



IDS WORKING PAPER

Volume **2016** No **466**

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Giulia Mascagni
March 2016

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IDS Working Paper 466
© Institute of Development Studies and Swiss Agency for Development and Cooperation 2016
ISSN: 2040-0209 ISBN: 978-1-78118-300-7

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Giulia Mascagni

Summary

Fiscal decentralisation has become a widespread phenomenon in developing countries and it has attracted increasing attention in the past few decades. The supporters of decentralisation argue that it can bring about positive outcomes, whether economic or political in nature. For example, since local governments are closer to citizens, they can be expected to be more responsive to their needs. In addition, decentralisation may trigger positive effects in terms of political participation and accountability. Whether these theoretical benefits are achieved in practice is an open question that this paper aims to address. After providing an overview of the main issues and challenges in the design and implementation of fiscal decentralisation, the paper reviews the existing evidence on the impact of fiscal decentralisation on economic and political outcomes at the local level. By doing this it aims to assess whether decentralisation delivered on its promises.

Keywords: fiscal decentralisation; sub-national taxation; intergovernmental transfers; property tax; natural resources.

Giulia Mascagni is a Research Fellow at the Institute of Development Studies. Her main research interests relate to taxation, public finance, aid effectiveness, economic development and evaluation of public policy.

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Acknowledgements

This paper was funded by the Swiss Agency for Development and Cooperation (SDC) as part of the IDS project 'The Governance of Service Delivery'.

1 Introduction

Since the 1990s decentralisation has become a widespread phenomenon in the developing world, although early experiences began in the 1970s and expanded in the 1980s. International organisations and donor countries supported this process, as it was largely consistent with parallel developments in the industrialised world such as the prevalence of conservative governments and the process of European integration (Olowu and Smoke 1992; Tanzi 1996). After having been largely ignored for decades in the standard public finance literature, decentralisation became a central topic in the 1990s (Tanzi 1996). The 1988 World Development Report by the World Bank is seen as a landmark in recognising this trend. It had a dedicated chapter on 'Financing Local Government' which fully embraced the view that 'decentralizing both spending and revenue authority can improve the allocation of resources in the public sector by linking the costs and benefits of local public services more closely' (World Bank 1988: 154).

The promises of decentralisation are both economic and political in nature (Bahl and Martinez-Vazquez 2007). The standard economic argument is that sub-national governments, being closer to the local community, are more responsive to citizens' needs and better placed to understand their preferences. Therefore the devolution of powers to the sub-national level would bring gains in terms of allocative efficiency: resources are spent more efficiently when they are allocated at the local level, since decisions would be more in line with the community's preferences (Bardhan and Mookherjee 2006; Bird 1990; Tanzi 1996). This is particularly the case for matters that directly affect communities that are geographically well defined. For example, it makes more sense to decentralise the function of garbage collection, which affects the community where the service is provided, than national defence, which affects all citizens regardless of their location.

On the political side, autonomous local governments are expected to contribute to democratic development and local accountability. The relation between revenue generation and state building, argued by scholars at the national level (Brautigam, Fjeldstad and Moore 2008; Moore 1998), is likely to be stronger at the local level due to the higher proximity of political elites to the population (Fjeldstad 2001a). If local governments can take decisions on both spending and revenue that are publicly attributable to them, they should be more accountable to their citizens (Bird 2011; Bird and Smart 2002). In functioning electoral systems, citizens are able to reward or sanction them through their vote. In such contexts, local governments would then be more likely to consult their constituencies, therefore making political processes more participatory and ultimately benefiting the development process more generally (Olowu and Smoke 1992). In multi-party democracies, politicians' survival is dependent on the vote, therefore giving them an incentive to care about distributive justice rather than allocating all benefits to a handful of political friends or powerful elites. Therefore, in principle, decentralisation should improve distributional outcomes at the local level (Bardhan and Mookherjee 2006; Bird 2011; Tanzi 1996). Other possible advantages of decentralisation underlined by scholars are related, for example, to the generation of information in the relation between the centre and local governments, which in turn may contribute to increasing transparency more generally (Bird 1990). Whether these theoretical benefits are achieved in practice is an open question that this paper aims to address.

Despite agreement on 'the case for decentralisation', critics expressed doubts even at a relatively early stage of this debate. More than questioning decentralisation in general, they underlined the need to think carefully about what functions to decentralise, at what level of government, and in which sectors (Prud'homme 1995). In particular, some functions may naturally belong to the central state, such as redistribution and macroeconomic stabilisation (Dixit and Londregan 1998; Bird 1990; Fjeldstad 2001a). As far as redistribution is concerned, Prud'homme (1995) notes that if it is entirely left to sub-national governments 'the

poor in well-off regions will fare better than the poor in more deprived regions'. This is not a desirable outcome, as in principle every person in a country should have equal opportunities and access to basic services regardless of the geographical location. Therefore, while there may be a small role for local governments, it is fairly established that redistribution is primarily the mandate of the central government (Bird 2011; Dixit and Londregan 1998; Fjeldstad and Heggstad 2012; Fjeldstad 2001a). Regarding macroeconomic stabilisation, decentralisation may represent a threat if large deficits are generated at the local level. It is almost universally the case in all decentralised countries that local expenditures are larger than locally generated revenues (Bird 2011; Fjeldstad 2001a; World Bank 1988), so that local governments are usually highly reliant on transfers from the centre. If the national government acts as a lender of last resort, local deficits can potentially undermine debt sustainability and affect inflation at the national level (Bird 2011; Fjeldstad and Heggstad 2012; Tanzi 1996). More generally, early observers accept that decentralisation may make macroeconomic management more difficult due to the challenge of coordinating the different levels of sub-national government (Bird 1990; Fjeldstad 2001a; Prud'homme 1995).

In addition to these potential dangers of decentralisation, devolving functions away from the centre is likely to imply a loss of economies of scale (Bardhan and Mookherjee 2006). These losses may be further amplified by administrative inefficiencies that are typically more acute at the local level than at the centre, particularly in developing countries (Fjeldstad and Heggstad 2012; Prud'homme 1995; Smoke 1993; Tanzi 1996). Finally, there is an inherent tension between the central and local governments, which is both a matter of political alignment and of coordination of decision-making across different communities (Bardhan and Mookherjee 2006). While some level of autonomy is desirable and inherent in the very process of decentralisation, a common concern of central governments is to ensure that lower tiers do not fall too much out of line (Bird 1990). One way of dealing with this is monitoring performance with respect to certain objectives, for example in the area of education or health. However these controls can sometimes fall into political patronage (Brollo, Nannicini, Perotti and Tabellini 2013; Olowu and Smoke 1992).

Ultimately, whether the promises or the dangers of decentralisation prevail, is an empirical question and its answer depends on the specific context and on the way in which such a process is implemented (Bird 1990; Bardhan and Mookherjee 2006; Fjeldstad and Heggstad 2012; Smoke 2013). Bird (1990) importantly noted that 'the structure of government in any country largely reflects its history', an idea also shared elsewhere in the literature (Bird 2011; McLure 2001; Smoke 2013). As underlined by several authors, successful decentralisation requires a number of prerequisites that are often lacking in developing countries, such as an educated and politically aware citizenry, the prevalence of law and order, the conduct of free and fair elections, effective electoral competition, and reliable information channels, amongst others (Bardhan and Mookherjee 2006; Prud'homme 1995). Moreover, central governments may have political motivations to prevent true autonomy at the local level (Olowu and Smoke 1992; Smoke 1993), thus practically impairing success even in a well-designed decentralisation process. The way the different levels of government interact will have implications on redistributive outcomes (Dixit and Londregan 1998).

Against this background, this paper provides a review of the existing debates and evidence on decentralisation, with a particular focus on the revenue side. The paper's objective is twofold. Firstly, it aims to review the main issues to be considered in the design of local revenues. After an overview of the general challenges and opportunities in section 2.1, these are illustrated more specifically in the case of three key revenue sources for local governments in developing countries: property taxes (section 2.2), intergovernmental transfers (section 2.3) and natural resource revenues (section 2.4). Second, it takes a more practical view on decentralisation by asking whether fiscal decentralisation is associated with better economic and political outcomes (respectively, sections 3.2 and 3.3). In addition, section 3.4 explores the revenue mix and the interaction between sources of revenue, such

as local taxes and transfers. By doing this, this paper aims to take stock of the existing body of knowledge on decentralisation, as well as practical experiences in the developing world. Section 4 concludes by offering some initial assessment of whether decentralisation delivered, in practice, on its theoretical promises.

2 Local revenue design: opportunities and challenges

The word ‘decentralisation’ has been widely used to describe the transfer of powers and functions from central governments to sub-national levels. Almost invariably the process involves the (re)organisation of a government in multiple levels, usually comprising a national government, a state or province level, and a town or municipality level (Bird 1990). In practice, however, the concept of decentralisation has a number of nuances that it is useful to clarify at the outset, as they will be relevant throughout the discussion. These nuances can be broadly summarised as follows (Martinez-Vazquez, McClure and Vaillancourt 2006; Tanzi 1996):

- *Deconcentration* is the transfer of decision-making power to central government offices located at the sub-national level, within parameters specified by the central government.
- *Delegation* is the transfer of the function of service delivery to the sub-national level, but the central government retains responsibility for it and for revenue-raising activities. It is essentially an administrative decentralisation.
- *Devolution* is the transfer of responsibilities for service delivery and some forms of revenue collection. It is a type of decentralisation that usually involves political and fiscal aspects.

In this paper, and in the broader economic literature, the word decentralisation usually means devolution (Martinez-Vazquez *et al.* 2006). However, even when a system is designed to *devolve* powers and responsibilities, its implementation in a particular country context may result in a scenario where the government has little room for manoeuvre – more similar to delegation or administrative decentralisation. Understanding the nuances in the concept of decentralisation is therefore crucial in the analysis of its effects because the degree and type of responsibility transferred to the local government would imply different potential effects on political and economic outcomes, as it will emerge clearly from the following discussion.

2.1 Revenue assignment

Experts in fiscal decentralisation often refer to the ‘revenue assignment problem’ to indicate the set of government decisions on the distribution of revenue-raising responsibilities across levels of government (Bahl and Martinez-Vazquez 2007; Martinez-Vazquez *et al.* 2006). It includes both the choice of which taxes to assign at which level, as well as what functions and aspects of decision-making to devolve. For example, the local government may administer the property tax and decide what rates to apply; however there may be a case for the definition of the tax base and its actual assessment to be centralised, to ensure coordination and to avoid distortions.

To a certain extent, decisions on revenue assignment depend on expenditure assignment (Bird 2011; Martinez-Vazquez *et al.* 2006). For example, if the local government is only responsible for managing minor local services, such as garbage collection or support for local markets, the revenue assignment problem is relatively simple. Instead if it is responsible for delivering important public services such as health or education, more substantial

resources should be made available at the local level. These would normally include both locally-levied taxes and intergovernmental transfers, which imply some sort of formula for sharing central resources amongst local governments. The question on expenditure assignment is therefore somehow a precondition for revenue assignment decisions and it is briefly discussed in the next paragraph.

In thinking about expenditure assignment, it is useful to consider what functions should be transferred to the local level. Generally the objectives of governments, and more specifically of public finance, fall into three broad categories: equity through redistribution, efficiency in the allocation of resources, and stabilisation (Bird 2011; Fjeldstad 2001a; Martinez-Vazquez *et al.* 2006). On the one hand, as discussed in section 1, redistribution and stabilisation are normally in the mandate of the central government, although a role exists for the sub-national level in ensuring an equitable distribution of resources. On the other hand, it has been argued that local governments can be particularly active in the area of efficient allocation of resources, since they are better placed to respond to the preferences and needs of local communities (see section 1). This is often referred to as the principle of subsidiarity, whereby public services should be delivered by the 'lowest level of government compatible with the size of the benefit area associated with those services' (Martinez-Vazquez *et al.* 2006). However even within the domain of efficient allocation of resources, there is potentially a great degree of variation in the scope of services and responsibilities allocated at the local level. The final outcome of the expenditure assignment decision is likely to be determined not only by objectives of efficient allocation of functions, but also by considerations of national unity and ethnic diversity, by political factors and, importantly, by the existing situation in the country considered (Bird 2011; Tanzi 1996).

Similarly, revenue assignment is determined by a variety of factors, including *objective* principles and more *subjective* preferences that central governments may have on power sharing. There are a number of principles in assigning revenues at the sub-national level, which can also be seen as desirable characteristics of local taxes. The following list is proposed by Smoke (2013) but these principles are widely accepted amongst experts (see for example Bird (2011), Fjeldstad (2001a) and Bahl and Martinez-Vazquez 2007).

- *Adequacy* follows directly from the discussion on expenditure, and it requires local revenues to be adequate to cover the sub-national budgetary needs.
- *Buoyancy* refers to the extent to which the tax yield increases with growth in the economy and expenditure needs. Ideally the two sides of the budget should grow at least proportionally.
- *Stability* is required for local government to make plans and provide services, which would be undermined by volatile revenues that fluctuate often and in unpredictable ways.
- *Efficiency* regards the minimisation of distortions in the economy and the need to keep a proportionate relation between taxes and benefits, in the form of public services.
- *Equity* should be ensured both horizontally (across similar individuals) and vertically (amongst different groups, for example in terms of income).
- *Autonomy* denotes the ability of local governments to make decisions and to take responsibility on local tax matters.
- *Administrative feasibility* indicates the need to make revenue collection responsibilities proportionate to the administrative capacity of the local government.
- *Political feasibility* captures the extent to which a tax is likely to be accepted by the citizenry, and in what form.
- *Integration/consistency* relates to the need for all local taxes to make sense in the context of the national fiscal system.

In practice a tax that satisfies these principles should be levied on a base that is relatively immobile, for example property rather than labour. If the tax base can move between one area and another, the tax will create economic distortions, encourage aggressive

competition, and generate imbalances across regions – thus going against the efficiency and equity principles. The issue of mobility is related to spillover effects and externalities. In the presence of large externalities or spillover effects to other jurisdictions, public functions may be better assigned to the central level or at least they should be closely coordinated by the central government (Martinez-Vazquez *et al.* 2006). A similar case could be made for tax bases that are unequally distributed across a country, such as wealth or income, which should be taxed centrally to ensure redistribution and regional equality (Fjeldstad 2001a).

Since taxes should be proportionate to the benefits from public services (the principle of adequacy), it is important to make sure that the jurisdiction where the revenue is generated is the same as the one where the service is required. So for example if someone generates an income in jurisdiction A but has her primary residency in jurisdiction B, taxing her income in A will create a disconnection between revenues and expenditures. This is obviously not a problem for a single individual, but it can imply a substantial shift of resources away from where they are needed if a similar situation applies to a large group of people. This is one of the reasons why it is generally agreed that local taxes should focus more on consumption rather than income, as the former indicates more accurately the location where the public services are required (Martinez-Vazquez *et al.* 2006).

The discussion so far suggests that there are three types of revenues that are particularly suitable to be transferred at the local level: property taxes; fees, licences and user charges; and some indirect taxes. Property taxes are the most important source of revenue for local governments worldwide (Bahl and Martinez-Vazquez 2007; Moore 2013) and section 2.2 is dedicated specifically to them. Fees, licences, and user charges are typically levied on very specific and localised services, such as markets, slaughter houses, parking, and registration of motor vehicles (Fjeldstad 2001a; Smoke 1993). They are therefore clearly related to a specific benefit or public service, which would normally be provided in a well-defined geographical area. Finally some specific indirect taxes can be transferred to the local level, and this is particularly the case for excises and some ‘sin’ or ‘bads’ taxes applied for example to lotteries, betting, or motor fuels (Fjeldstad 2001a). However, for redistributive reasons, the bulk of indirect taxes would still be the responsibility of the central government as it is argued for example in the case of value added tax (VAT) (Bird 2011; Fjeldstad 2001a). Indeed, consumption is likely to be distributed highly unevenly across a country – higher in large urban areas and lower in rural areas with a high prevalence of subsistence agriculture. In addition, the national government normally retains control over trade taxes (a major source of revenue for many developing countries) and income taxes. However, sub-national governments can apply a ‘piggyback’ tax added to the national personal income tax and sometimes also to excises that are set centrally (Bahl and Martinez-Vazquez 2007; Bird 2011).

Even when all the principles for revenue assignment are taken into account, it is important to ensure that the political responsibility for local taxes is transferred together with administrative functions. In the words of Martinez-Vazquez *et al.* (2006: 21), ‘if fiscal decentralization is to be a reality, sub-national governments must control their own sources of revenue’. This view, which is widely shared by experts (see for example Bird 2011), suggests that if decentralisation is to deliver on its promises, it must be a *true* decentralisation rather than just deconcentration or delegation. In practice this means that local governments must be allowed by law to set key tax parameters, most importantly the marginal tax rate, and they should be clearly seen by citizens as responsible for local taxes (Bird 2011; Martinez-Vazquez *et al.* 2006). This would trigger incentives for local officials to show that they are providing benefits and services in return for tax payments, thus establishing a relation of accountability with the citizens and sowing the seeds for a social contract. In many developing countries, where the central government has a strong leadership and sub-national governments are not very powerful, there may be political obstacles to the transfer of power and control over taxes to the local level. This can in some

cases be avoided through a good design of revenue assignment responsibilities; but if 'the central government in the end can control the actions of subnational governments, those governments may for most purposes be considered to be more agents of the central government than independent actors' (Bird 1990: 281).

2.2 Property taxes

Having in mind the list of principles for a good local tax, it is not very surprising that the property tax is the main source of local financing in many countries as it satisfies almost all these principles – at least potentially. Provided that administrative constraints can somehow be relaxed, it is certainly true that this tax could potentially generate sufficient amounts of resources to meet the principle of *adequacy*. In addition, it is a particularly stable source of revenue, as the tax base would not vary much at times of crisis or economic downturn. This feature, however, also means that the property tax is not typically buoyant with respect to economic growth: it does not grow automatically with economic growth or income. This is a particularly undesirable feature for local governments as they would have to go back to voters for consultation to increase rates or reassess properties if they want to achieve revenue increases. Moreover, by being levied on a rather immobile base, it prevents competition amongst regions. The property tax also benefits from rather low competition from higher levels of government, that are typically willing to leave it to the sub-national level. While this can be partly explained by the fact that the proximity to communities and land makes it easier for lower-tier governments to assess and manage the tax, it can also be due, from a cynical viewpoint, to the unpopularity that this tax usually faces (Bahl and Martinez-Vazquez 2007).

Importantly, the property tax can ensure a relatively good correspondence between tax payments and benefits. It is plausible that businesses and residential owners will perceive a benefit from public services, such as policing, street lighting and garbage collection that is proportionate to the value of their properties. In this sense, the property tax can be considered a 'rough kind of benefit charge' (Bahl and Martinez-Vazquez 2007: 3). It follows that it is vertically equitable since real estate, particularly in developing countries, is typically concentrated amongst wealthy landlords. Since the richest segments of society are usually better positioned to avoid or evade income taxes (see for example Fairfield and Jorratt 2014), the property tax can also play a role in redistributing the tax burden. This, of course, is true unless exemptions and preferences are granted (formally or informally) to the well-off to ensure political support. For example, Fjeldstad and Heggstad (2012) report that exemptions and political interference in collections are common in Anglophone Africa.

Due to these benefits, the property tax is generally recognised as the ideal local tax. It represented over 2 per cent of GDP in OECD countries in the 2000s, reaching 3–4 per cent of GDP in the US and Canada, but only 0.60 per cent in developing and emerging countries (Bahl and Martinez-Vazquez 2007). Despite its low share of GDP, the property tax represents an important portion of local revenues. Bird (2011) shows that in most decentralised states it is mostly levied at the state or local level, while income and indirect taxes are levied mostly at the central level. Bird and Slack (2006) report that 'property taxes accounted for 40 percent of all sub-national taxes in developing countries and 35 percent (up from 30 percent in earlier decades) in developed countries' (Bird and Slack 2006: 8). However, this share is lower in Africa, despite widespread reforms in the past two decades that introduced the property tax in most countries. In that context, it is normally a local tax levied mostly on urban properties, while rural areas are often exempted (exceptions are South Africa and Namibia) (Fjeldstad and Heggstad 2012).

It is therefore clear that this tax has an important role to play in local revenue generation. However, it is still underused in developing and emerging countries for two main reasons: administrative and political constraints (Bahl and Martinez-Vazquez 2007; Fjeldstad and

Heggstad 2012). First, since property taxes are usually not self-assessed, all the administrative burden falls on local administrations that already face severe capacity constraints. Administration of this tax requires relatively high costs related to information-gathering, assessment, and register-keeping, particularly when introducing the tax or during reassessments. The problems related to valuation may lead to a perception of inequality in the system, in turn creating compliance problems. Moreover, they make revenues even less elastic, as the tax base does not follow growth in the value of properties unless they are regularly re-evaluated (Fjeldstad and Heggstad 2012). As a result, the revenue yield may even be lower than the total costs involved in collection, potentially making this tax unattractive to local governments. Second, the property tax is particularly unpopular amongst taxpayers. Partly, this is due to the fact that it is not related to any earning, like the income tax, or easily concealed in prices, like VAT (Bahl and Martinez-Vazquez 2007). Moreover, in developing countries property owners may exert stronger resistance to paying a tax for which they see few benefits in return, particularly where housing conditions are poor and basic services are not provided extensively (Fjeldstad and Heggstad 2012).

Despite the importance of property tax, it is useful to put it in the more general perspective of local revenue generation. While the property tax accounts for 40 per cent of local taxes, it covers only 10 per cent of local government expenditure (Bird and Slack 2006). These numbers suggest the presence of a large gap between taxes and expenditure, which is filled almost exclusively by intergovernmental transfers.¹ In fact several authors (see for example Fjeldstad and Heggstad 2012; Martinez-Vazquez *et al.* 2006; Tanzi 1996) noted that if the standard principles for efficient revenue assignment are followed (see section 2.1), not much would be left for sub-national governments to raise in tax revenue. The largest sources of tax revenue in developing countries, namely trade and indirect taxes on goods and services, are levied exclusively (in the former case) or mostly (in the latter) at the central level. The problem is even deeper in developing countries, which normally 'err on the conservative side and assign fewer revenue sources than could be justified by fiscal federalism principles' (Smoke 2013: 5). As a result, in almost all decentralised states, and particularly in developing countries, transfers are essential.

2.3 Intergovernmental transfers

In the words of Bird (1990: 278), 'money is at the heart of intergovernmental matters in all countries'. Therefore the way in which local revenues, including transfers, are designed and implemented can tell a lot about the nature and quality of relations between the centre and the local level. Intergovernmental relations involve a variety of actors. The obvious ones are the central and sub-national governments, where the latter usually involve multiple levels. A variety of approaches to the intergovernmental distribution of power is possible, ranging from a complete empowerment of local governments where they are able to set their own tax systems; to a situation where most taxes are collected centrally, with some portion of them shared at the local level and very few options for local revenue generation (Smoke 2013). Even when the intergovernmental system is designed to give autonomy to the sub-national level, however, this may not translate in practice. Central governments may have an interest in exerting more control than necessary, therefore preventing true autonomy (Smoke 2013). Moreover, the powers and responsibilities devolved may not be commensurate with the administrative and political capacity of local governments. This may result in poor implementation, which in turn would undermine the positive political effects that may emerge, particularly in terms of accountability. If citizens believe the government is not providing the services they need, or not efficiently so, they will be reluctant to pay taxes, and tax collection will consequently be more reliant on coercion than on consensus.

¹ Some sub-national governments are able to count on borrowing, but this is not common practice in many countries and, even when they are allowed, loans are strictly capped for reasons related to national macroeconomic stability.

While the main relation of interest is the one between the central and local governments, it is important to keep in mind that there is a multitude of actors involved. Smoke (2013) provides a list of those, which includes:

local government oversight ministries (Ministry of Local Government, Home Affairs, Interior, etc.), coordinating ministries with a broad mandate to oversee an aspect of public sector operations (Ministry of Finance, Planning, Civil Service, etc.), special purpose ministries (Ministry of Rural Development, Urban Development, Special Areas, etc.) and ministries involved in service delivery (education, health, transport, etc.). (Smoke 2013: 10)

On the one hand, the involvement of central government agencies and ministries is necessary to ensure the coordination and consistency of local policies in the context of broader, national plans. On the other hand, even if all these actors were willing to cooperate with local governments, they may not be well coordinated, therefore creating a potentially large administrative burden for local governments.

As far as intergovernmental transfers are concerned, design issues mostly revolve around addressing vertical and horizontal imbalances. Vertical imbalance refers to the correspondence between spending responsibilities and available revenues at all levels of government. Since tax revenues typically only cover a portion of local expenditures in developing countries, transfers play a crucial role in ensuring vertical equity. Horizontal imbalance refers to equity in the distribution of resources amongst governments at the same level in different regions. Vertical equity considerations determine how much of the centrally collected revenue should be redistributed at the sub-national level, while horizontal equity considerations influence the formula used to share revenues across regions.

Considerations on vertical and horizontal equity are therefore at the core of the intergovernmental distribution of resources, which is typically regulated by a pre-set formula. Revenue-sharing formulas establish which taxes are redistributed at which level, through fiscal transfers, and by which amount. Such formulas can concern the whole pot of taxes, or specific tax types. Both options have been observed in developing and emerging countries. For example, Argentina, Brazil, Pakistan, and Russia had experiences with sharing only specific tax types (Fjeldstad 2001a). However, this may create distortions as, for example, central governments may have an incentive to increase revenues from the source that is not shared, to maximise the amount of revenue available to them. Moreover, distortions can be introduced if, for example, central governments favour rate increases for taxes that are shared sub-nationally rather than taking the most efficient decision on what tax rates to increase. For these reasons, the best way to organise revenue-sharing is to decide on a percentage of the whole pot of taxes to be shared across levels of government (Bird and Smart 2002; Fjeldstad 2001a).

Furthermore, the formula may imply some degree of conditionality related to local performance with respect to specific objectives – typically, the provision of public services that are considered essential such as health or education. Whether transfers are conditional or unconditional depends on broader objectives, but also on the political preferences of the central government and particularly the degree of control that it wants to keep over resources that are redistributed locally. Making transfers conditional may be attractive to central governments, to ensure coordination and national coherence as well as political control. If central control is so tight that the survival of local governments is conditional on approval from the centre, clientelistic intergovernmental relations may emerge. This would result in making local governments accountable to national political leaders, rather than to local taxpayers, therefore breaking the accountability link that is at the core of the potential political benefits of decentralisation.

There are also other, more technical, challenges that make full conditionality even less feasible and desirable. Put simply, the problem is that a region may perform poorly, for example in terms of access to basic services, precisely because it is underfunded. Transfers should take into account this possibility and still be available in poor regions despite poor performance. One of the ways to overcome this problem is to design matching grants with variable rates according to income levels (Bird and Smart 2002). This implies that a poor region with low income would be required to contribute a smaller proportion of public investments in, say, health, than a region with higher income. In other words, 'the matching rate faced by any particular locality for any particular program should therefore be higher the greater the degree of central interest and the lower the (expected) degree of local enthusiasm (price elasticity) and ability (income elasticity) to support the program' (Bird and Smart 2002: 905). While Northern countries such as the US and Canada have experimented with this type of matching grants, there are few good examples from developing countries. This is most likely due to the high information requirement that a good matching grant design requires, which is normally unavailable in developing countries.

Because of these difficulties, most developing countries adopt some form of block grant that is distributed to sub-national governments according to a formula that takes into account both expenditure needs and fiscal capacity (Fjeldstad 2001a). However, unconditional block grants clearly create a problem of incentives, since the availability of resources from the centre results in a soft budget constraint at the local level (Bardhan and Mookherjee 2006; Bird 2011). If the amount of transfers is decided *ex post*, any government would have the incentive to overspend and undertax. In this way, it would obtain citizens' approval for delivering services to the community without having to pay the political cost deriving from tax collection. Instead, the resources needed to cover expenses would come from taxation in other regions or from centrally collected taxes, for example on international trade. A way to make the budget constraint 'harder' is to decide *ex ante* the amount of transfer, according to a set formula based on characteristics that are not immediately manipulable by the local government, such as the region's population. While this type of formula helps in bringing some fiscal discipline to local governments, it is far from being a comprehensive solution.

The key remaining issue is information (Bordignon, Manasse and Tabellini 2001), particularly with respect to the assessment of fiscal capacity. The central government does not have all the necessary information on local tax bases to be able to separate poor regions with a small tax base (and therefore low tax revenues) from regions with larger tax bases but less enforcement (therefore appearing to have equally low tax revenues). Bordignon *et al.* (2001) show that a possible solution, at least theoretically, is to use the tax rate as a proxy for the size of the tax base and of the effort the government is making to collect taxes. The authors argue that if tax revenue is more valuable for a poor region, which may be plausible given the overall lower level of basic services, tax effort will be relatively cheaper. They show that if this is the case, a poor region would impose a higher tax rate while a relatively richer region would prefer a lower rate, therefore revealing the true size of their tax base despite information asymmetries. The argument holds in theory, but it is unclear whether it can be applied in the complex reality of a developing country.

In a way, transfers can be seen as an *unearned* source of revenue, as opposed to taxation that can be considered *earned*. On the one hand, in the case of taxation, local governments need to make the organisational effort to collect revenues and they have to engage in a reciprocal relation with citizens where they extract taxes in exchange for public services (Fjeldstad 2002). In this sense, taxation is *earned* because it has a clear administrative and political cost attached to it. On the other hand, transfers do not depend on this reciprocal relation with citizens, and in this sense they are *unearned*. Instead, they are provided according to a formula that cannot always take into account performance, or at least not fully, as discussed above.

2.4 Natural resource revenue

Natural resources can be considered as another source of unearned revenue since governments can benefit from it without having to engage in a reciprocal relation of accountability with citizens. The standard revenue assignment principles imply that natural resource revenues should be collected by the central government rather than at the sub-national level (Bird 2011; Fjeldstad 2001a). This is mainly justified by the fact that natural wealth is usually distributed unevenly across the national territory, making the intervention of the national government necessary to ensure some form of redistribution. Therefore, natural resource revenues usually reach sub-national governments in the form of transfers from the centre, and as such they are subject to the same issues of incentives and asymmetric information discussed in the previous section. These issues will not be repeated here. Instead, this section focuses on additional considerations that are specific to the distribution and management of natural resources at the sub-national level.²

Whether natural resources can produce positive economic and political outcomes is an open question and it depends on both the way in which revenues are extracted, and how they are redistributed at the national level. What is most relevant for decentralisation is the latter issue, on redistribution of resources. Arellano-Yanguas and Mejia-Acosta (2014) argue that the redistribution rules for natural resources depend both on economic and technical issues, as well as political issues. As far as the latter is concerned, they underline the importance of two dimensions in particular: the extent to which local actors are connected to national politics, and the degree of bargaining power that they have.

As in the case of intergovernmental transfers, the distribution of natural resource revenue at the sub-national level involves decisions on both vertical and horizontal equity. Let's start from the vertical dimension and the specific considerations needed in the case of natural resources. On the one hand, some types of natural resource revenues, such as royalties, are dependent on international commodity prices and therefore suffer from high volatility. So there would be a case for the centralisation of such revenues to protect local governments from volatile revenues that may make their budgets vulnerable to broader international dynamics and unsustainable. Instead, central governments can rely on various forms of stabilisation at the national level, such as stabilisation funds and a more flexible use of borrowing. On the other hand, it is desirable to share some portion of revenues with sub-national governments to satisfy their demands for participation in the benefits from resource wealth and to compensate producing regions from possible losses and negative externalities.

Interestingly, Arellano-Yanguas and Mejia-Acosta (2014) show that the fact a state is unitary or federal does not necessarily have implications for the extent of decentralisation of natural resource revenues. Federal countries like Mexico decentralise fewer revenues than unitary states like Bolivia and Peru. However, certainly federal states are better positioned to manage such decentralisation, along the lines of existing federal structures. Another interesting finding from the same authors is that unitary states tend to decentralise at the municipality level, while federal ones do so at the state or region level. This is consistent with a broader political argument in fiscal decentralisation, whereby centralised states favour transferring resources to the lowest levels of government because they usually are not powerful enough to represent a serious challenge at the national level.

The horizontal dimension is linked closely with the losses and externalities from extraction activities. Indeed, the key issue here is whether to redistribute revenues to all regions or just to those that produce the natural resource. The case for focusing only on producing regions is based on the idea that they should be compensated for the loss of non-renewable assets and for possible negative externalities due to the presence of extractive operations. In

² This section draws largely from the comprehensive work of Arellano-Yanguas and Mejia-Acosta (2014).

addition, producing regions can demand more revenue to finance the necessary infrastructure and public services required to support the extractive sector, as its presence may put additional pressure on already constrained local administrations. However, focusing only on producing regions has at least two problems. First, it is likely to create grievances amongst regions that do not produce natural resources but still feel entitled to their share of national wealth. Second, it may be difficult to limit the losses and externalities from extraction clearly along the lines of existing jurisdictions. A neighbouring region that is not producing natural resources may still have to provide services to allow the extractive sector to work properly and it may still be affected in terms of, for example, prices and labour market dynamics. Ideally, the central government would quantify externalities and feed a measure of these into a sharing formula. However, information problems are again at work, and make this very difficult in practice. Different countries have adopted different solutions: Peru redistributes only to producing regions, Brazil shares resources also with regions that provide essential services to the extractive sector, and Colombia has a mixed system where all sub-national governments get some share of total revenues (Arellano-Yanguas and Mejia-Acosta 2014).

3 What do we know? The practice of fiscal decentralisation in developing countries

The discussion so far has focused on the theoretical promises of fiscal decentralisation and on how different sources of revenue can be designed to bring about potential political and economic benefits, as well as to overcome potential challenges. If a system is well designed there are, in principle, great gains to be obtained from fiscal decentralisation. For example, local taxes may trigger virtuous circles of social accountability; the decentralisation of tax and expenditure may result in efficiency gains since fiscal choices would be more aligned with citizens' preferences; and local political institutions can be strengthened by being empowered with new functions and responsibilities. However, even if such positive effects are plausible in theory, do they occur in practice?

A recent paper argues that the theory and practice of fiscal decentralisation are out of sync (Smoke 2013). This is not because policymakers in developing countries ignore the wealth of literature on revenue and expenditure assignment or the standard principles of fiscal decentralisation. On the contrary, these principles are generally followed in practice and it is very rare to observe an inappropriate allocation of revenue across levels of government. Instead, the reasons for the gap between theory and practice are more nuanced and complex. Although generalisations are difficult to make, the following factors can, in different combinations, contribute to explaining the practice of decentralisation (Smoke 2013: 8–23):

- *National political economy.* Decentralisation is a highly political, as well as technical, process. History and politics influence both its design and implementation, thus contributing to success or failure.
- *National bureaucratic environment.* A multitude of ministries and agencies are typically involved in decentralisation and they should not only be engaged but also coordinated to ensure positive outcomes.
- *Sub-national political dynamics and accountability.* Electoral and non-electoral relations of accountability and political power dynamics are essential to understanding outcomes from decentralisation. For example, the presence of political capture and powerful elites may result in distortions and inequalities; while the degree of awareness and interest of citizens affects political participation.

- *Capacity and leadership* matter greatly. However, it is important to understand the nuances of where capacity is needed (for example: valuations or actual collections of property tax?) and what type (classroom-type or hands-on?).
- *Lack of strategic orientation* in decentralisation and fiscal reform programmes, in the sense that not enough attention is paid to how reforms are *implemented* in technical, political, and institutional terms.

These factors are largely confirmed in the empirical studies reviewed in this section. Although this literature is very large, most studies are largely anecdotal and cannot offer solid and rigorous evidence. Therefore, before going into the details of the empirical results, section 3.1 provides an overview of the main methodological challenges encountered in the empirical literature. Against that background, and keeping in mind these caveats, sections 3.2 and 3.3 review the existing evidence to highlight the critical elements of success or failure, without aiming to be fully comprehensive.³ The outcomes of interest are divided in two broad categories: (1) public service delivery and other economic outcomes, such as inequality and poverty reduction; and (2) political outcomes, related to accountability and intergovernmental political dynamics. Clearly, however, this distinction is somewhat fictitious since economic and political aspects coexist and are closely interrelated in practice. In addition, section 3.4 looks at the interaction of various sources of local revenue and how it can affect the effectiveness of fiscal decentralisation.

3.1 Methods and challenges in empirical research

In an ideal world, studies on the impact of fiscal decentralisation would compare two situations, one with decentralisation and one without, with identical conditions otherwise. For example, researchers may want to analyse a country before and after decentralisation occurred, but where all other conditions have remained the same. Or, they may compare two countries that are very similar under all other circumstances, except that one is decentralised and the other is not. However, these ideal settings are hardly ever found in practice. Policy changes do not occur in isolation from other country-level developments, and countries are different in a number of ways. Therefore, researchers have to work creatively to approach as much as possible these ideal conditions, while still working in environments where multiple confounding factors coexist. In doing so, they face at least three sets of obstacles.

First, there is no uniform measure of decentralisation. Some studies use the ratio of local tax to total regional revenues (Caldeira, Foucault and Rota-Graziosi 2012), most use share of sub-national expenditure over total government spending (Sepulveda and Martinez-Vazquez 2011), while others use both (Sow and Razafimahefa 2015). Although these measures are closely related, they capture different aspects of decentralisation. In some cases, the preference for one measure is clearly stated according to the study's objective. For example, studies looking at decentralisation's effects on the efficiency of public service delivery may find it more relevant to use the expenditure ratio. However, the share of decentralised expenditure is not necessarily a measure of how autonomous local governments are in making decisions on these expenditures. Therefore it does not necessarily give us information about the nature, quality, and effectiveness of decentralisation, as recognised by some authors (Faguet 2008; Ivanyna and Shah 2010; Tranchant 2008). A detailed discussion about potential measures of decentralisation and what they can or cannot capture can be found in Ivanyna and Shah (2010). On the other hand, revenue decentralisation is more indicative of fiscal autonomy, and is therefore expected to be closely related to accountability and responsiveness (Caldeira *et al.* 2012; Sow and Razafimahefa 2015). These challenges make it difficult to ensure that the chosen measure actually captures the intended process, and not broader political dynamics. Moreover, the use of different

³ A more comprehensive list of sources is reported in the Bibliography for the interested reader.

measures in the literature sometimes prevents the comparison of specific results across studies.

Second, it is very hard to establish relations of causality from decentralisation to specific economic or political outcomes. In comparing communes or countries, it is generally the case that richer areas have higher levels of public services, higher fiscal autonomy (local taxes) and are generally wealthier. Across countries, high-income countries are typically more decentralised and have bigger governments than low-income countries. All these conditions occur at the same time, making it difficult to establish clear causal links between two specific aspects. In addition, pre-reform conditions, such as income per capita or the size of government, influence the potential impact of decentralisation, since there may be a minimum level of administrative and physical local infrastructure needed to reap its benefits. Quantitative studies address this issue with the inclusion of control variables, instrumental variables or other econometric methods such as GMM or fixed-effects panel data models (Caldeira *et al.* 2012; Sepulveda and Martinez-Vazquez 2011; Tranchant 2008). Despite the value of these techniques, often the econometric results are still not beyond doubt. Qualitative research can use comparative case studies to identify impacts of decentralisation, or to disentangle what the factors are that prevent or ensure that such impacts would occur. Although they can offer important lessons (Faguet 2008), these studies are still largely descriptive and do not necessarily address causality in a conclusive way. Moreover, decentralisation is likely to have indirect effects through the macroeconomic and institutional environment, that interacts in various ways with pre-existing conditions and with more direct outcomes. In fact, rather than looking for decentralisation's effects on institutions, it should be recognised that decentralisation is an institutional reform in itself and the manifestation of an institutional process that spans long before and after the actual decision to decentralise (Sepulveda and Martinez-Vazquez 2011).

Last but not least, adequate data to underpin rigorous analysis are not always available. Clearly, this is a bigger challenge in low-income countries that, as a result, are underrepresented in the literature. Moreover, cross-country studies are faced with the additional challenge of comparability: data cover different years in different countries, may be based on different definitions and may derive from different data collection procedures. While country case studies overcome this issue, their results are often difficult to generalise.

As a result of these challenges, the literature on fiscal decentralisation is relatively scattered and piecemeal, while still being quite vast.

3.2 Service delivery and economic outcomes

One of the obvious theoretical implications of fiscal decentralisation is that it can improve service delivery, since local governments can be more responsive to citizens' needs and preferences. Empirical quantitative studies have looked at whether this occurs in practice or not. For example, Reinikka and Svensson (2004) show that Uganda's public expenditures on education were largely captured by local officials and politicians rather than reaching the poor. The authors show that only 13 per cent of the central government grant to primary schools actually reached these schools. Additionally, the distribution of funds is found to be endogenous to the social and political background of the school: those catering for richer students can negotiate and obtain greater shares of funding, with obvious equity implications. Caselli and Michaels (2013) report similar results in relation to natural resource revenues in Brazil. The authors start by showing that oil wealth resulted in higher revenues for municipalities that, according to official reports, were reflected in additional spending particularly in the following sectors: housing and urban development, transportation, education, and health. However, microeconomic data from the Brazilian census reveals that this increased spending does not translate into better indicators related to these sectors or in income increases. While this may be due to a lag in time for the outcomes to occur, a

plausible explanation is that the political elite captures the oil revenues for activities of 'self-preservation' or just to enrich itself. An example of the former is the creation of patronage jobs or benefits to allies within the administration, for which the authors provide some supportive evidence. The importance of elite capture is also confirmed by Crook and Sverrisson (2001), showing that positive outcomes are less likely to occur where there is no challenge to local power structures, therefore leading to elite capture by a few powerful groups rather than broad-based accountability.

While elite capture may be an explanation for the missing link between resources and outcomes, it is also possible that local authorities do not have the necessary administrative and political capacity to spend. Or, in the words of Loayza, Rigolini and Calvo-Gonzalez (2011), they have 'more than they can handle'. These authors show that Peruvian municipalities struggle to spend the resources that are allocated to them, resulting in low execution rates. This is due to factors related to budget size and the allocation process, capacity of the municipal administration, local needs, and constraints related to political economy considerations. They conclude that decentralisation should focus not only on transferring resources, but also on building the necessary technical and political capacity for sub-national administrations to be able to handle such responsibilities. Therefore a gradual approach to decentralisation may be preferable.

Other papers tell a more positive story. Litschig (2008), using Brazilian data from the 1980s and 1990s, shows that federal transfers had positive effects on the quality of public services and particularly on educational attainment. This effect is particularly due to higher teacher-student ratios in municipal elementary schools.⁴ The cross-country analysis of Sow and Razafimahefa (2015) supports the presence of these beneficial effects on service delivery, with three important qualifications. First, the positive impacts can only occur once a basic level of public expenditure is already in place, showing a U-shaped relation between fiscal decentralisation and the efficiency of public services. Most low-income countries have expenditures lower than the necessary level. Second, the political and institutional environment influences this relation, both in terms of the level of corruption (negative effect) and the degree of autonomy of the local governments (positive effect). Third, revenue decentralisation has a positive impact on service delivery in all countries, illustrating the importance of transferring both expenditure and revenue responsibilities to the local level.

As far as Africa is concerned, Maro (1990) shows that in Tanzania decentralisation has been associated with positive effects of service delivery. Using data from the 1970s to the mid-1980s, after Tanzania's reform of 1972, the author shows that increased expenditure on roads, primary education, health, and clean water supplies has led to increased provision of these services in rural areas and has reduced the average distance from these facilities. However, the provision of services, despite being expanded, does not seem adequate as many facilities are shown to lack essential materials, staff and maintenance. This is a common feature of many low-income countries, where the overall quantity and quality of services provided in poor areas is very low. As a result, citizens are often dissatisfied with public services and this, in turn, can be an important factor in promoting tax resistance, as shown by Fjeldstad (2001b) for Tanzania. He argues that 'in circumstances where taxes are perceived to be unfair and people receive few tangible benefits in return for taxes paid, we may expect that only coercive methods of tax enforcement will generate tax revenues' (Fjeldstad 2001b: 295). Physical coercion to extract taxes can generate conflicts with taxpayers, preventing the generation of positive political or economic outcomes. In this context, donors can further undermine good governance by focusing on the level of tax collection rather than the process by which tax is extracted.

⁴ While this may seem at odds with the results from Caselli and Michaels (2013), it is important to note that this study looks at transfers rather than oil revenues, besides using a different sample of local communities in a different timeframe.

Other potential economic outcomes of decentralisation, such as reduced poverty and inequality, are closely related with the effectiveness of public services discussed above, since better services can be a channel for achieving such outcomes. Steiner (2007) develops a conceptual framework for the potential effect of decentralisation on poverty reduction, which includes various channels such as efficiency in service delivery due to informational advantages of local governments, increased local revenues, and participation. The validity of this framework is then tested in the case of Uganda. Confirming the argument of Smoke (2013), the author finds that the theory and practice are disconnected, for three main reasons. First, the limited level of participation and missed opportunities for dialogue result in a lack of information that prevents the potential efficiency gains: the local authorities are not connected to the preferences of the people. Second, local capacity and staffing are not aligned with responsibilities – an argument that is echoed repeatedly in the literature. Third, corruption and patronage, including in the relations with the central government, result in decisions being based on political advantage rather than efficiency considerations.

Crook (2003) largely confirms these results by showing that in several sub-Saharan African countries decentralisation has not led to a challenge to local elites that are either indifferent to pro-poor policies or reluctant to adopt them. Therefore, political processes both between the local government and citizens and between the local and central governments are key to obtaining the promised effects of decentralisation on poverty reduction. The author argues that:

the degree of responsiveness to the poor and the extent to which there is any impact on poverty are determined primarily by the politics of local-central relations and the general regime context – particularly the commitment of the central political authorities to poverty reduction.

(Crook 2003: 77)

The cross-country analysis of Sepulveda and Martinez-Vazquez (2011) contributes to this negative picture by showing that fiscal decentralisation increases both poverty and inequality. However, in the case of inequality, the negative effect becomes smaller with government size, eventually turning positive when governments represent at least 20 per cent of GDP. After this threshold, decentralisation can reduce inequality. However, as it was the case in Sow and Razafimahefa (2015), most developing countries are below this threshold and may therefore fail to reap the benefits of decentralisation. Evidence from Benin (Caldeira *et al.* 2012) supports the existence of a threshold beyond which decentralisation can help to reduce non-monetary poverty through improved access to basic services. Although all communes in Benin benefited from better access to drinking water and sanitation systems than under the centralised system, the effect of decentralisation on other services was more ambiguous. Only wealthier communes reap the full benefits in terms of non-monetary poverty, while poorer ones can even experience adverse effects. The latter are shown to focus more on basic services, such as drinking water, while neglecting primary education. This could potentially perpetuate and even exacerbate inequality in a decentralised system.

A more positive story can be told for Bolivia and Colombia (Faguet 2008). In both countries, moving decision-making from the centre to local governments resulted in a shift of resources from infrastructure and economic production to social sectors such as education, water and sanitation, and health. Moreover, poorer districts generally received more resources than under the centralised system, although overall equality in the distribution of resources deteriorated in Colombia. This may be due to a relatively equal distribution of resources under the centralised Colombian government, in contrast to the highly unequal pre-reform situation in Bolivia. The comparison between these two cases shows that outcomes are dependent on the situation preceding the decision to decentralise, including economic and political characteristics both at the central and local levels. In both countries local taxes increased following decentralisation, though more substantially so in Colombia than in

Bolivia. This difference is probably due to the sequencing of reforms that in Colombia focused first on local tax capacity and then on further administrative and political decentralisation. This allowed Colombian local governments to take additional responsibilities in a more gradual and effective way than in Bolivia.

As far as macroeconomic imbalances are concerned, Faguet (2008) also shows that decentralisation in Colombia has contributed to increased debt, fuelled by large borrowing by sub-national governments. However, it is difficult to establish causality given other economic imbalances occurring in the region at the same time. Still, this illustrates the importance of hard budget constraints to maintain fiscal discipline in a decentralised state. The cross-country analysis of Aldasoro and Seiferling (2014) looks specifically at the relation between decentralisation and debt accumulation. The authors show that vertical imbalances in local government financing can contribute to increased debt, therefore potentially representing a concrete danger of decentralisation.

3.3 Political outcomes

The evidence discussed in the previous section not only underlines the importance of political factors, but also identifies them as a prerequisite for the realisation of positive outcomes in terms of service delivery and poverty reduction. Some of the political aspects of local government financing have already emerged, such as the relations with national governments and the existing political environment. The following paragraphs review in more detail some of the evidence specifically focused on the relation between local revenue and political outcomes. The focus is on three interrelated aspects in particular: relations with the central government, quality of local institutions and leadership, and accountability.

First of all, several studies underline the importance of national politics and the relation between central and local politicians. Crook and Sverisson (2001) show that in the successful case of India (West Bengal), national politicians were highly committed to a pro-poor strategy and willing to actively support local politicians to achieve it. On the other hand, in failed cases like Nigeria and Mexico, central governments used the distribution of resources to establish or consolidate patronage relations. This is confirmed in the case of Sierra Leone by Jibao and Prichard (2013), who note that 'the large revenue gains described here coincided closely with the emergence of greater support for tax reform at the national level' (Jibao and Prichard 2013: 24). Importantly, national support in Sierra Leone did not imply direct interventions or increased resources from the centre, but rather encouragement of local governments to overcome tax resistance, though a demonstration effect and non-interference in local tax efforts. Equally there are examples where the central government's behaviour fuels factors associated with failure, such as patronage and corruption. For example Brollo and Nanniccini (2012) show that in Brazil discretionary transfers are allocated strategically to support mayors that are aligned with the president's coalition and to punish political enemies. Aligned mayors receive approximately one third larger discretionary transfers for infrastructural development.

This finding raises an important question regarding accountability: are local governments accountable to their citizens or to higher levels of government? Brollo (2010) shows that in the Brazilian case the latter is true. By looking at the release of reports from an anti-corruption programme, the author shows that municipalities where corruption violations were uncovered were punished by the central government with lower transfers. However, the central government reduced transfers selectively to non-aligned municipalities, to minimise political loss. While mayors who are both aligned with the president and not corrupt are rewarded with higher transfers, the central government helps aligned corrupt municipalities to go through the punishment process more quickly. The author argues that voters tend to punish corrupt politicians only if reports are unveiled no more than six months prior to the election. However, lower transfers to corrupt mayors trigger dissatisfaction and compromise

their electoral success. Crucially, however, electoral punishment seems to be driven by the manipulation of transfers by the central government rather than a reputation effect amongst citizens. Juul (2006) confirms this result in the case of Senegal, by showing that local officials are primarily accountable to the national party hierarchy rather than to citizens.

Second, and closely related to the issue of intergovernmental relations, different sources of revenue may have different implications in terms of the quality of local institutions. For example Brollo *et al.* (2013) show evidence in favour of a political resource curse where windfall resources have adverse effects on corruption and the quality of politicians. The authors use data from Brazilian municipalities to show a causal relation from increased transfers to higher corruption and to lower quality of political candidates, measured with education levels. A larger budget size, thanks to transfers, allows politicians to extract rents while still being able to please voters with public expenditure. Therefore, it is harder to detect, and thus punish, bad politicians when they can count on a large budget. This, coupled with a lower quality of political candidates induced by transfers, leads to an increased probability of re-election of incumbents. The quasi-experimental results in this paper support all these mechanisms.

However, cross-country evidence shows that decentralisation is not always associated with higher corruption. On the contrary, Ivanyina and Shah (2010) report that it can significantly improve good governance and reduce corruption. These authors make particular efforts to capture decentralisation as the actual movement of decision-making closer to the people. Using different measures, they show that political decentralisation matters, even when fiscal decentralisation is already taken into account.

As far as natural resources are concerned, there is a large literature on the natural resource curse at the national level (see for example Dalgaard and Olsson 2008 and Vicente 2010). However, less evidence is available on the effect of receiving large sums of natural resource revenue at the sub-national level. One of these studies is that of Arellano-Yanguas (2011), which looks at the case of Peru where natural resource revenues have been concentrated largely in the producing municipalities. Despite increased resources, producing municipalities still experience large popular discontent due to inefficient spending and increased political conflict. As far as the latter is concerned, the author shows that the *canon minero* (the transfer linked to resource revenues) is associated with increased social conflict. Importantly this effect is due to the presence of the *canon minero*, rather than of the extractive sector in itself. On the one hand, conflict arises between citizens and mining companies over the allocation of rents. The disconnection between local and central elites, as well as the institutional weakness of the central state, resulted in the inability of the national government to support local administrations and mitigate conflicts. On the other hand, the presence of the *canon minero* created conflicts between citizens and local governments, between levels of government, and amongst administrations at the same level due to the inequality in the distribution of the transfer. The author therefore concludes that the presence of natural resource revenue helps to aggravate the resource curse. More generally, it is still unclear whether decentralisation reduces or fosters local conflicts in practice, while this interaction is certainly related to the characteristics of ethnic minorities and to the local institutional environment (see Tranchant 2008).

Importantly, if external sources of funding have adverse effects on the quality of institutions and leadership, as the evidence above seems to suggest, they would also undermine local revenue generation through earned sources of revenue, such as property taxes. Indeed, political leadership and the quality of institutions crucially affect the capacity of local governments to extract taxes. The quality of local leaders is one of the key elements underlined by Smoke (2013) and it is confirmed empirically, for example in the case of property tax collection in Sierra Leone (Jibao and Prichard 2013). The latter study shows that strong leadership and political will are crucial, particularly in the case of property taxes where

enforcement involves confrontation with local vested interests. This evidence, combined, shows how the mix of local government financing can lead to a vicious circle where high reliance on fiscal transfers (or other external revenues, such as natural resources) may have adverse political effects on local administrations, which in turn compromises their administrative and political capacity to collect taxes, which closes the circle by implying even higher reliance on external sources of funding.

Third, existing political structures of participation and accountability matter, such as the existence of fair and competitive electoral systems, a tradition of democratic government, and institutional representation of the poor. Juul (2006: 844) argues that 'in rural areas of West Africa, people seldom make substantial requests for specific services in return for the taxes paid. Rather, the expectation is that such services will be provided through political patrons at local or national level'. Depending on how new elites of local administrators interact with traditional structures of power, decentralisation may improve accountability or weaken it even more. In Sierra Leone, areas where new administrators were closely related to previous traditional chiefs experienced lower levels of public services and perpetuated elite capture (Clayton, Noveck and Levi 2015). On the other hand, when local administrators are in conflict with traditional chiefs, such disputes and competition lead to better economic outcomes as well as improved accountability and legitimacy of local governments.

Looking at natural resources, Monteiro and Ferraz (2010) show that the presence of a democratic system can prevent them from having adverse effects on accountability in the long run. However, in the short run, the availability of royalties from natural resources still create a large incumbency advantage, for the two elections following the windfall boom. Leaders use the additional resources to increase public budgets, particularly by creating jobs, while no impacts can be found on service delivery (consistent with Caselli and Michaels 2013). This indicates the strategic use of funds to create patronage jobs and reward allies. In the short run governments can get away with extracting rents because voters do not have complete information on the size of the budget increase. However, in the longer term, when information becomes available and the increase in public sector jobs becomes visibly disconnected with service delivery, voters do punish politicians. If such democratic mechanisms are not in place, the positive political advantages linked to accountability and participation are unlikely to occur. Particularly, information is key in many cases, both in the sense of voter ignorance on the extent of resources and in the sense of political dialogue and participation over budget processes (see for example Steiner 2007 and Crook 2003).

3.4 Revenue mix

A few studies have looked specifically at whether and how earned and unearned sources of revenue relate differently with economic and political outcomes. This evidence seems to confirm the hypothesis that earned sources of revenue are more likely than unearned revenues to encourage political dialogue and accountability, with positive effects on service delivery and ultimately on economic development. However, it is important to keep in mind the nuances underlined in the discussion so far and the importance of taking into account the local context in which local governments obtain their sources of financing.

On the political side, Paler (2013) shows some support for this hypothesis by carrying out a field experiment in Indonesia. The author explores the difference between tax revenue and windfall revenue on accountability and the relation between citizens and the government. The main finding is that a higher reliance on earned revenue, compared with unearned windfall revenues, provides stronger incentives for citizens to monitor the budget. This result suggests that taxpaying enhances the demand for information about the public budget. An increase in the perceived share of tax in total revenue results in a greater sense of ownership over public funds and therefore stimulates participation, with positive implications in terms of accountability. On the economic side, Hoffman and Gibson (2005) try to separate the effects

of taxes and external transfers on service delivery. The authors analyse district-level data from Tanzania and Zambia to test whether the source of government income influences the type of policies adopted, as reflected in choices relating to the allocation of public expenditure. They find that in both countries an increase in local tax revenue results in a higher proportion of public expenditure used for service delivery, while an increase in external funds encourages local governments to spend more on consumption expenditures. Donor funds do not appear to have any systematic impact on local spending.

So far the discussion has focused on the relation between different sources of revenue and various types of outcomes – economic and political. However, it is equally important to look at how different sources of revenue interact with each other. If fiscal transfers directly reduce tax effort, some of the positive effects from local revenue generation can be undermined. In other words, there is a question of whether external sources of revenue crowd out tax effort. While this issue has been touched upon in other studies reviewed here, the following paragraphs focus in particular on studies that try to quantitatively estimate the direct effect of transfers on local tax effort.

A number of studies in the literature look at the issue of crowding out as a secondary research question, while the primary interest is on the effect of transfers or natural resource revenue on spending. In order to assess the effect on spending, however, authors ask the preliminary question of whether all additional revenues translate into expenditure or whether there is a crowding-out effect. If a new source of revenue simply crowds out another one, then total spending is unchanged and we may expect a small or no impact on outcomes as a consequence. For example, Caselli and Michaels (2013) and Litschig (2008) find no evidence that, respectively, natural resources or transfers decrease local taxes or other local revenues.

Other studies focus specifically on the tax effort question. Table 3.1 summarises the results of some selected studies and shows that in all cases considered the effect of transfers on tax revenue is negative. However, it is important to note the difficulty of establishing a relation of causality, rather than a mere correlation, between transfers and local taxes. As underlined by Besfamille and Sanguinetti (2004: 18), ‘instead of investing in reforming its tax administration, the local authority can also lobby the central government to obtain discretionary transfers’. In their theoretical framework, therefore, transfers are endogenous and they are determined simultaneously with local tax collections. Transfers may also be negatively associated with local tax collection when poorer regions, which have a lower tax base, receive more transfers, precisely because they are worse off. If these issues is not tackled properly in the econometric estimation of the effect of transfers, we cannot interpret the negative effects as adverse causal impacts. These challenges are clearly related to the previous discussion on methods in section 3.1.

Table 3.1 Local tax effort: A crowding-out effect?

Study	Country	Effect on tax
Liu and Zhao (2011)	China	negative
Mogues and Benin (2012)	Ghana	negative
Panda (2009)	India	negative
Rajaraman and Vasishtha (2000)	India	negative
Sivagnanam and Naganathan (1999)	India	negative
Besfamille and Sanguinetti (2004)	Argentina	negative

4 Conclusions

The overall question in this paper was: did fiscal decentralisation deliver on its promises? The immediate answer is that the evidence on political and economic outcomes is mixed and often disappointing. Increased local expenditure is not always transferred to citizens through better services and improved living standards; while political patronage and elite capture are still widespread problems. However, there are some success stories that should be acknowledged.

Perhaps the disappointing results are due more to unrealistic promises about decentralisation, than a failure of decentralisation altogether. There are many reasons why the theory, including the possible benefits from fiscal decentralisation, is out of sync with the practice, as discussed in section 3. Importantly, even a well-designed system may not be beneficial when it is implemented poorly. In other words, failure can occur even in presence of an acceptable design.

Section 3 has identified several factors that are key to success or failure. They can almost be seen as preconditions that need to be in place if the theoretical benefits of decentralisation are to be realised. For example, the relation between the national and sub-national levels is key on several levels. First, the central government should be politically committed to decentralisation and willing to effectively transfer power and authority to local governments. Second, it should provide strong leadership on objectives such as revenue mobilisation and poverty reduction. A strong state can also manage conflicts that may arise, both amongst sub-national governments for the distribution of central revenues and between local governments and citizens.

Existing local conditions, for example in terms of participation, capacity, and size of government, can determine the extent to which the benefits can be reaped in practice. While fiscal decentralisation can enhance accountability, a basic level of political participation and engagement at the local level is necessary for such an accountability relation to be established in the first place. So the relation between demands for accountability and successful fiscal decentralisation works in both ways. Similarly, some studies show that there may be a minimum necessary threshold of public expenditure below which decentralisation does not yield its promised beneficial effects.

More generally, there is a complexity of factors that explains the success of decentralisation and the outcomes from different sources of financing. The mix of critical factors is country-specific and highly dependent on existing conditions before and after decentralisation is implemented, including the reasons why the country embarked on such a process.

The available evidence seems to suggest a higher risk of adverse political and economic effects from unearned sources of revenue, such as transfers and natural resources. Instead, earned local taxes can trigger positive effects through participation and accountability, as discussed particularly in section 3.4. However, the evidence base on the positive effects of earned sources of revenue at the sub-national level is still rather thin.

Finally, additional rigorous research is required to shed more light on the factors and mechanisms through which decentralisation can be beneficial, both economically and politically. Such research will be facilitated as more data become available, as the lack or unavailability of sufficient data is one of the biggest obstacles to expanding the evidence base. More and better data may also encourage researchers to use methods that can establish causality more clearly, in addition to the insights from high-quality qualitative analyses.

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