The political and economic consequences of decentralization

Decentralization has become one of the most important forms of contemporary policy reform and institutional redesign in the last several decades. It is not difficult to find empirical evidence supporting this claim. A recent survey finds that sixty-three of seventy-five developing countries have been undergoing some decentralization of authority (Garman et al, 2001, page 205). Moreover, an index of regional authority in forty-two democracies and semidemocracies reveals that twenty-nine countries have regionalized and only two have become more centralized since 1950 (Hooghe et al, 2010). In addition, around half the member states of the European Union have carried out significant decentralization and regionalization reforms since the 1980s, while none has become more centralized (Hooghe and Marks, 2001). These have not been surprising trends when viewed in the broader contexts of governments all around the world pursuing, in the past half century, greater economic efficiency in the public sector and stronger grassroots democratic institutions and representation for their citizens.

However, as usual in the social sciences, the relationship between cause (decentralization) and effects (improved government efficiency, better governance, and so on) is not so simple. The decentralization processes also have consequences, often unintended, for a wide range of political and economic issues such as corruption, party systems, and turnout, on the one hand, and poverty and inequality, long-run macroeconomic performance, the development of social capital, and effectiveness of tax assignment, on the other. The papers in this issue are intended to shed light on and advance our understanding about some of these questions. Let us examine them.

The debate on the impact of political institutions, particularly the territorial sovereignty (unitary or federal), on governance remains unresolved. The mechanisms behind a positive relationship between decentralization and governance might be compensated to some extent by other mechanisms playing in the opposite direction. Multilevel institutions create new opportunities for local actors, improve the quality of public policy, and reduce administrative costs by increasing the proximity between government and citizen as well as governmental understanding of citizen preferences [among others, see Escobar-Lemmon (2003) and Weingast (1995)]. However, if the electoral control of incumbents falters as a result of an inability to assign responsibility in multilevel governance, politicians are no longer forced to act in the best interest of the public (Anderson, 2006; Lago-Peñas and Lago-Peñas, 2010). Clarity of responsibility might be then a key challenge for the success of decentralization processes. According to Gerring and Thacker (2004), Kunicová and Rose-Ackerman (2005), or Treisman (2000), for instance, unitary polities experience lower levels of corruption because of, among other things, the more hierarchical arrangement of political institutions and the existence of fewer veto points. On the contrary, Fisman and Gatti (2002) find a negative relationship between fiscal decentralization and perceived corruption, and Treisman (2007) concludes that the link between perceived corruption and federal structure is not at all robust. Kyriacou and Roca-Sagalés (2011) address this question directly. Relying on data from 101 countries, the authors find that fiscal decentralization has a positive impact on government quality—
corruption, rule of law, regulatory quality, and government effectiveness—while political decentralization—in the form of subnational elections, checks, and balances (bicameralism), and especially decision-making decentralization (federalism or autonomy)—tends to mitigate this positive impact of fiscal decentralization. Different mechanisms account for this negative relationship. First, endowed local officials with fiscal resources may be prone to being captured by local interests. Second, the existence of a regionally elected upper house with the power to block the lower house’s financial legislation may be preventing improvements in government performance which would normally arise from fiscal decentralization. And, third is the problem of clarity of responsibilities in decentralized frameworks already mentioned above. All in all, this negative impact of political decentralization on government quality disappears when controlling for the extent of experience with statehood or public administration. A more positive perspective on the effects of decentralization on corruption is provided in the paper by Ivanyna and Shah (2011). Relying on data from 182 countries, the authors build a new composite index of decentralization, capturing political, fiscal, and administrative autonomy of local governments, and show that not only fiscal decentralization but also political decentralization in the form of ‘voice’ (or political accountability) have a significant negative effect on reducing corruption ‘exit’ options, as measured, for example, by competition among jurisdictions, are less effective in reducing corruption.

The degree of political and economic centralization is a crucial variable in explaining changes in the number of national parties over time within countries. According to the seminal contributions by Chhibber and Kollman (1998; 2004) (see also Harbers, 2010), party systems are shaped by the authority granted to different levels of government or, in other words, by fiscal and political decentralization. Chhibber and Kollman (2004, page 21) summarize the argument in the following way:

“Federal policies of the national governments hinder or help minor, regional-based parties to survive on the national scene, and, therefore affect the nature of party coalitions and the party systems. Party systems become more national as governments centralize authority; in contrast, there are more opportunities for regional, state, or provincial parties to thrive as provincial or state governments gain more authority relative to the national government.”

However, this rational choice argument has been challenged by the more recent literature on party politics. As explained by Hopkin (2009, page 196), “the focus on parties’ internal organizational logics does not provide us with a simple key to understanding the causes and consequences of decentralization... making theory-generation far more challenging.” In this issue Lago-Peñas and Lago-Peñas (2011) revisit the link between federalism and the formation of national party systems by performing a cross-section time-series analysis of 227 elections in seventeen Western European countries over the period 1945–98. Their results do not provide compelling evidence in favor of the decentralization hypothesis, although the argument connecting the party systems and decentralization seems to work for some countries.

Decentralization is accompanied by the dispersion of governance across multiple jurisdictions. As is well known, subnational elections are understood as second-order elections: they are perceived to be less important than first-order elections (national elections) because there is less at stake (Schmitt, 2005). This has two crucial implications. First, according to the ‘transfer hypothesis’, voters shift their evaluations of the national government to the subnational level and then their voting behavior in subnational elections reflects national considerations (Rohrschneider and Clark, 2008; Rosema, 2007). That is, all else equal, electoral accountability in the terms of Manin et al (1999) should be higher in national elections than in subnational elections.
Consequently, there is a trade-off between efficiency and accountability when decentralization takes place. Second, turnout is significantly lower in second-order elections than in first-order elections. Given that unequal turnout is systematically biased against less well-to-do citizens it then spells unequal political influence (Lijphart, 1997), low turnout is a serious democratic problem particularly in decentralized countries. Blais et al (2011) focus on the unequal representation problem and test the impact of decentralization on turnout. They argue that, as national governments exert less political and economic control over local areas, the turnout gap between first-order and second-order elections should decrease.

Until now, the concept of social capital(1) has been, at best, a secondary idea in economic discussions on decentralization of both the expenditure and revenue sides of the budget. However, social capital is both a relevant input and a valuable potential output of decentralization processes. In particular, the stock of social capital and its dynamics may determine the balance between advantages and disadvantages of decentralization. In the short run, the higher the stock of social capital, the stronger the benefits of decentralization. In the long run, the net gain derived from decentralization will depend on the capacity of decentralization to stimulate the accumulation of social capital. The short-run relationship is supported by the empirical evidence on the effects of decentralization in different clusters of countries. In those with lower social and human capital stocks, decentralization will make quality of public services worse. The reason is that decentralization aggravates the lack of technical capacity in public management and, with it, the expected decentralization benefits from greater accountability and better matching of preferences tend to vanish (Azfar et al, 1999; Bruno and Pleskovic, 1996; Treisman, 2002). In the long run things may be different. Political and fiscal decentralization changes formal institutions and then may affect social capital in a positive way. But informal institutions are very relevant for economic and political performance, as new institutional economics has repeatedly shown. Only if changes in formal institutions are able to change informal ones will the most positive effects of decentralization arise. Hence, the causality from decentralization to social capital is not guaranteed and significant lags are possible. De Mello (2011) takes into account those caveats when testing the hypothesis that, by giving people more voice in the government decision-making process, fiscal decentralization fosters social capital, measured in terms of interpersonal trust. On the basis of data from Brazil and Indonesia, de Mello’s paper shows that the cohorts of individuals that have been exposed to decentralization are in general more provoice (and trustful of strangers in the case of Brazil) than their counterparts that have not been exposed to decentralization. Moreover, cross-country evidence based on World Values Survey data suggests that people living in federal or decentralized countries find it more important than their counterparts living in unitary or centralized countries to have a voice in government decisions, which, in turn, is associated with greater social capital.

Even though decentralization has taken hold and has been consolidated in most developed countries, the importance of this institutional process of reform and government redesign has taken special presence and significance among developing countries in all regions of the world over the last several decades. At the same time, two of the biggest challenges faced by developing countries are the high incidence of poverty among their citizens and wide inequitable disparities in the distribution of income. International institutions and bilateral aid agencies have also over the past several decades unequivocally supported policy initiatives in the developing world in support

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(1) On the meaning and scope of this concept, see the book edited by Dasgupta and Serageldin (1999) and the survey by Sobel (2002).
of both decentralization, and poverty reduction and a more equal distribution of income. An important unresolved issue that so far has not been addressed in the literature is whether those two policy thrusts, for further decentralization and for poverty reduction and more equal income distribution, are reinforcing each other or, otherwise, are contradictory and working in opposite directions. This question, it must be noted, is different from another related question that has received more attention in the literature: whether decentralization leads to more or less economic convergence across regions [most recently examined by Rodriguez-Pose and Ezcurra (2010)]. There are multiple channels through which decentralization, on the one hand, and poverty and income distribution, on the other, can interact; these relationships may not be just unidirectional from decentralization to poverty and distribution, but also simultaneous. Sepulveda and Martinez-Vazquez (2011) investigate theoretically the possible channels through which fiscal decentralization may affect poverty and income inequalities and, using a large panel dataset for developed and developing countries studies, investigate these empirical relationships, attempting to control for the issue of simultaneity. These authors find that decentralization is likely to lead to increases in the poverty head-count ratio and the poverty gap, but that it may also lead to reductions in income inequality if the general government represents a significant share of the economy (20% or more).

In the recent upsurge of interest in the economics literature on the effects of fiscal decentralization, the issue that has been studied with most intensity is that of the effects of decentralization on the macroeconomy, and, in particular, the relationship between decentralization and economic growth. That interest can be traced back to Oates’s (1993) conjecture that static economic efficiency gains associated with the decentralized provision of public goods are likely to be translated into some form of dynamic efficiency, leading to faster economic growth. In theory, there are multiple channels through which fiscal decentralization may affect growth, and some of these channels may be direct—for example, through how fiscally decentralized expenditure decisions may affect the accumulation of public capital—or indirect—for example, how fiscal decentralization may affect macroeconomic stability, and in turn how stability in prices or employment may affect economic growth [as discussed, for example, in Martinez-Vazquez and McNab (2003)]. In reality, in the already voluminous empirical literature we can find as many studies that find negative effects of decentralization on growth as those that find positive effects or no effects. Some of these discrepancies may be explained away as due to different methodologies and definitions employed or the different countries and period covered in the studies. However, there has been less than clarity in the literature for this divergence in results. Schnellenbach and Feld (2011) shed considerable light on this difficult puzzle. The authors provide a broad survey of the literature on fiscal federalism and long-run macroeconomic economic performance, identify differences between the types of studies (cross-country versus single-country studies), and emphasize the relevance of the broader institutional frameworks underlying decentralization. The institutional details matter; a system of cooperative federalism (à la Germany, for example) is likely to produce different results from a system of competitive federalism (à la Switzerland or the United States, for example). Similarly, we should expect different results of fiscal decentralization in developed countries with mature legal and democratic institutions from those in autocratic regimes with immature governance institutions. The overall conclusion reached by Schnellenbach and Feld is that there appears to be no trade-off between fiscal decentralization and long-term macroeconomic economic performance of countries provided that a broader institutional framework is in place.
One of the most significant trouble spots in the design of fiscally decentralized systems around the world has been with the fundamental pillar of revenue assignments to subnational units. There is wide consensus in the theoretical and policy literatures on fiscal federalism that a significant degree of tax autonomy carries many virtues for the workings of decentralized systems, such as greater political accountability and efficiency, and overall more fiscal responsibility of subnational actors (Bahl and Linn, 1992; Oates, 1972). And yet the extent of revenue autonomy—but for a handful of countries such as the United States, Canada, and a few European countries—is low among developed countries. More troublesome is that the level of revenue autonomy in practically all developing countries that have decentralized in the past several decades is even much lower, often just a fraction of what we observe in some developed countries (Bahl and Bird, 2008; Martinez-Vazquez, 2008). Why this is so had not been explained in the literature on fiscal federalism. Bahl and Cyan (2011) take on this challenge and advance four main arguments for explaining the disparities in revenue autonomy between developing and developed countries. The first is that electoral regimes may not be in place for seeking the accountability gains to be captured through revenue autonomy. A second reason is that, given the wide regional disparities in economic capacity, tax decentralization could result in unacceptable disparities in the ability to fund subnational expenditure needs. Third, tax administration costs may be higher for subnational governments in developing countries and it simply may not be that feasible to lower them. And, fourth, there may exist a fear that providing greater discretionary tax powers to subnational governments may crowd out central revenues, although the authors find this not to hold true in developing countries, and actually find the opposite effect, or crowding in, to hold in the case of developed countries.

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