

# THE IMPACT OF FISCAL AND POLITICAL DECENTRALIZATION ON GOVERNMENT QUALITY\*

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Fiscal decentralization refers to the distribution of tax revenues and expenditures among the different levels of government. A system is more fiscally decentralized the greater the proportion of tax-revenues and expenditures “owned” by lower levels of government. Political decentralization takes different forms: *electoral decentralization* (a country holds regional and/or local elections); *decision-making decentralization* (a country’s constitution assigned at least one policy area exclusively to sub-national governments, something which is typical of federations); *bicameralism* (a country has a regionally chosen upper house that could block lower house financial legislation).

Government quality refers to several dimensions: control of corruption (the extent to which public power is exercised for private gain as well as capture of the state by elites and private interests); (2) rule of law (the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence); (3) regulatory quality (the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development) and; (4) government effectiveness (the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government’s commitment to such policies).

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Theoretical arguments have been advanced to explain why fiscal and political decentralization may either reduce or increase government quality. Fiscal decentralization puts resources in the hands of better informed benevolent local governments and thus potentially allows them to better cater towards their citizens. If sub-central governments are only interested in maximizing their revenues, then fiscal decentralization can improve their performance insofar as it opens up the possibility of inter-jurisdictional competition: people who feel over-taxed or over-regulated may vote with their feet and move towards jurisdictions that apply less fiscal pressure on them. On the other hand, inter-jurisdictional competition may reduce the tax resources available to sub-central governments to the detriment of government quality.

Political decentralization in the form of sub-national elections empowers voters and so is likely to improve government quality but it may also lead to the capture of sub-national politicians by special interests thereby having the opposite effect. Political decentralization in the guise of a bicameral system may protect against bad government but it may also prevent improvements in government effectiveness. And political decentralization in through the allocation policies to sub-national governments may either improve government quality (since sub-national governments are better informed) or reduce it, if it makes more difficult for citizens to assign merit or blame to the different levels of government.

Based on a sample of up to 101 countries over the period 1998-2006 and controlling for a whole set of variables which may influence government quality, we have applied standard econometric techniques to analyze the impact of fiscal and political decentralization on government quality as previously defined. Our main finding is as follows: fiscal decentralization improves government quality but political decentralization reduces the positive effect of fiscal decentralization on government quality and, importantly, it does so much more strongly in immature democracies (those with less than 50 years of continuous democratic rule). This is not surprising since the relevant

literature has attributed the beneficial effects of democracy to the extent to which democratic norms and practices have taken root among citizens. These norms are transmitted from one generation to the next through a process of socialization. The longer a country has experienced democratic rule, then democratic norms have diffused more extensively and intensively.

Our empirical analysis suggests that insofar as the objective of decentralization is to improve government quality, then this should take the form of fiscal rather than political decentralization. But, of course, governments may decentralize for other reasons: to overcome macroeconomic instability; to respond to pressure from the people for democratization; to diffuse secessionist tendencies. If political decentralization is pursued to fulfill some other objective then, from the perspective of government quality, it is likely to be more "affordable" in mature democracies.