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## The Impact of Fiscal Decentralization: Issues in Theory and Challenges in Practice

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# The Impact of Fiscal Decentralization

## Issues in Theory and Challenges in Practice

Jorge Martinez-Vazquez

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# The Impact of Fiscal Decentralization

## Issues in Theory and Challenges in Practice

Jorge Martinez-Vazquez

Asian Development Bank

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# Introduction

Over the last several decades, a revolution has been occurring in many countries around the globe, with the devolution of fiscal and political powers to subnational governments. This trend could be as influential for good governance and for improving the lives of ordinary citizens as major institutional transformations of the past century, such as decolonization in Africa and Asia or the transition from planned to market economies in the former Soviet Union and the People's Republic of China (PRC).

Due to decentralization, many subnational governments have become key public sector actors. As such, their roles have grown, and expectations placed on them have increased. As countries continue to abandon centralized governance, it becomes increasingly important to know the impact of decentralization on a number of economic issues including growth and development; reducing poverty and achieving the Millennium Development Goals; advancing public services, such as education and health; and achieving greater macroeconomic stability with lower unemployment and inflation. The fundamental question is whether the ongoing decentralization trend is helping or hurting with these issues. The impact of devolution on a gamut of fundamental institutional issues, such as country unity versus separatism as well as the level of corruption, should also be scrutinized.

This policy note explores (i) why countries choose to decentralize their governance; (ii) what economic theory expects from decentralization; and (iii) what is known about the impact of decentralization on a relevant list of economic and political variables, as well as what conclusions are appropriate.

# The Causes and Basic Theory of Decentralization

Countries begin decentralization processes for different reasons. Some are searching for a more efficient—and leaner—public sector, while others are disenchanted with the performance of planning and centralized policies (e.g., socialist economies). There are often grassroots demands to achieve democratic ideals. On the other hand, some movements are designed to contain or to appease centrifugal forces, ethnic conflicts, and/or separatism, and to diffuse social and political tensions by allowing local cultural and political autonomy. There may even be some political opportunism using decentralization for electoral objectives and/or just a desire to not be left behind in this popular form of institutional reform. While governments do not generally decentralize to pursue greater macro stability and economic growth, decentralization may impact upon these.

“Decentralization” generally means the devolution of decision-making powers. A related concept is “deconcentration,” in which operations are decentralized, but decision-making powers are not devolved. For example, many observers state that Bangladesh is a deconcentrated system, in which local governments are still subject to the control of central authorities, as opposed to a decentralized one, in which local governments have autonomy to set their own priorities and decide how best deliver public services. In addition, decentralization does not necessarily denote an erosion of central control nor of powers over issues and processes with national dimensions.<sup>1</sup> Instead, it has political, administrative, and fiscal dimensions that are replicated more or less completely in different vertical spheres (i.e., regional and local).<sup>2</sup>

In recent years, there have been multiple extensions of the traditional theory of fiscal federalism (or the organization of intergovernmental fiscal relations) first developed by Oates in 1972. Viewing government as a benevolent agent, he created a decentralization theorem, which states that in the presence of diverse preferences and needs, provision of services from a decentralized government will lead to increased citizen welfare. This occurs because decentralized government leads to information advantages and more flexibility in adapting to citizens’ needs and preferences, as emphasized earlier by Hayek (1945). Today, the growing second-generation literature is based on the theory of “public choice,” assuming a political economy with selfish officials, as opposed to the benevolent agents in the previous literature. A branch of this literature, known as market-preserving federalism, focuses on incentives for government officials not to deviate from good behavior and emphasizes the role of decentralization as a mechanism to control an intrusive, expansive public sector and to support effective private markets (Weingast 1995, McKinnon 1997).

Classical federalism and the Tiebout hypothesis (addressing the competition among local governments and the mobility of individuals to find their preferred package of services) play major

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<sup>1</sup> For example, until very recently in the Lao People’s Democratic Republic, the central government lacked control over tax administration and customs and budget execution, making genuine decentralization impossible since the central government was too weak.

<sup>2</sup> For example, India is a very decentralized system at the federal–state level, but not at the state–local level.

roles in the theory of local public finance.<sup>3</sup> Unlike the case of pure Samuelson goods (in which the addition of individuals does not diminish the amount available to others and no one can be excluded from its consumption), the efficient decentralized provision of local goods (with crowding in consumption and some excludability) is possible via the mechanism of mobility of households (i.e., “voting with their feet”—that is, moving—and sorting into homogenous communities). This concept is important to the understanding of decentralization in the United States (i.e., increased efficiency in the public sector), but it is not necessary to justify the advantage of fiscal decentralization in delivering more efficient outcomes in the delivery of public services. In fact, household mobility across local jurisdictions, like in the United States, hardly exists elsewhere.

The classical principles for decentralization design are well traveled across countries and over time. Hundreds of decentralization programs proposed by the Asian Development Bank, the International Monetary Fund, the World Bank, bilateral donors, and policy advisors have been inspired by these principles. After certain design issues have been addressed (e.g., hard budget constraints), the classical framework has been quite successful.

But decentralization is not an automatic remedy. The dangers of decentralization have been listed by many, and include a lack of capacity causing macro instability (Prud’homme 1995, Tanzi 1995). Others have tracked the diversion of funds in decentralized settings (Reinikka and Svensson 2004) while still others have warned of the dangers of capture by local elites (Bardhan and Mookherjee 2000).

Thus, is uniform central provision the right counterfactual for decentralization? It may not be if central governments are able to diversify and customize the provision of public services similarly to decentralized governments. However, further questions are raised regarding whether deconcentration can be as efficient as decentralization because of the lack of information and the lack of interest in diversifying the provision of public services. Further, it is questionable how diversity, complexity, proximity of local officials, political constraints, accountability, incentives, corruption, and state capture by local elites affect the success of decentralization.

Until recently, hard quantitative evidence has been scarce on the impact of decentralization, as it is difficult to isolate its effect from other processes in society and institutional changes in the public sector. The econometric issue of the endogeneity issue is also a key factor. Thus, there is need to evaluate whether decentralization is the cause of certain outcomes or simply the effect of other ongoing processes, such as democratization or economic growth, and statistical studies need to control for the possible presence of reverse causation.

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<sup>3</sup> The classical federalism model rests on (i) the assignment of expenditure functions by benefit areas, based on the fiscal equivalence principle (jurisdictions should coincide with the benefit areas of services [Olson 1969]), with macro stability and income redistribution—including progressive taxation—reserved as central functions (Musgrave and Abel 1959); (ii) revenue assignments based on the benefit principle (those that benefit from the service should pay the tax) for the financing of subnational public services; (iii) equalization transfers used to address horizontal disparities (based on fiscal capacity and expenditure needs), and conditional grants used to correct spillover benefits or externalities and to encourage subnational expenditures on national priority areas; and (iv) responsible subnational borrowing to finance infrastructure following the golden rule (borrow only for capital expenditures).

# Evidence of the Impact of Fiscal Decentralization on Economic and Fiscal Variables

Decentralization has generally positively impacted education outcomes. In Bolivia, Faguet (2004) found that decentralization made public investment in education and other services more responsive to local needs. In Indonesia, Simatupang (2009) and Qibthiyah (2008) also noted improved education outcomes after decentralization, such as in overall and female literacy rates, years of schooling, and dropout rates for primary and secondary education. In Colombia, Faguet and Sánchez (2006) found that decentralization improved public school enrollment, and Barankay and Lockwood (2007) stated that the degree of decentralization was positively related to educational attainment in Switzerland. Peña (2007) and Solé-Ollé and Esteller-Moré (2005) found that the proportion of successful students in the last course of secondary education in Spain improved with decentralization, mainly due to increases in government efficiency. Finally, Habibi et al. (2003) noted that decentralization had a positive, significant impact on secondary enrollment ratios in Argentina, and King and Özler (1998) similarly discovered that a decentralized education program much improved test scores in Nicaragua.

In the health sector, decentralization has had more mixed results. In Argentina, Habibi et al. (2003) found that revenue decentralization had a significant impact on decreasing infant mortality, and Robalino, Picazo, and Voetberg (2001) similarly discovered that countries where local governments manage a higher share of public expenditures tended to have lower mortality rates. Khaleghian (2003) noted that expenditure decentralization was positively related to improved health outcomes in low- and middle-income countries, while Robalino, Picazo, and Voetberg (2001) posited that decentralization may lead to increases in regional disparities in health expenditures due to the absence of a mechanism to transfer resources from rich to poor jurisdictions. Strumpf et al. (1999) stated that local government health planners allocated declining proportions of their budgets to public service activities. Schwartz, Guilkey, and Racelis (2002) suggested that local public health expenditures increased after decentralization but, over time, local governments decreased the share of revenue allocated to public health.

Regarding other services, the evidence on the impact of decentralization is also mixed but strongly positive. In Porto Alegre, Brazil, Santos (2005) noted that decentralized participatory budgeting by citizens led to increased access to water and sewage services. In the Republic of Korea, Wade (1998) found increases in efficiency in decentralized irrigation systems as opposed to inefficient centralized systems in India. For infrastructure, the World Bank (1994) cited numerous cases in which delivered infrastructure in decentralized settings was of better quality and completed at lower costs than in centralized settings.

A growing number of household surveys have also shown more citizen satisfaction with decentralized delivery. In Indonesia, Hellman et al. (2003) found this to be true, but there were some problems because the selection of the centralized services for the survey—police protection—may not have been balanced in what people generally say they like. Azfar, Kähkönen,

and Meagher (2001) and Azfar and Livingston (2002) found for the Philippines and Uganda that after decentralization, local budgets better matched citizens' priorities, or were perceived to do so.

The proposition that fiscal decentralization enhances economic efficiency may have a corresponding effect on the dynamic setting of economic growth (Oates 1993). Theoretically, according to Couderc and Ventelou (2005) and Brueckner (2006), fiscal autonomy is associated with higher output per unit of labor and higher steady state growth rates. However, a causation path is not clear, and decentralization may affect growth indirectly through its impact on other economic variables (Martínez-Vázquez and McNab 2002). In fact, empirical evidence is mixed, with Xie et al. (1999), Zhang and Zou (1998), Lin and Liu (2000), and Thiessen (2003) finding negative impacts. Martínez-Vázquez and McNab (2003) cited no direct effect on economic growth but an indirect effect through macro stability. More recently, Feld et al. (2004) noted that in Switzerland, greater subnational fiscal autonomy has led to faster economic growth, and that matching grants from the center reduced growth. Qiao et al. (2008) find a positive impact of fiscal decentralization on growth in the PRC.

Traditionally, some authors (e.g., Tanzi 1995, Prud'homme 1995) and the International Monetary Fund have warned about the macro dangers of decentralized regimes, while others (McLure 1995, Sewell 1996) have minimized these claims, but without empirical corroboration. Raw deficit and debt level figures do show that central governments are less fiscally disciplined, although different degrees of fiscal coordination exist.

Earlier empirical evidence on the impact of fiscal decentralization on macroeconomic stability is mixed. Where macroeconomic instability predated decentralization, such as in Argentina and Brazil, decentralization has not made economies worse (Dillinger, Perry, and Webb 2000). There may be a correspondence between increases in subnational deficits and central government expenditures and deficits in the subsequent period (Fornasari, Webb, and Zhou 2000). Further, no clear relationship appears to exist between decentralization and the level of inflation (Treisman 2000; Rodden, Eskeland, and Litwack 2003). More recently, Martínez-Vázquez and McNab (2003) found that revenue decentralization led to more price stability, especially with revenue decentralization.

Traditionally, there are two competing arguments regarding the effects of decentralization on poverty. Traditional public finance literature advises against the participation of subnational governments in redistributive policies (Stigler 1957, Musgrave and Abel 1959), but there is growing recognition of the important role of subnational governments in facilitating, catalyzing, and coordinating the implementation of pro-poor policies (Bahl et al. 2002). Fiscal decentralization can directly affect poverty and income inequalities in a myriad of ways, and they ultimately depend on the specific characteristics of each fiscal decentralization process. For example, fiscal decentralization can alter poverty and income inequality through its effects on the composition of public expenditures. Arze del Granado, Martínez-Vázquez, and McNab (2005) found that the share of education and health in total government expenditures increased with fiscal decentralization. However, Bardhan and Mookherjee (1998) suggested that the benefits of decentralized service delivery may primarily go to local elites.

Sepúlveda and Martínez-Vázquez (2010) recently found that decentralization has a positive (i.e., nonlinear) effect on measures of poverty and the Human Development Index. The impact on income distribution was also positive when the relative size of the government sector in the economy is large. With similar results, Crook and Manor (1998) and Crook and Sverrisson (2001) noted the positive impact of political and administrative decentralization on poverty reduction outcomes in some selected developing countries. Similarly, Von Braun and Grote (2002) and Lindaman and Thurmaier (2002) discovered the positive impact of decentralization on poverty as captured by the Human Development Index. Galasso and Ravallion (2001) noted that Bangladesh's

food-for-education program became more pro-poor with decentralization, and Bardhan and Mookherjee (2003) suggested that decentralized management advanced poverty alleviation goals in West Bengal, India.

Yet other studies have shown that decentralization can negatively impact poverty levels. West and Wong (1995) found that decentralization resulted in lower levels of public services in poorer areas of the PRC, and Ravallion (1998) observed that decentralization generated substantial inequality in public spending in poor areas of Argentina. Azfar and Livingston (2002) found no evidence of improved efficiency and equity of local public service delivery associated with decentralization in Uganda. Decentralization may also contribute to increased disparities due to differences in institutional capacities and socioeconomic endowments among areas. Further, decentralization may imply a reduction of the influence of poorer areas over the allocation of financial resources and transfers (Cheshire and Gordon 1996, Prud'homme 1995, Rodríguez-Pose and Gill 2005, Besley and Ghatak 2003).

On the other hand, decentralization may contribute to reducing disparities because of greater transparency and by bringing more efficiency and equalization. For example, Québec's more progressive and egalitarian welfare state compared to other provinces may have later contributed to strengthening social protection elsewhere in Canada (Béland and Lecours 2010). Others have also found that decentralization is associated with a general reduction in territorial disparities, including Weingast (1995), McKinnon (1997), Qian and Weingast (1997), Shankar and Shah (2003), and Rodríguez-Pose and Gill (2005). In addition, positive results have been found in most single-country studies, such as those by Qiao et al. (2008) for the PRC, Bonet (2006) for Colombia, Bagchi (2003) for India, Hill (2008) for Indonesia, and Silva (2005) and Hill (2008) for the Philippines. Others have found conclusions that go both ways depending on various conditions such as the wealth of a country, dimension of its existing disparities, and presence of solid fiscal redistribution systems (Rodríguez-Pose and Ezcurra 2010).

This line of research is still evolving, and significant progress has yet to be made with data and decentralization measurement to establish the causal link between decentralization and pro-poor service delivery.

Special attention has been given to the decentralization experience of the PRC. Several papers, such as those of Qian and Weingast (1997) and Qian and Roland (1998), suggest that decentralization there provided incentives to local governments for economic success. In the view of those authors, the country's township and village enterprises were sources of growth and an example of "market-preserving federalism." In contrast, Ponomareva and Zhuravskaya (2001) note that Russian Federation's decentralization provided negative incentives to development through the "clawback" of any additional revenues generated by subnational governments via the reduction of central government transfers. Not much is known about how decentralization may contribute to the development of local economic activity; the doubt lingers in the literature that local officials may not always be the best entrepreneurs, because they may lack business experience and do not take decisions assessing the proper business risks.

# Evidence of the Impact of Fiscal Decentralization on Governance

Strong evidence from panel data shows that fiscal decentralization increases the share of education and health expenditures in total government expenditures, especially in developing countries (Arze del Granado, Martínez-Vázquez, and McNab 2005; Shelton 2007). In addition, Faguet (2004) found evidence that fiscal decentralization increases investment in social sectors, such as education, urban development, water and sanitation, and health care.

Classical works by Brennan and Buchanan (1980) and also by Niskanen (1975) depicted government as a revenue-maximizing, mythical leviathan; they argued that with mobility of individuals and private companies, fiscal decentralization imposes a check on government growth through tax competition. Oates (1985) posited that greater decentralization may result in the loss of certain economies of scale with the consequent increase in administration costs and the size of government. Prud'homme (1995) and others suggested that the relative poorer quality of local bureaucrats is likely to weaken public expenditure management and result in higher supply costs of public services. Overall, no consistent evidence has been found to support or reject this leviathan hypothesis, where government size is measured as government tax revenues or expenditures as a fraction of personal income. While Wallis and Oates (1988) and Zax (1989) found supporting evidence for this hypothesis, Giertz (1983), Oates (1985), Nelson (1987), and Forbes and Zampelli (1989) rejected it.

Martínez-Vázquez and Yao (2009) noted that the increase in public employment at the subnational government level as a consequence of decentralization often overwhelms the corresponding decrease in public employment at the central level. As a result, the level of total public sector employees unambiguously increases with the degree of fiscal decentralization of a country. Marqués Sevillano and Rosselló Villalonga (2004), in Spain, found that the increase in the number of public employees at the regional government level was 1.6 times the reduction of the number of public employees at the central government level during the period of decentralization, 1990–2003. For India, Rajaraman and Saha (2008) found that horizontal splintering of the federation into smaller subnational governments (where size is measured as population or gross state domestic product) increased the total size of the subnational civil service across all subnational governments. However, these findings do not mean that decentralization is more inefficient than centralization; for example, a larger number of employees may respond to a more efficient offer of public services as desired by citizens, which requires more labor-intensive production technologies.

Decentralization can lead to subnational tax competition and other forms of competition, but this may not be desirable. From a political economy perspective, competition may help control government size and solve the “common pool problem” (the tendency for agents to overuse and ultimately destroy a commonly owned resource). However, there is the possibility of the “race to the bottom,” that is, that competition among jurisdictions will drive them to continue to lower taxes in order to attract businesses or, more mildly, that taxes and public spending will be possibly pushed below the social optimum (Zodrow and Mieszkowski 1986, Wilson 1999). However, government accountability can be increased through yardstick competition, in which

local residents evaluate the performance of their local government by comparing the achievements in neighborhood jurisdictions (Besley and Case 1995).

Furthermore, there is a mutually reinforcing relationship between fiscal decentralization and democratic governance. Decentralization promotes democratic governance, and democratic governance is required to reap the full benefits from fiscal decentralization. An important impetus for fiscal decentralization in Africa, Eastern Europe, Latin America, and the former Soviet Union was the democratization of the political systems in many of these countries (Rondinelli and Nellis 1986, Taillant 1994). Decentralization—especially political through local elections and participation—can improve governance through local accountability (Blair 2000, Manor 1999). Martínez-Vázquez and McNab (2006), using panel data, discovered that governance and decentralization support each other in a bidirectional casual relationship, yet some odd results exist; De Mello and Barenstein (2001), using cross-country data for 78 countries, found that the association between fiscal decentralization and governance gets stronger as the share of nontax revenues and transfers in total subnational revenues increases.

From a theoretical perspective, decentralization may help reduce corruption because of enhanced accountability and competition among local governments (Weingast 1995, Arikan 2004); “exit” (migrating to other jurisdictions) and voice (voting at local elections) mechanisms at the local level; higher levels of information and transparency at the local level (Seabright 1996, Boadway and Shah 2009); higher probability of detection and punishment at the local level (Carbonara 2000, Wildasin 1995); enhanced transparency (Ahlin 2000); and lower transaction costs for citizens and improved countervailing institutions (Boadway and Shah 2009). There are also negative reasons, such as decentralization weakening monitoring, control, and audit by central agencies, thereby creating opportunities for corruption (Ackerman 1978, Tanzi 1995, Prud’homme 1994); political decentralization promoting higher incidence of corruption through involvement of a larger number of officials in dealing with potential investors like feudal lords and oligarchs (Shleifer and Vishny 1993); higher incidence of clientelism (protecting and benefiting political supporters) and interest group capture where the elite dominate the local political scene (Shah 1999; Litvack, Ahmad, and Bird 1998; Bardhan and Mookherjee 2000); and higher incentives for corruption at the local level due to poorer compensation, lower career prospects, and lower morale.

Empirical findings skew toward a positive impact of decentralization on corruption. Gurgur and Shah (2005), Arikan (2000), and Fisman and Gatti (2002) noted that decentralization reduced the overall level of corruption, and Ivanyna and Shah (2010) found that decentralization has a significant negative (but positive in the sense of good governance) effect on corruption regardless of the choice of the estimation procedures or the measures of corruption used. Crook and Manor (1998) suggested that political decentralization reduces grand theft but increased petty corruption in the short run—but in the long run, both go down. In Colombia, Fiszbein (1997) found that competition for political offices allowed responsible, innovative leadership; improved service delivery; and reduced corruption at the local level. Similarly, Kuncoro (2000) found that in Indonesia, administrative decentralization led to lower corruption as firms relocated to areas with lower bribes. De Mello and Barenstein (2001), based upon cross-country data, concluded that tax decentralization was positively associated with improved quality of governance. Azfar, Kähkönen, and Meagher (2001) stated that household perceptions in the Philippines and Uganda were that corruption is less at the local government level, a common finding in other countries.

Decentralization may also encourage more collective action, interaction, and ultimately social capital (Tarrow 1994, Hooghe and Marks 2003). Those who have been exposed to decentralization tend to be more outspoken and trusting of public officials. Further, there is a positive effect on people’s pro-voice attitudes that goes beyond the political environment (De Mello 2011). On

the negative side is the position that institutions, including decentralization, do not affect social capital (Bourdieu 1986; Coleman 1988, 1990). However, some researchers found no clear empirical evidence for or against the impact of decentralization on social capital.

Moreover, fiscal decentralization seems to increase welfare and government quality since subnational governments adapt easier to satisfy citizen preferences (Oates 1972). In addition, fiscal decentralization can constrain governments' misbehavior because it opens up the possibility of interjurisdictional competition (Brennan and Buchanan 1980, Weingast 1995). In the absence of coordination, the creation of additional levels of regulatory and fiscal authority may lead to "overgrazing" the commons (the pool of revenues raised by the central government in the entire country) by the multitier government structure (Shleifer and Vishny 1993). However, competition may reduce tax pressure and thus the capacity of local governments to collect sufficient taxes to provide basic public goods (Oates 1999). Local governments may compete for capital by helping agents cheat the central government in ways that reduce the central government's capacity to enforce regulations and to collect taxes (Cai and Treisman 2004).

Huther and Shah (1998) found that fiscal decentralization was associated with greater citizen participation, more political and democratic accountability, social justice, and improved economic management. De Mello and Barenstein (2001) and Fisman and Gatti (2002) found that more fiscally decentralized countries tended to be more efficient. Estache and Sinha (1995) found that expenditure decentralization related to more infrastructure spending at subnational levels in developing countries and, to a lesser extent, in developed ones. Dreher (2006) and Kyriacou and Roca Sagalés (2009) posited that fiscal decentralization had a positive effect on institutional quality. Also, De Mello (2011) found that fiscal decentralization had a positive impact on government quality.

Certain institutional setups provide incentives to local governments to exploit the fiscal commons (central pool of revenues) thus exporting tax burdens to other regions in the country, especially where subnational governments operate with soft budget constraints. Subnational governments tend to be more inefficient if they face soft, rather than hard, budget constraints (Qian and Roland 1998). This issue has been modeled in a sequential game theory framework (e.g., Rodden, Eskeland, and Litwack 2003) that found a final stage where a bailout is the preferred solution (i.e., irresponsible behavior may be endogenous to decentralized systems like Brazil and India). Another reason developed by Wildasin is the difficulty of central governments committing to a no-bailout policy because of the "too big to fail" story (some subnational governments can be too big and important for the central authorities to let them go bankrupt).

# Evidence of the Impact of Fiscal Decentralization on Political Outcomes

There is increased interest in explaining why nations break up (Bolton and Roland 1997, Alesina and Spolaore 1997). Factors may include (i) differences in regional preferences over fiscal policy and other issues, (ii) the efficiency losses in economies of scale from separation, and (iii) tax issues arising from variations in regional per capita incomes. Kymlicka (1998), who reviewed such cases as Catalonia and Québec in detail, concluded that federalism may not only provide a viable alternative to secession in multinational states but that moving in this direction may also actually induce more people to think that secession is a more realistic alternative to federalism. Curtice (2006) explored survey evidence on perceptions of national identity and the support for various devolution arrangements by residents of Scotland and Wales. His conclusion was not as bleak as Kymlicka's, but neither was it encouraging for those who hope that the political solution to national disunity lies in decentralization. Sorens (2008) argued that there is an alternative to secessionism—regionalism—which he defines as territorial recognition within the state. He found that regional autonomy increased the share of votes received by both regionalist and secessionist parties. In summary, no one as yet has any clear ideas or evidence about the impact of decentralization on national unity (Bird, Vaillancourt, and Roy-César 2010).

Intuitively, decentralization should contribute to increased turnout in subnational elections and perhaps to lower participation in national elections. However, people seem more prone to vote when the legislature and government to be elected have more power or authority (i.e., in national contests). The evidence is consistent except for Switzerland, where low turnout rates in national elections have been attributed to decentralization and direct democracy (Farago 1996). On the other hand, although Blais, Anduiza, and Gallego (2011) found that in Canada decentralization was associated with lower turnout in national elections, they observed no real effect in Spain. However, in Spain, regional elections showed lower levels of turnout, although the gap varied significantly across regions (Pallarés and Keating 2003, Vallès 2009). Similar findings exist for United Kingdom turnout in devolved elections in Scotland and Wales. Turnout in regional elections in Germany was also significantly lower than in national elections, although the gap has decreased over time (Jeffery 2009).

The relative authority of national and subnational governments in a country helps determine the success or failure of subnational parties and, therefore, the formation of a national party system (Brancati 2008). Voters are less likely to support national political parties as the national government becomes less important, or the reverse. There is ample evidence that political and economic decentralization affect party system nationalization (Brancati 2006, 2008; Chhibber and Kollman 1998, 2004; Montero and Samuels 2003; Cox and Knoll 2003; Chhibber and Murali 2006; van Biezen and Hopkin 2006; Sabatini 2003; Thorlakson 2007; Harbers 2010). Further, Lago Peñas (2010) did not find robust relationships between the degree of decentralization and the nationalization of party systems.

# Conclusion

Answers to the many questions on the impact of fiscal decentralization are not certain, even with the additional research that is needed. However, there are grounds to be positive and optimistic about the overall impact of decentralized systems, especially when they are well designed and implemented. Much work still needs to be done to discover how to improve the design and implementation of fiscal decentralization systems.

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## **The Impact of Fiscal Decentralization** Issues in Theory and Challenges in Practice

This publication analyzes the impact of fiscal decentralization and the resultant issues and challenges that countries face in practice. It traces the evolution of fiscal decentralization as a significant and consequential global reform that has made subnational governments' key public sector actors in a majority of countries. This note touches upon its various aspects: incidence and presence in the world; foundation in economics; impact of a list of outcomes, including economic growth, macroeconomic stability, poverty and income distribution, and service delivery and political accountability. It confirms the positive overall impact of decentralized systems, especially when they are well designed and implemented with examples from around the world, including those from Asia and the Pacific.

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