



# **Fiscal Decentralization and Intergovernmental Finance Reform as an International Development Strategy**

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## **Abstract**

Decentralization and intergovernmental finance have been a common element in international development efforts for many years. However, the success of fiscal decentralization as a development strategy is decidedly unclear, and there is growing skepticism about the effectiveness of (fiscal) decentralization as an international development strategy. This short essay explores the current state of knowledge with respect to fiscal decentralization and assesses the relevance of fiscal decentralization to the wider international development agenda, using the fiscal aspects of decentralization as an entry-point into the broader discussion of decentralization. A nuanced assessment of the potential effectiveness of fiscal decentralization reform around the world requires recognition of the following facts: (1) The intergovernmental dimension of public finance is critically important for the public sector to support economic growth and deliver public services in an effective and pro-poor manner. (2) Sound fiscal decentralization reforms require sound decentralized finances as well as sound decentralized governance and administration. (3) Not all countries are at the same stage of fiscal decentralization, and different policy responses are appropriate under different conditions. (4) There is an institutional bias against decentralized approaches in the implementation of international development projects. (5) Realistic expectations and realistic counterfactuals are needed about the benefits of fiscal decentralization in the developing country context. (6) It would be useful to engage in a systematic stock-taking of the state of knowledge surrounding fiscal decentralization and to foster a strong ongoing engagement on the topic to strengthen the practice of fiscal decentralization reforms and the reform of intergovernmental finances.



# Fiscal Decentralization and Intergovernmental Finance Reform as an International Development Strategy

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## 1. Introduction

Although fiscal decentralization reforms and intergovernmental finance have been an important element of international development activities over the past 25 years, fiscal decentralization and subnational finance have not always been approached with the same level of enthusiasm by the international development community. Almost invariably, the road to greater fiscal decentralization is described as having “dangers” (Prud’homme 1994), “pitfalls” (Tanzi 2001) and in need of “rethinking” (Litvack, Ahmad, and Bird 1998). A recent global conference of decentralization experts focused exclusively on the *obstacles* to decentralization around the world (AYSPS 2008), while a recent World Bank workshop highlighted local revenues and local regulation as major obstacles to economic development (Corthay 2009). The hesitant support for fiscal decentralization reforms in international development circles has been compounded by some recent evaluations of support to decentralization reforms in lesser developed and transitional economies, which have been relatively critical of the effectiveness of support to fiscal decentralization reforms (OECD/DAC 2004; World Bank IEG 2008).

Fiscal decentralization is commonly defined as the transfer of fiscal power and resources from the central government to subordinate or quasi-independent (subnational) government units. The fiscal federalism literature (e.g., Oates 1999) posits that numerous economic benefits arise from shifting public finances “closer to the people,” including a more efficiently sized (smaller) public sector, improved allocative efficiency (as a result of a better match between the services supplied by the public sector and the needs of local communities), and a more competitive and innovative public sector. Whereas the potential benefits of fiscal decentralization reforms as presented in the

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fiscal federalism literature have been hard to measure and relatively abstract, anecdotal evidence of the practical concerns and potential costs of decentralized finance—macroeconomic instability, lack of fiscal discipline, inefficient public spending due to weak local administrative capacity, local corruption and local elite capture—often carry significant weight in policy debates surrounding the topic.

It is hard to dispel this critical view of decentralization. While there are some developing and transition countries where fiscal decentralization reforms have been relatively successful,<sup>1</sup> it is indeed quite hard to come up with developing country examples where fiscal decentralization reforms have been an indisputable success story. Furthermore, to the extent that rigorous academic research has been done on the potential benefits of decentralization, little systematic evidence is available to confirm that decentralization is consistently a positive force in promoting economic growth, improved public service delivery, and poverty reduction. In fact, until fairly recently the biggest potential benefit of fiscal decentralization—improved public service delivery—has largely been ignored in the empirical decentralization literature. As a result, disappointingly little is known about the determinants of effective decentralized public service delivery.

Given the current state of knowledge on fiscal decentralization and the seemingly pervasive skepticism about its positive impact, it is appropriate to at least be concerned about the benefits of fiscal decentralization reforms in developing and transition economies and the ability of the development community to effectively support such fiscal decentralization reforms. Indeed, the uncertainty and skepticism begs the very real question whether international development organizations (whether international financial institutions such as the World Bank or bilateral development agencies such as USAID) should reduce or even eliminate altogether their support for fiscal decentralization reforms in favor of newer, experimental development approaches or in support of more traditional, “proven” development strategies (such as support for large-scale infrastructure projects).

The short answer to this question should be a resounding no. In fact, a strong argument can be made that fiscal decentralization (or more accurately, reform of intergovernmental finances) should play a *more* central role in the global development agenda.

In an attempt to answer this question in greater depth, this short essay explores the current state of knowledge with respect to fiscal decentralization, and assesses the relevance of fiscal decentralization to the wider international development agenda. The discussions in this note take an expansive view of fiscal decentralization and intergovernmental finance. For example, rather than considering political decentralization and administrative decentralization as separate dimensions of decentralization reform, the argument pursued below considers local governance and local administration as integral parts of the institutional framework that determines whether decentralized finances can be spent effectively and efficiently. Likewise, although devolution is

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<sup>1</sup> Recent fiscal decentralization reforms that are frequently considered to have been relatively successful include Poland, Indonesia, and South Africa.

widely considered to be the preferred intergovernmental fiscal arrangement by proponents of decentralization, care should be taken not to downplay the potential role of deconcentration in a gradual evolution or transition from highly centralized fiscal systems towards greater decentralization. The political economy of decentralization and intergovernmental reforms is another important aspect of decentralization and intergovernmental finance that cannot be ignored.

Given the complexities involved in achieving a more decentralized public sector, it should come as no surprise that decentralization processes are seldom linear, and are sometimes characterized as “taking two steps forward, one step back.” Yet since shortcomings in the pursuit of real-world fiscal decentralization reforms will fail to deliver the expected improvements in public service delivery, poverty reduction and the improved efficiency of the public sector, a concerted research agenda is needed to inform better policy practices in the field of fiscal decentralization and intergovernmental finance reform.

## **2. The motivations behind fiscal decentralization reforms**

An important starting point in assessing the relevance of fiscal decentralization to international development efforts is acknowledging that fiscal decentralization means different things to different people. Broadly speaking, fiscal decentralization is typically approached from one of four angles in international development.

First, fiscal decentralization can be approached as a relatively narrow public finance reform with the limited goal of encouraging fiscal discipline and improving the efficiency, equity and effectiveness of public finances. The public finance objective of reducing (centralized) public sector spending was the driving force for much of the fiscal decentralization (or “anti-centralization”) reforms in developing economies supported by the World Bank and other international financial institutions as part of public sector reforms during the 1980s and early 1990s. These early reforms tended to focus more on reducing central spending and downsizing the ineffective, bloated, and overly centralized civil service apparatus in many countries, and did not always focus adequately on the introduction of effective subnational institutions. While most PFM reform programs and public expenditure / fiscal accountability reviews (PEFARs) continue to consider subnational finances, more often than not, subnational expenditures are often relegated a secondary role in such exercises. To the extent that the use of intergovernmental transfer resources and local revenues are considered in the context of such public finance reviews, the emphasis tends to be on the relative inefficiency of local public spending (rather than on the inefficiency and ineffectiveness of central spending programs).

A second angle from which fiscal decentralization is pursued in international development is in the context of wider governance reforms. This should come as no surprise, as decentralization reforms in many countries (particularly in most transition economies and in post-conflict situations) are spurred by governance considerations; decentralization is often used as a strategy to reduce the monopoly of the central level over political and economic space by distributing

power and resources between different government levels. In these cases, fiscal decentralization is generally treated merely as one of several dimensions needed to achieve a more decentralized governance structure in a country. In contrast to the public finance-driven fiscal decentralization reforms, governance-driven decentralization reforms have tended to focus on the pursuit of policy objectives such as improving participatory governance, achieving community empowerment, ensuring accountability, or supporting poverty reduction. The primary role of fiscal decentralization in such broader decentralization reforms tends to be to ensure that funds flow to the subnational level; this requirement sometimes comes at the expense of the level of attention that is paid to the design of the intergovernmental funding flows and the efficiency aspect of public finances. In fact, in numerous developing and transition countries, enthusiasm about democratic reforms has led to the emergence of a decentralized system where governance was placed as close as possible to the people, resulting in highly fragmented and inefficiently small jurisdictions incapable of planning for, or delivering, the local public services assigned to them in an efficient manner.<sup>2</sup>

Third, sectoral decentralization reforms have tended to be pursued as a public administration or public management reform driven from within the sector, typically as an attempt to enhance the efficiency and equity with which sectoral resources are managed. The reach of sectoral programs is almost always limited to a single sector, and as a result, seldom has the ability to systematically improve intergovernmental fiscal structures or subnational governance institutions. To the extent that such efforts have been funded by external development resources, such reforms have been able to achieve some measure of success, often by setting up sectoral development programs or basket funds (for instance, in the context of a SWAP) which transfer development resources to the local level. More often than not, such sectoral programs operate in a parallel manner to the regular public finance system. While there may be cases in which such parallel funding modalities can be justified on a temporary basis (particularly, when a government's own intergovernmental fiscal system fails to funnel resources to local service delivery units), in other cases, such parallel mechanisms actually perform worse than the government's own intergovernmental transfer system.<sup>3</sup> In other cases, sectoral "decentralization" programs are nothing more than intra-ministerial deconcentration programs, where elected local governments are by-passed completely in favor of decentralization directly to the service delivery unit, to local boards appointed by the line ministry, or directly to the "community."

Ironically, the first three motivations for fiscal decentralization reform tend to focus on policy interventions that largely take place at the central government level. As such, their impact on the quality of local governance and local public service delivery is often only indirect. The fourth motivation for fiscal decentralization reform is specifically to strengthen local public

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<sup>2</sup> During the late 1990s, several developing and transition countries embarked on the consolidation of subnational jurisdictions or the re-assignment of expenditure responsibilities to higher government levels after realizing that functions were assigned to a government level with jurisdictions that were too small to effectively perform their duties.

<sup>3</sup> For instance, see Boex and Tidemand (2008) for an analysis of intergovernmental fiscal flows in Tanzania which finds that externally funded development programs tend to be less timely and complete than the government's own recurrent transfer schemes.

administration and local service delivery. In the context of developing and transition economies, this often takes the shape of capacity building program for local government officials. Sometimes these programs only focus on a select number of local governments within a particular geographical area (so-called Area-Based Programs) or are limited either to urban or rural local governments in a country. While the potential direct impact on the quality of local administration and local government service delivery from such interventions is large, the long-term impact and sustainability of such local capacity building efforts are often limited unless these interventions are supported by the central government and are closely integrated into the decentralization policies and systems in place at the center.

In real-world policy reforms, the distinctions between these four approaches to fiscal decentralization are often amplified by the institutional dynamics of fiscal decentralization reforms.<sup>4</sup> The public finance motivation for fiscal decentralization reforms tends to be championed by the Ministry of Finance whenever expedient to its view of public finance management. In these cases, the Ministry of Finance tends to find support from like-minded development partners with fiscal expertise, such as the World Bank. In contrast, governance-driven fiscal decentralization reforms tend to be driven by the Ministry of Local Government (or its equivalent) as part of a broader decentralization agenda and, more often than not, lacks support (or is opposed outright) by the Ministry of Finance and other sector ministries. Not infrequently, when fiscal decentralization reforms are promoted by the Ministry of Local Government, the reform is seen as a “sectoral reform,” and suspicions arise (whether justified or not) that the reform is an attempt by the Ministry of Local Government to expand its own institutional power and its control over the public sector’s fiscal resources. Governance-driven fiscal decentralization reforms can typically count on support from a variety of development agencies, including UNDP, USAID and many European bilateral development agencies. Sectoral decentralization efforts often find support within the respective sectoral sections of development agencies and international financial institutions, regardless whether actual sectoral decentralization is being pursued or not.

Finally, a wide variety of international development agencies support capacity strengthening and reform efforts at the local level, including USAID, GTZ, and many other bilateral development agencies. However, unless such efforts are coordinated through a sector-wide approach, such efforts seldom reach all local governments in a country in a systemic manner. Furthermore, such local capacity development initiatives are not always received with enthusiasm at the central government level, as the benefits of these programs largely by-pass the central officials which oversee the subnational level.

A successful fiscal decentralization strategy should address all four dimensions of fiscal decentralization noted above: public finance and intergovernmental fiscal relations, governance, sectoral reform and local government strengthening. Fiscal decentralization reforms will fail when devolution of fiscal resources is not accompanied by appropriate local governance

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<sup>4</sup> See Bahl (1999) for a more extensive discussion of the institutional dynamics and stakeholder support for fiscal decentralization.

mechanisms which ensure that local finances are properly prioritized and administered at the local level. Similarly, the reform efforts will fail when policy reforms at the central level are not accompanied by capacity strengthening at the local level. Yet few decentralization reforms around the world have recognized that fiscal decentralization is a comprehensive reform of the public sector which needs to address these four different dimensions of fiscal decentralization simultaneously. No doubt, this problem has contributed to the limited real-world success of fiscal decentralization reforms around the world.

This challenge is further compounded by the divergence of institutional incentives within a central government. Even if there is strong political support for decentralization reforms at the highest political levels (the President and parliament), the institutions incentives are rarely aligned in such a fashion that the different stakeholders within the central government all champion comprehensive fiscal decentralization reforms at the same time. Yet without tackling both the fiscal as well as the non-fiscal (governance and sectoral service delivery) aspects of fiscal decentralization reform in a comprehensive manner—and without securing the institutional support from the Ministry of Finance as well as the Ministry of Local Government and the relevant line ministries—fiscal decentralization reforms are virtually doomed to fail from the outset.

At the risk of over-simplifying the situation, it is further fair to state that the incentives placed on development agencies and international financial institutions are such that their interests in fiscal decentralization also often only focus on part of the intergovernmental fiscal system. For instance, as soon as the money for a local development grant scheme is disbursed, the incentive for appropriate monitoring and follow-up (first, to ensure that the resources are spent as intended, and second, that the incentives and fiscal systems for the appropriate maintenance of this infrastructure are in place) is often lacking. Thus, while many development agencies support fiscal decentralization from one or more of the perspectives described above, few, if any, development agencies (nor their counterparts in government) benefit from a critical review of the effectiveness of their efforts in supporting fiscal decentralization reforms.<sup>5</sup> As a result, a considerable gap seems to have arisen between the potential benefits from fiscal decentralization and the actual benefits arising from fiscal decentralization reforms around the world.

### **3. The state of knowledge on fiscal decentralization**

It is coming in vogue to divide the current literature on fiscal decentralization into two generations. While this division considerably oversimplifies the evolution of the literature on fiscal decentralization and intergovernmental finance, it is nonetheless a useful device for classifying the research and thinking on fiscal decentralization.

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<sup>5</sup> In addition, it is not uncommon that a lack of coordination within the country office of development partner results in a sectoral department or section supporting sectoral “decentralization” efforts that are inconsistent with the host government’s (fiscal) decentralization policy, which may be support by the same mission’s governance section.

### The traditional fiscal federalism literature

Much of the early academic literature on fiscal decentralization and subnational finance was developed in the United States and other developed economies, driven by the insights of prominent economists such as Tiebout (1956), Musgrave (1959), Buchanan (1965), Olson (1969), and Oates (1972).<sup>6</sup> Rooted in public finance theory, the establishment of decentralized public sector was seen to be the answer to a conceptual public choice problem: how does a society ensure allocative efficiency in the presence of a population that is diverse and heterogeneous across space? Much less attention was paid during this era to the empirical analysis of decentralized finance in the United States or other developed economies. The actual practice of early fiscal decentralization reforms in colonial territories and early developing economies garnered even less attention.<sup>7</sup>

The conceptual guidance that has arisen from the early public economics literature has been the hallmark of sound fiscal decentralization reform around the world for the last half-century: develop a subnational territorial-administrative governance structure based on the concept of fiscal equivalence; assign functions across different government levels in accordance with the subsidiarity principle; assign revenue sources to the local level based on the correspondence principle; provide intergovernmental transfers to fill the fiscal gaps which arise at the local level from externalities and redistributive policy objectives; and allow for subnational borrowing (and provide capital development grants) to correct for the intertemporal mismatch between the costs and benefits of subnational infrastructure.

The orientation of this first generation of fiscal federalism literature was largely geared towards application in developed economies, and fully predicated on the assumption that effective and democratic subnational governance and administrative mechanisms were in place. In other words, it was assumed that—when assigned the right functions and given access to financial resources, through the right combination of own source revenues and intergovernmental transfers—local governments would “work.”

For instance, much of the testing of the Tiebout’s hypothesis—one of the most prominent hypotheses in the field of local public finance—has been done using U.S. state or local fiscal data.<sup>8</sup> While the assumptions about the efficiency of local governments which underlie fiscal federalism theory have only limited merit when considering state and local fiscal relations in the United States (and perhaps in a handful of other industrialized economies), these assumptions are completely inapplicable in many developing and transition economies around the world—often with little or no democratic traditions at the subnational level. Therefore, for any of the

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<sup>6</sup> In turn, these economists drew on earlier generations of economists for relevant insights and inspiration, including Buchanan’s acknowledgement that Knut Wicksell laid an important foundation for later developments in public finance and fiscal federalism.

<sup>7</sup> For an early discussion of applied decentralization reforms in developing countries, see Hicks (1961).

<sup>8</sup> Charles Tiebout (1956) posited the hypothesis that, under certain assumptions, residents would have an incentive to reveal their preferences for local public expenditures by sorting themselves into local jurisdictions that offered their preferred basket of local public goods and services in an efficient manner.

traditional fiscal federalism literature to be relevant for fiscal decentralization reforms in developing and transition economies, the ramifications of the institutional environments prevalent in developing and transition countries have to be explicitly explored and recognized. Although the gap between theory and reality in fiscal federalism was certainly clear to its conceptual fathers, the implications from this knowledge gap were not necessarily evident in the implementation of the first generation of fiscal decentralization reforms.<sup>9</sup> Nonetheless, an important point to recognize in the current discussion of the state of knowledge on fiscal decentralization is the admission that the depth of our understanding of fiscal decentralization—particularly the dynamic of fiscal decentralization in developing and transition economies—continues to be relatively limited.

Highlighting the limits on the current state of knowledge is the widespread consensus among experts that the current measures of fiscal decentralization used in empirical research are wholly inadequate to compare or analyze the “true” degree of fiscal decentralization across countries. Virtually all the existing empirical research measures fiscal decentralization as the share of public expenditures that is made subnationally (the expenditure decentralization ratio, or EDR). This measure can be justified only based on the assumptions (which as already noted above, are readily made in the economics literature but seldom hold true in the real-world context) that, first, local governments have full control over the financial resources at their government level and, second, local officials are fully accountable to their constituents. In the absence of these assumptions, the EDR merely measures the degree of anti-centralization (i.e., the share of public expenditures that is not under the direct control of the center), rather than measuring the share of public resources over which subnational governments and their constituents are meaningfully empowered. Yet, despite the obvious shortcomings of the measures of fiscal decentralization being used in the empirical literature to date, there is no agreement on how to properly measure fiscal decentralization, and only limited efforts are being made to improve the measurement of fiscal decentralization (Ebel and Yilmaz 2002; Boex and Simatupang 2008).

Another indicator of the limits on the state of knowledge surrounding fiscal decentralization is the uncertainty surrounding the effectiveness of fiscal decentralization reform in the real world. The empirical literature on the topic has thus far been unable to conclusively establish whether fiscal decentralization reforms are—as a rule—associated with economic growth or improvement of public service delivery (or improved public service delivery outcomes), or whether the risks and failures of fiscal decentralization (such as macroeconomic instability, local corruption or local elite capture) carry the day in decentralized countries and outweigh the potential benefits of the reform.

These shortcomings in the (theoretical and empirical) fiscal federalism literature do not seem to be unrelated to the shortcomings of fiscal decentralization reforms around the world, particularly in developing and transition economies. While the specific challenges hindering the successful implementation of real-world fiscal decentralization reforms are often quite dissimilar across

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<sup>9</sup> Weingast (2006, 46) notes that because many institutional issues were often only dealt with in an implicit manner in the “first generation” fiscal federalism framework, “many decentralizations in the last 20 years have been designed without attention to these conditions.”

countries, a common problem encountered in such reforms appears to be the disconnect between the devolution of fiscal resources (whether as intergovernmental transfers from a central government's own budgetary resources, or whether provided through external loans or donor grants) and the nature and functioning of subnational political and administrative institutions.

### The Emergence of Second Generation Fiscal Federalism

In fairness, the academic research on—and the policy practice of—fiscal decentralization is not necessarily as incomplete and out-of-touch as the foregoing discussion may suggest. Indeed, a shift has occurred in recent years in the debate surrounding fiscal decentralization and fiscal federalism. It is increasingly recognized that fiscal decentralization should not just be defined as the shifting of resources and fiscal authority to the subnational level, but rather as the empowerment of people through the fiscal empowerment of their local governments (Bahl 2005). As such, a consensus is gradually emerging around a “second generation” of fiscal federalism, which emphasizes that “institutions matter” and calls for the field of fiscal decentralization to look beyond the traditional fiscal pillars of decentralization that emerged from the early public finance and public choice literatures (Weingast 2006).

Although the contrast between the two generations within the fiscal federalism literature is perhaps over-emphasized, the newer strand of fiscal federalism literature recognizes that the concept of fiscal decentralization requires us to look beyond the strictly fiscal aspects of fiscal decentralization and, in fact, broadly co-opts the non-fiscal aspects of decentralization reforms as well. As such, this second generation of fiscal decentralization thinking urges policy reformers not to start from a blank slate when it comes to designing a country's intergovernmental fiscal architecture, but to use the existing institutional framework in a country as a starting point for reforms, and to proactively incorporate elements of participatory and accountable governance and public administration into the design and practice of fiscal decentralization.

A common thread in the more recent fiscal federalism research is that local political and administrative institutions are no longer taken for granted; instead, it is explicitly recognized that the benefits from fiscal decentralization—whether in terms of improved economic growth, improved public service delivery outcomes, or improved allocative efficiency due to greater subnational discretion over public resources—are predicated on the need to have appropriate intergovernmental and subnational institutions in place.

As such, an emerging body of “second generation” research on fiscal federalism explores the opportunities of fiscal decentralization in different institutional environments, explicitly recognizing the different dynamics imposed by the institutional (political and administrative) frameworks in different countries. As such, important questions are now being asked—and empirically answered—about the real-world impact of fiscal decentralization on economic growth and service delivery outcomes (e.g., Martinez-Vazquez and McNab 2003; Asfaw et al. 2007); the actual degree of local elite capture in India (e.g., Bardhan and Mookherjee 2006); the ability of communities to detect corrupt practices and ensure accountability in Indonesia (Olken 2007); and the determinants of effective local financial management in Tanzania (Boex and Muga 2009).

An unfortunate effect of the classification of fiscal federalism into two generations is that this classification seems to have somewhat polarized the debate surrounding fiscal decentralization. On one side stand the more traditionally oriented public economists, who—while accepting that politics is inherently an important factor in shaping the effectiveness of intergovernmental fiscal arrangements—adhere to the foundations and principles established by the economics literature in the 1950s and 1960s. On the other side stand political scientists and institutional economists who, in their approach to analyzing intergovernmental fiscal relations, focus extensively on the political and institutional aspects of the public sector's finances.

Both generations, of course, are correct. The differences between the generations are more based on style and emphasis than truly substantive. The old view is prone to being more abstract and theoretical as well as more normative or prescriptive, whereas the young man tends to be more pragmatic, less bound to convention, and positive in his approach. What seems to get lost in the debate, however, is the common ground that both generations share: the notion that a well-functioning decentralized system requires both a sound system of intergovernmental finances as well as well-functioning decentralized political and administrative institutional framework.

Capturing and consolidating these recent gains in knowledge regarding the links between subnational governance and the effectiveness of decentralized finance, as well as filling remaining gaps in our knowledge where needed, will go a long way in allowing us to separate fact from fiction when it comes to claims made about fiscal decentralization reforms, and to come up with a much more nuanced picture on how fiscal decentralization reforms can contribute effectively to economic development, improved service delivery and poverty reduction.

#### **4. Assessing the ongoing relevance of fiscal decentralization to international development**

Given the wide-ranging nature of fiscal decentralization reforms in the real world and the current state of knowledge on fiscal decentralization, the skepticism regarding the effectiveness of fiscal decentralization reforms around the world is understandable: although fiscal decentralization reforms have been pursued in literally dozens of countries over the past half century, there is no conclusive empirical evidence to suggest that fiscal decentralization actually has a consistent, positive impact on public service delivery and governance.

Yet, in the absence of strong empirical evidence to the contrary, it would be equally inappropriate to dismiss the relevance of fiscal decentralization and intergovernmental finance as an effective public policy reform in international development as it would be to embrace fiscal decentralization reforms as an article of faith. In this light, several key arguments could be made in a nuanced assessment of the potential effectiveness of fiscal decentralization reform around the world.



### 1. The intergovernmental dimension of public finance is critically important

Nomenclature and generational perspectives aside, there is little disagreement among policy experts that getting the intergovernmental dimension of a country's public finances right is critically important.

Sound economics and sound public administration require budgetary resources to flow in a manner that links these resource allocations as closely as possible with the policy objectives being pursued and with the desired policy outcomes. For instance, the budget formulation process should generally translate a government's policy desire to improve the quality of (or access to) primary education to increased spending on effective primary education programs.<sup>10</sup> In a similar vein, sound public finance management requires that public resources are properly allocated vertically between different levels or tiers in the intergovernmental structure, and horizontally across the national territory, in such a manner that resources arrive at the service delivery units within the various subnational jurisdictions in proportion to their relative need. For instance, budgetary norms or grant allocation formulas are often relied upon to ensure that primary education resources are distributed across the national territory in proportion to the number of school-aged children in each jurisdiction, possibly with some adjustments for regional cost variations and other needs factors. Failure to address the intergovernmental dimension of public finance by failing to ensure that budgetary resources are distributed to the jurisdictions where they are needed most will almost certainly lead to a suboptimal use of public resources. While this point is often underemphasized in public expenditure reviews, intergovernmental financing mechanisms and fiscal decentralization (whether of the deconcentrated or devolved kind) are indispensable tools to enhance the efficiency public service delivery, to promote poverty reduction and to achieve sound public finance management.

While the intergovernmental dimension of public finance is quite possibly equal in importance as getting the sectoral (or program-based) distribution of budget resources right, it should be explicitly noted that this does not necessarily mean that a more decentralized allocation of resources is always more efficient. The traditional public finance literature already clearly recognized early on that the optimal degree of decentralization is constrained by the need for fiscal equivalence as well as the presence of scale economies in the provision of subnational public services (Olson 1969). The emphasis of the more recent literature has elucidated that, at least in the short to medium term, the absence of participatory mechanisms, efficient subnational administration and downward accountability provided by sound effective local institutions yield further constraints on achieving efficiency in the delivery of public services at the subnational level. As such, intergovernmental fiscal reform will not always require greater decentralization: sometimes more centralization or qualitative improvements in a country's intergovernmental fiscal or institutional architecture are warranted, especially when the possibility for achieving relatively accountable subnational governments is weak.

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<sup>10</sup> This is normally done in the context of a program-based budget formulation process.

## 2. Sound fiscal decentralization reforms require sound decentralized finances as well as sound decentralized governance and administration

As noted earlier, the second generation fiscal federalism literature emphasizes that “institutions matter” and calls for the field of fiscal decentralization to look beyond the traditional fiscal pillars of decentralization. Yet despite a difference in emphasis with the earlier generation of fiscal federalism research, few aligned with the first generation would object to the notion that the benefits of fiscal decentralization are generally not realized unless a country moves towards a greater degree of fiscal decentralization without simultaneously decentralizing (some) political power, political accountability and administrative control to the subnational level.

However, real-world experiences in decentralization reform suggest that, in practice, the decentralization of political and administrative authority may be more difficult to achieve than the decentralization of fiscal resources itself. While it is possible—albeit difficult—to persuade central authorities to devolve or deconcentrate financial resources, central officials are often even more reluctant to devolve political and administrative control. Therefore, political and administrative decentralization are increasingly recognized as binding constraints on the potential success of real-world fiscal decentralization reforms.

Two institutional constraints are encountered in pursuing a broader decentralization agenda that recognizes that successful fiscal decentralization is only possible if the other dimensions of the decentralization process keep pace. First, as external entities, international development agencies and international financial institutions are frequently poorly positioned and/or institutionally disinterested to affect changes in the intergovernmental political and administrative organization of sovereign states. Second, although the decentralization of fiscal resources is an inherently political reform which shifts power over fiscal resources away from central authorities, pursuing the reform of the country’s political constitution itself is often politically unacceptable, especially in countries where the ruling party has a monopolistic hold on power (Olowu 2003; Weingast 2006).<sup>11</sup>

## 3. Not all countries are at the same stage of fiscal decentralization

A potential reason to question the continued relevance of fiscal decentralization as part of the broader international development agenda is the limited progress that has been made in the devolution of fiscal resources from central authorities to subnational governments over the past several decades. Indeed, the available data suggest that—despite the hundreds of millions of dollars spent in support of fiscal decentralization reforms around the world—the share of fiscal resources that has been devolved to subnational governments has actually not increased substantially (or at all) over the past few decades.

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<sup>11</sup> Given the political power that derives from control over the civil service apparatus in many developing and transition countries, most central governments have similarly shown a lack of appetite for reducing their control over the civil service.

This finding would be a particular concern if the sole objective of fiscal decentralization reforms has been to maximize the share of public spending (or revenue collections) that is done by autonomous, elected subnational governments. In reality, however, substantial effort within decentralization reforms has gone into improving the efficiency and effectiveness of intergovernmental fiscal mechanisms and decentralized public spending. Furthermore, not all countries are at the same stage of the decentralization process. In fact, for many previously highly centralized countries, establishing a new, elected level of regional or local governments and rapidly devolving financial resources to this level would be a highly risky and inappropriate approach.<sup>12</sup>

Rather than focusing on fiscal devolution in itself as being the logical end-point of any fiscal decentralization (or intergovernmental fiscal reform) process, these reforms should be seen as a much more gradual and iterative process, that involves the explicit recognition that fiscal decentralization is not only a technical fiscal reform process, but that such reforms are intensely political (e.g., Faletti 2005; Bahl and Martinez-Vazquez 2006). In fact, different countries are at different points in the spectrum from highly centralized to highly decentralized, and as such, different countries have different expectations of the short-run and intermediate-term outcomes to be pursued by their fiscal decentralization reforms. Although the pace and sequence of decentralization reforms varies from country to country, and is often far from linear,<sup>13</sup> a more or less logical sequence of decentralization reforms emerges to the extent that fiscal decentralization reforms are driven by the most significant shortcoming at each stage of the decentralization spectrum. In this scenario or sequence, a country would move from a highly centralized state through a phase of vertical deconcentration and then horizontal deconcentration, before slowly building towards readiness for fiscal devolution during each step.<sup>14</sup>

Such a sequence suggests that substantial progress can be made on a country's decentralization agenda without actually achieving devolution. Indeed, a well-deconcentrated budget structure—if done right—can produce significant benefits over a fully centralized budget structure in terms of improved vertical fiscal balance, improved horizontal fiscal balance, and increased budgetary transparency. However, few proponents of decentralization would take satisfaction in achieving a well-deconcentrated system of public finances. As a result, limited attention is paid in either

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<sup>12</sup> As further discussed below, this issue takes on special significance in the context of post-conflict situations, and in fragile, failing, and failed states.

<sup>13</sup> As noted by Oates (2004, 349), “Contrasting forces, some leading to increased fiscal centralization and some to greater decentralization, are producing an ongoing restructuring of public sectors throughout the world.”

<sup>14</sup> In highly centralized countries (in which fiscal decision-making is fully concentrated within the line ministries at the central level), the main intergovernmental policy concerns tend to be the presence of horizontal fiscal inequities and the lack of responsiveness of the budget formulation process to subnational needs. The most common policy response to these predicaments is vertical deconcentration of functions of resources within line ministries. In turn, the duplication and the lack of inter-sectoral coordination at the subnational level associated with vertical deconcentration tend to lead countries to pursue a horizontally deconcentrated approach. In turn, the absence of downward accountability in a horizontally deconcentrated structure promotes the pursuit of devolution. There is a logic to such sequence, as in every step, the increase in subnational fiscal discretion is balanced with increased subnational accountability in order to ensure the efficient and accountable use of public resources.

policy practice or in the fiscal decentralization literature to top-down budgetary deconcentration as an alternative (or at least, as an intermediate stage) to fiscal devolution.

Likewise, in the absence of elected local governments in a country, the development of bottom-up participatory community institutions (such as community organizations, user groups or community development councils) is sometimes seen as a parallel structure. As such, social action funds or community-driven development modalities are often seen as unsustainable in the long run and a threat to the establishment of a functioning and sustainable local government system, as opposed to being seen (or used) as a stepping-stone for the establishment of a nascent local government structure.<sup>15</sup>

#### 4. There is an institutional bias against decentralization in international development

In addition to the technical challenges involved in achieving fiscal decentralization reforms and the hesitance of some institutions in the international development community to conceptually lend support to fiscal decentralization, perhaps an even more important institutional bias within the international development community should be acknowledged, notably that the delivery of programs by international development agencies themselves is often done in a centralized manner.

Given that donor agencies and international financial institutions need to have their primary counterparts at the central government level, a combination of institutional self-interests (by the donor agency as well as by the counterparts at the central government level) will often bias the implementation of development projects to the central government level. While this is true for most development activities in general, ironically, the implementation of (fiscal) decentralization reforms is no exception, explaining the large number of decentralization projects that seek to impose fiscal decentralization reform in a top-down manner, sometimes empowering the central institution that is supposed to champion decentralization (typically, the Ministry of Local Government) more than the subnational governments themselves.

In addition, the longer time frame required for the benefits from fiscal decentralization reforms to emerge—as well as the indirect and hard-to-quantify nature of these benefits—puts support for fiscal decentralization reforms on uneven footing with other development interventions which result in more concrete, timely and tangible outputs. Despite an emphasis on governance within the World Bank and other development agencies during the 1990s, international financial institutions and certain development agencies seem to be increasingly hesitant to get involved in the realm of governance outside a few narrowly defined areas, such as anti-corruption. The governance reforms required to “get fiscal decentralization right” are often neither

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<sup>15</sup> In recognition of the fact that Social Action Funds and CDD modalities are unsustainable without being linked to the local government level, these modalities are increasingly anchored at the local government level, and therefore converging in their design with Local Capital Development Funds. Whereas situations should be avoided where these modalities essentially fulfill the same function (as is the case in Tanzania, for instance), in other countries, there is scope for the development of community-based development programs prior to the establishment of a more traditional local government development program (for instance, consider Cambodia and Afghanistan).

uncontroversial nor risk-free as broad-based political and institutional support is needed for fiscal decentralization reforms to succeed.

The centralized bias of development projects is not only driven by the institutional need for donors and development partners and their counterparts at the central government level. Perhaps just as important is the administrative ease with which centralized programs can operate; it is simply easier to set up a single central Project Management Unit within a counterpart ministry to procure goods, services or capital infrastructure on behalf of local governments, then it is to monitor funding flows to—and procurement and expenditures by—potentially hundreds of local governments. The fact that such a centralized program structure fails to empower local governments and that such a program design makes it less likely that resources are used less efficiently often seems to be a secondary concern.

#### 5. Realistic expectations are needed about the benefits of fiscal decentralization in the developing country context

Although the improvement of intergovernmental fiscal relations is a critical element in improving public finance management and governance of the public sector, it is important to set realistic benchmarks against which to judge the success of fiscal decentralization reforms. One common complaint of skeptics and critics of fiscal decentralization is the scarcity of success-stories when it comes to fiscal decentralization reforms, particularly in the least developed countries.<sup>16</sup> The implicit counter-factual held in mind is a vision of effective, well-functioning subnational public sector not unlike those found in Western Europe, Japan or North America.<sup>17</sup>

With or without fiscal decentralization reforms, comparing the effectiveness of local governments in industrialized and developing economies provides a completely misleading and unrealistic standard. Indeed, developing countries would instantly cease to be developing countries if they had the capability to put in place public finance management systems (whether at the central government level or at the local government level) along the lines of those found in New Zealand, the U.K, or the United States.

The proper counter-factual to be used in judging fiscal decentralization reforms (in any country, but particularly in developing economies) is whether a fiscally decentralized public sector is able to function, allocate resources and deliver public services in a more efficient manner than a more centralized system would, holding other conditions constant. Such a comparison would not pit decentralized finance in a LDC (with its low administrative capacity; imperfect governance and

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<sup>16</sup> To the extent that there are success stories of fiscal decentralization reforms, these tend to be in transition countries or post-transition countries (such as South Africa or Poland) rather than in low-income developing economies.

<sup>17</sup> When the effectiveness of state or local governments in developed economies is used as a comparator for the relative shortcomings of subnational governments in less developed countries, problems faced in subnational government finance in developed countries are frequently downplayed or overlooked. Few experts would support the re-centralization of state fiscal powers in the United States despite the fact that, for instance, four Illinois governors have been convicted for corruption in the past four decades.

accountability systems; elite capture problems, low revenue performance) against an ideal counterfactual, but rather against a highly centralized public sector in a developing country context (with its pitfalls of low administrative capacity; imperfect governance and accountability systems; elite capture problems, and low revenue performance).

Whereas numerous public expenditure tracking surveys (PETS) have found that significant financial leakages arise in fiscally decentralized system, these findings are seldom compared to the financial performance and the leakage of funds within central government systems.<sup>18</sup> Engaging in a comparative analysis of decentralized system with neighboring deconcentrated systems might be able to debunk (or in fact, lend critical support to) the implicit hypothesis that centralized systems are necessarily more efficient than more decentralized systems.

#### 6. Topics of special interest related to fiscal decentralization and international development

There are a number of topics which carry particular importance or which are of particular interest at the policy intersection between fiscal decentralization and international development at this time. Such emerging issues include fiscal federalism and national unity; the assignment of revenues from natural resources; decentralization and the environment; and corruption and decentralized finance. (Ahmad and Brosio 2006). Several additional topics can be identified as emerging topics in the fiscal decentralization literature, with specific policy relevance today. Although by no means an exclusive list, these topics include fiscal decentralization and poverty reduction; fiscal decentralization and urban finance; and intergovernmental finance in post-conflict countries; these and similar issues require further attention in the policy research agenda in the field of decentralization.

*Fiscal decentralization, local governance and subnational budget transparency.* One of the reasons for pursuing a decentralized system of intergovernmental fiscal relations in many countries is to promote the efficient delivery of public services based on the notion that local governments are more participatory, responsive and accountable public sector institutions. As alluded to in the previous section, however, our knowledge of how local governance, local administration and public finances impact the ability of local governments to deliver effective public services is incomplete. For instance, is it adequate to have elected councils at the local government level to achieve participation, responsiveness and accountability at the local level, or should other preconditions be met in local governance systems to ensure the efficient management of subnational finances? For instance, are local primary elections (in contrast to allowing political parties to centrally appoint local candidates) a pre-condition to ensure that local political leaders are responsive to the needs of the local community rather than to the

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<sup>18</sup> There is some evidence to suggest that funding flows are equally disrupted—and similar leakages occur—in a centralized public sector when funding flows are run through multiple line ministries, directorate and offices, requiring bureaucratic sign-offs at each stage. For instance, a recent study in Tanzania suggests that when financial resources are provided to local governments through transfer mechanisms that are fully integrated into the government's public finance system, that these resources are received in a more timely and complete manner than development funds that are provided through vertically managed parallel development programs (Boex and Tidemand 2008).

whims of central government? Similarly, what standards or norms or subnational budget transparency should be achieved to ensure effective bottom-up accountability at the local level? More generally, what is the relative importance of local administrative capacity vis-à-vis good local political leadership or adequate local finances in ensuring satisfaction with the delivery of local services? While the specific answers to these questions is context specific and may vary from country to country, knowing these answers will be uniformly important in achieving more efficient resource utilization within the public sector.

*Fiscal decentralization, results-based budgeting and poverty reduction.* The goal of decentralization reforms is to empower local communities through their local governments; to achieve an equitable allocation of public services and resources across the national territory; and to improve the delivery of key public services, including education and health care. In the context of developing economies, assuring equity—in the form of policies designed to alleviate poverty—takes on even greater urgency. In many LDCs, such policy objectives are set forth in a national strategy for poverty reduction and economic growth, and a program-based budget structure is used at the central government level to link central government spending to the desired policy outcomes.

However, since most pro-poor public services tend to be functions that—in accordance with the subsidiarity principle—should be delivered at the local government level, the attainment of the Millennium Development Goals and other development objectives in a country will critically depend on the proper functioning of the nexus between fiscal decentralization and poverty reduction. Yet, despite the obvious importance of the topic, relatively little is known how to properly operationalize a national poverty reduction strategy by combining aspects of results-based budgeting at the national and subnational levels along with an appropriate system of intergovernmental fiscal relations. A common dilemma is how subnational development plans or subnational poverty reduction plans should be harmonized with the national development (or poverty reduction) strategy, in terms of planning, budgeting and reporting. A review of international practices on this question might be able to identify certain international best practices which could be emulated elsewhere.

*Fiscal decentralization and urban finance: achieving collective local action and addressing urban infrastructure development.* The implementation of fiscal decentralization and good local governance in rural areas in developing economies is often constrained a weak economic base, high poverty rates and low residential mobility. In contrast, urban areas in developing and transitional economies tend to have a much stronger economic base, while the geography of urban areas typically facilitates local participation, information exchange, and accountability. Under these conditions, urban municipal governments provide a platform for collective local action, where local governments can act relatively autonomously to identify the collective needs of the community, generate own source revenues, and to fund the provision of these local public services from own source revenue collections. The impact of basic municipal services (such as refuse collection and street lighting) on the quality of urban life is easily underestimated.

In many developed economies, (urban) local governments readily provide such a platform for collective local action, where a successful (so-called “Wicksellian”) link is established between the local benefits and costs of local public services. However, in developing countries that lack an adequate degree of political decentralization, this link is easily broken: if local officials have no incentive to spend own source revenues (or unconditional resources) on priorities that have been identified by the local community—or if local communities are unable to hold their local officials accountable—, then local governments lose their function as a platform for collective local action. In line with the “second generation” fiscal federalism literature, the role of local governance institutions in achieving this Wicksellian link should be understood much better in the developing country context. In turn, fiscal decentralization reforms should pay much closer attention to this issue.

At the same time, depending on the exact revenue sources assigned to the local government level, the financing of urban infrastructure development may well be beyond the fiscal capacity of urban local governments to fund from own sources. Not only do urban areas tend to be the engines of national economic growth (and therefore, require substantial investment in transportation and communication investment), but urban areas in the developing world still frequently face the challenge of rapidly expanding their urban infrastructure to accommodate millions of rural residents who continue to see a move to an urban area as the main opportunity for improving their lives. The infrastructure funding implications for these urban challenges should be recognized in the fiscal decentralization reform process and should be incorporated in the design of any sound system of intergovernmental fiscal relations.

*Fiscal decentralization in fragile states and (post-)conflict situations.* A special class of countries of concern to the global development community includes fragile, failing, failed and (post-) conflict states. Decentralized finance plays a unique role in fragile, failing and failed (FFF) states since in many of these countries, an effective central state is absent. In fact, one of the points made in favor of decentralization is that it has the potential to reduce centrifugal forces and ethnic conflicts within a country by moving power and resources down to disenfranchised groups and by giving them voice (Brancati 2009). However, there is considerable disagreement in policy circles whether (or under what conditions) decentralization is able to reduce intra-state instability and conflicts, or whether decentralization contributes to such conflicts.

In many FFF states the fiscal environment is *de facto* highly decentralized, as the state (i.e., the central government) often lacks the authority that is needed to put in place and enforce a sound system of intergovernmental finance. In contrast, a pattern common in other FFF states and in many post-conflict countries is a tendency to over-centralize the public sector and to fully concentrate fiscal power at the center.<sup>19</sup> Either scenario creates major challenges in achieving an effective horizontal and vertical allocation of budgetary resources, as both unregulated decentralization as well as highly centralized budget processes generally lack the appropriate

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<sup>19</sup> In contrast, another response which is not uncommon to authoritarian or post-conflict regimes is for the center to pursue decentralization as a mechanism to gain legitimacy or to weaken the vertical competition for power.

mechanisms to ensure that budget resources are properly funneled towards public service delivery units, or that an equitable distribution across regions and local jurisdictions is achieved.

While the dynamics vary considerably across FFF states and post-conflict environments, a key commonality is the need for the public sector to produce results fast, since the very legitimacy of the state depends on quickly achieving an acceptable level of public service delivery. In contrast to regular fiscal decentralization reforms, therefore, this means that FFF states—despite weak political and administrative systems—need to move much more quickly to achieve effective funding for decentralized (or at least, deconcentrated) public services, as these countries do not have the luxury of transforming their intergovernmental fiscal system in a gradual and incremental manner over time.<sup>20</sup>

## 5. Conclusions and way forward

To answer the main question of this short essay, whether fiscal decentralization and intergovernmental finance are still relevant in international development practice today, the short answer should undeniably be affirmative. But, the community of experts that believe in the potential benefits of fiscal decentralization has often taken the pursuit of fiscal decentralization as an article of faith and has been complacent in substantiating—and where appropriate, qualifying—the various potential benefits of fiscal decentralization. Likewise, the development institutions that have promoted fiscal decentralization—whether as an ingredient in sound public finance management, good governance, or effective and efficient (sectoral) service delivery—have often pursued reform agendas narrowly focused on one-off fiscal devolution, without necessarily considering the often-time gradual and iterative nature of decentralization and the possible sequencing of reforms. Neither have real-world fiscal decentralization reforms always adequately considered the political economy aspects of the reforms, or the need for fiscal decentralization reforms to move in unison with the decentralized political and administrative frameworks. As such, steps should be taken on three fronts to move forward the agenda of fiscal decentralization and intergovernmental finance in the international development community.

First, an ongoing, structured policy research agenda is needed to widen and deepen our understanding of fiscal decentralization. To move forward with a credible international development agenda on fiscal decentralization and intergovernmental finance, it is imperative that the discussion moves beyond the current generational debate *whether* governance and institutions matter in the effectiveness of fiscal decentralization reforms. Instead, an evidence-based research agenda should be pursued much more coherently as to *how* governance and institutions matter in the effectiveness of fiscal decentralization reforms and in achieving effective decentralized public service delivery. The answer to this question will vary from region to region, and possibly from country to country.

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<sup>20</sup> Although community-level interventions such as social action funds or community development funds are typically eschewed as being “anti-local government,” in a FFF state or post-conflict context, such modalities may not only serve the immediate function of quickly dispensing resource to fund public services and infrastructure, but such mechanisms may help lay the groundwork for the eventual emergence of an intergovernmental fiscal system.

To some degree this knowledge may already exist in dispersed form in the various literatures that inform the practice of fiscal decentralization. In other cases, such knowledge will have to be generated by original and creative policy research. The purpose for setting this agenda is not to rehash the existing knowledge on the traditional pillars of fiscal decentralization, but to identify the areas where our understanding of the topic is incomplete and needs to be strengthened. In many instances, these knowledge gaps will fall at the intersection between the strictly fiscal aspects of decentralization reform with either the political (i.e., governance) or the administrative (e.g., financial management) dimension of intergovernmental relations.

Second, support to fiscal decentralization and intergovernmental finance reforms around the world should be guided and informed by the available and expanding policy research on the topic as well as lessons learnt from international best practices.

In particular, in taking forward fiscal decentralization and intergovernmental finance reforms, the systemic nature of decentralization reforms as a “whole of government reform” should not be underestimated. Not only should a successful (fiscal) decentralization strategy address the technical issues raised in each of the four main institutional dimensions of fiscal decentralization reform (public finance management, governance, sectoral organization and local government capacity), but the reform process should also explicitly recognize the institutional incentives faced by each of the stakeholders involved in these four institutional dimensions. Ultimately, broad buy-in is needed within the government across ministries, subnational governments and other institutional stakeholders for fiscal decentralization reforms to be successful.

To improve the real-world implementation of fiscal decentralization and intergovernmental finance reforms, efforts will need to be made to distribute and share the advancing state of knowledge on fiscal decentralization and intergovernmental finance with policy practitioners in the field, thereby allowing the expanded understanding of fiscal decentralization reforms to strengthen the design of programs that are intended to promote or support fiscal decentralization reforms.

Finally, a strong argument can be made that there is a need to elevate the level of technical assistance and degree of policy support during the design and implementation of intergovernmental fiscal policy reforms in developing and transition countries. Unlike the delivery of routine technical assistance projects, the reform of a country’s intergovernmental fiscal architecture is an intensely technical reform with important political and institutional dimensions. It is impossible to achieve a fiscally decentralized public sector where decentralized local governments efficiently deliver public services by following instructions from a handbook or by following a flow diagram. Instead, the successful pursuit of fiscal decentralization reforms in international development will require a combination of institutional insights, policy agility, and the advanced technical expertise to analyze, design and implement the right combination of interventions to make the intergovernmental fiscal system work.

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