentralized systems, or of centralized versus decentralized systems.

Numerous reasons have been used to argue that, a priori, corruption should be a more important phenomenon at both the central and subnational levels of government.

Here are some of the arguments that can be used to make the case that corruption is a more significant phenomenon at the central level of government. Corruption is likely to distort the composition of government expenditure in a way that facilitates the use of bribes and kickbacks.[55] Mauro (1996) reasons that large capital investment projects or defense contracts may provide a more convenient and tempting vehicle for corruption.[56] In addition, the potential for the realization of economic rents is larger in the case of central government policies such as import quotas or tax privileges. Wildasin (1995) points out that the damage inflicted by corruption at the central level can be much larger. Because local officials have limited powers and budgets, it is much easier for central government officials to engage in enormous corruption schemes. Central government operations and activities tend to be less accountable and far more remote form the public eye. For example,

[53] For example, Transparency International identifies local government as one of the areas where corruption is most likely to flourish. See IRIS (1996).

[54] Corruption takes place through bribes to tax assessors, kickbacks or other side payments in the awarding of contracts or through political patronage in the appointment of local employees. See World Bank (1997).

[55] See Mauro (1996) and Tanzi (1997).

[56] However, Mauro (1994) actually finds no statistical correlation between corruption and capital investments as a whole (or spending on defense or transportation) as a share of government expenditures.

illegitimate increases in personal wealth are much harder to hide at the local level and local officials are less sophisticated in hiding them.

Klitgaard (1988) points out that corruption is enhanced by the presence of monopoly powers and discretion and is diminished by the presence of accountability. If decentralized governance limits the monopoly power of centralized governments and makes government more accountable to the grassroots, there may a presumption that decentralization may help reduce corruption. An accountable decentralized government also may be effective in reducing the overall level of corruption because it can serve local interests more fully and exercise checks and limits on the discretion of higher levels of government (IRIS, 1996).

A similarly long list of reasons has been used to conjecture a priori that corruption may be encouraged by fiscal decentralized systems. Tanzi (1994 and 1995) believes that the problem may be greater at the local level because corruption is often stimulated by contiguity, enhanced in local communities. Decentralization may also lower the transaction costs for corruption by creating localized opportunities, while the dedication of local bureaucrats to public services may be less than that of those working for the central government. Prud'homme (1995) also believes that corruption is likely to be more prevalent at the local level because there is more opportunity and pressure by local interests, and local officials may have more discretion and fewer obstacles because of the often blurred distinction between politicians and bureaucrats. Also, decentralized governments may be more prone to corruption because in many cases local public officials are paid very poorly by comparison to central government bureaucrats.

In summary, as Wildasin (1995) puts it, there may be a tradeoff between local corruption on a small scale and central corruption on a large scale and a priori it seems impossible to say which would be more serious. At this time, there is little systematic evidence of the links between corruption and fiscal decentralization. No empirical tests have been performed to determine if corruption is more commonly associated with fiscally decentralized systems. We will have to conclude with Oates (1993) that this is clearly an issue that matters in the design of public finances, in developing countries especially, but that there is no evidence at the present time to make it part of a case for or against decentralization.

*(c) Limited local capacity*: A serious concern often raised about increased decentralization in developing countries is the inadequacy of the local administrations and officials in these countries. The deficiencies take many forms: lack of adequate staffing, poor managerial and budgeting practices, lack of full time dedication, poor job environments, low wages, lack of education and skills, and inadequate continuous training. If these conditions do exist, the decentralization of responsibilities and financing could lead to waste and poorer provision of public services. This, of course, assumes that the centralized administration is more competent or does not incur the same level of deficiencies. However, the presumption that the central government has better administration capabilities is not always justified.[57]

Greater limitations in administrative capabilities at the subnational level strongly suggest that the devolution of tax and expenditure powers should be commensurate with the capacity of subnational governments to handle and manage certain types of services. However, recent experiences in developing countries do show that the capacity of decentralized governments may be easily underestimated.[58] More importantly, this capacity is not exogenous or fixed in stone and there is nothing irreversible in it. To a large extent the problem of low capacity of subnational governments in developing countries is a self-inflicted problem. Some developing countries have a poorly functioning system of decentralized government because it was designed that way. There are plenty of well trained, competent and honest citizens in most developing countries who would serve in the local and regional governments if the incentives were set right.[59]

In summary, the problem of low administrative capacity at the subnational level in developing countries is a real one and the design of a decentralized system of intergovernmental relations needs to take this into account, especially when and if the central government administration is more capable and can deliver local services better. However, this is not an irreversible problem. Fiscal decentralization needs to be accompanied by policies that strengthen subnational governments'

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[57] See Wildasin (1995) and Bird and Vaillancourt (1997).

[58] See, for example, Hommes (1995) and Wunsch and Olowu (1990).

[59] There may have also been some reverse causation. Smoke (1993) argues that the early emphasis of development economics on central planning and industrialization may have been a contributing factor to the weakness of local governments in many developing countries.

administrative capacity including appropriate training, better work environments, higher salaries and in general the professionalization of subnational government bureaucrats. In addition, even if administrative capacity is more limited at the subnational level, as Sewell and Wallich (1995) have said, there is no general presumption or reason to expect a central government's performance will always be better in representing the interest of the average citizen, and it may be at times a great deal worse.

### (iv) Empirical evidence on the interaction between fiscal decentralization and democratic governance

Little systematic empirical research has been dedicated to testing the strength of the bi-directional links between fiscal decentralization and democratic governance. At the present time, we have little knowledge about whether fiscal decentralization is preceded by the emergence of democratic institutions, whether fiscal decentralization encourages the establishment of local democratic institutions, or whether fiscal decentralization and subnational democratic governance occur at the same time. What we know about these issues is based on case studies and conjectures and observations from particular country experiences. The information base on decentralization and governance has been limited because case studies of the fiscal decentralization systems in particular countries often pay little attention to governance issues.

However, some general observations are possible from the existing literature. First, case studies of decentralized systems in developing countries that have dedicated expressed attention to governance issues find that democratic representation and general governance institutions in some developing countries with democratic regimes can be extremely weak to a degree that compromises the value or effectiveness of fiscal decentralized institutions.[60]

Second, there is evidence, at least in Latin America, that decentralization has helped to strengthen democratic governance in countries that have decentralized their public finances.[61] Fiscal decentralization has complemented existing democratic institutions and encouraged citizen

[60] See, for example, World Bank (1997).

[61] See Campell et al. (1991), Campbell (1993), de la Cruz (1994), Bidus (1995), Lopez Murphy (1995), Peterson (1996) and Martinez-Vazquez (1997).

participation in local governance. These improvements have come in the form of direct election of mayors and councils, open council meetings, and several other forms of citizens participation. There is also evidence from polls and surveys that decentralized governance gets high approval marks from citizens and that people seem to trust local governments more than central governments.[62] A particularly successful innovation in citizen participation in fiscal and management decisions at the local level in Latin America has been the creation of social investment funds.[63] The key to success of the social investment funds has been that they require a high degree of local resident involvement. However, rather than strengthening local governments, these funds have often tended to create institutions parallel to them.

Third, our knowledge of how fiscal decentralization affects governance is not limited only for developing and transitional economies, but also for industrialized countries. One difficulty is to put together proper data sets and to run appropriate tests. An example of this is provided in the literature that has tested Brennan and Buchanan's (1980) hypothesis that the Leviathan state can be reduced by the presence of fiscal decentralization. There is still no clear conclusion on this issue.[64]

### (v) Summary of issues and guidance for policy advice.

There are strong reasons a priori to argue that there should be a symbiotic relationship between fiscal decentralization and democratic governance. Explicitly, and more often implicitly, democratic governance is widely acknowledged in the economics literature as a necessary condition for effective fiscal decentralization. But clearly, there is wide consensus that the relationship also works the other way. Greater fiscal decentralization, especially the devolution or delegation of tax and financing and spending powers to subnational governments promotes democratic governance

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[62] See Fiszbein (1995) and World Bank (1995).

[63] The experience with social investment funds is discussed in Glaessner et al. (1994) and Campbell et al. (1991).

[64] Oates (1985) uses a cross section of countries and finds no evidence that the level of decentralization affects the size of the public sector. However, Ehdaie (1994) finds that the size of the public sector is smaller when decentralized governments have autonomous revenue sources. At the subnational level in the United States, Eberts and Gronberg (1988) and Zax (1989) find evidence that total expenditures are reduced with the number of local governments but Forbes and Zampelli (1989) find the reverse.

through representation and accountability. The strongest evidence for this comes from country studies and general evaluations of fiscal decentralization experiments in Latin America.

The arguments often made that fiscal decentralization may weaken good governance because it may lead to the domination of the political process by local elites or to more corruption can easily be countered with equally convincing arguments that fiscal decentralization may actually reduce political patronage and domination by elites and reduce the overall level of corruption. Country examples and particular incidents can be cited to support either position. Up to now there has been no systematic empirical investigation of these issues and their study should be a priority for future research.

Case studies of fiscal decentralized systems in developing and transitional countries show that democratic governance institutions and administrative capacity of subnational governments are often weak and can very well compromise the effectiveness of fiscal decentralization.

Several general policy recommendations follow. First, there is not only a need to strengthen technical assistance in fiscal decentralization to developing and transitional countries but technical assistance in fiscal decentralization should be paired with that focusing on strengthening democratic governance institutions. This should help build stronger fiscal decentralization systems. Although some important exceptions can be found, a significant amount of technical assistance in fiscal decentralization by USAID, The World Bank, and other multilateral agencies, has not given adequate attention to governance issues.[65]

Second, technical assistance and analysis should clearly distinguish between government deconcentration programs and fiscal decentralization. Considerable frustration has gone on in countries of the former Soviet Union or Eastern Europe because of the lack of understanding by government officials between the desire to deconcentrate central government operations and less well defined plans to decentralize or devolve fiscal power to subnational entities.[66] Both types of programs may be desirable but they are quite different in design and function.

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[65] There may be explanations for this, including the less technical or non-economic content of governance issues vis-a-vis revenue assignment or the design of transfers or the reluctance to look into aspects of the problem that are more political and therefore more sensitive.

[66] See, for example, Martinez-Vazquez et al. (1995), McLure et al. (forthcoming), and Martinez-Vazquez (1995)..

Third, technical assistance programs with the objective of strengthening local governments should avoid the creation of parallel governance institutions which in the longer term may work to further weaken the traditional entities such as municipal governments. For example, the development of social investment funds in Latin America often bypassed municipalities, thus wasting the opportunity to strengthen these institutions.

Fourth, there is a long list of governance issues that technical assistance on fiscal decentralization should pay attention to. These issues include the following: direct election of heads of the executive, balanced and independent roles of councils the executive branch, the ex-ante supervisory role of central governments, pre-emptions and mandates by the central government, creation of independent and voluntary associations of subnational governments, participation of the people in local government affairs, free flow of information on subnational government activities and budgets, independent ex-post audit function, potential for the privatization of public services, and improving the job environment and conditions, training and wages, of local government workers.

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