

2. Understanding decentralisation: theory, evidence, and practice

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Summary

What is decentralisation, what is its underpinning rationale, and why might it matter for development? This chapter reviews five decades of research on decentralisation and has three overarching objectives:

- a. to understand what decentralisation is, what it is not, and connect conceptual ambiguities in the literature to the mixed and inconclusive results that for so long plagued it;
- b. to distil an enormous literature on international experiences of decentralisation into clear empirical conclusions; and
- c. to derive policy lessons for countries considering decentralisation on how best to assign power over expenditures and responsibility for service provision, and also authority over taxation, among different levels of government.

I propose a concise definition of decentralisation that is both conceptually clear and empirically tractable, and review empirical evidence on decentralisation's ability to overcome some of the key obstacles holding back development.

Beginning slowly in the 1960s, and with gathering speed in the decades that followed, decentralisation has become one of the broadest movements and most contentious policy issues in development. Around the late 1970s it seized the imaginations of policy reformers, and has never really let go (Bardhan and Mookherjee 2006; Faguet 2004a; Manor 1999; Rondinelli 1981;

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Rondinelli, Cheema, and Nellis 1983; Ter-Minassian 1997). Many of us who began studying the phenomenon three decades ago assumed that the decentralisation wave was then cresting. To our surprise, the wave has continued to build across the world and shows little sign of subsiding.

A 1999 study by the World Bank estimated that between 80 and 100 per cent of the world's countries were implementing decentralisation in one form or another. This includes not only well-known reforms in developing countries such as Bolivia, India, and South Africa but also – under the guises of subsidiarity, devolution, and federalism – deep reforms in some of the world's most developed countries and regions, such as the EU, UK, and US. Since then, new or deepening reforms have been announced in more than 35 countries as diverse as South Korea, France, Cambodia, Turkey, Japan, and Kenya. It is not just the breadth of reforms across countries that impresses but also their depth. Campbell (2001) shows that, across Latin America, between 10 and 50 per cent of all central government revenues are now spent by subnational governments. Hence, we can summarise that decentralisation is happening, or has recently happened, in the vast majority of countries across the globe, with significant effects on these countries' fiscal accounts and (as we shall see below) on how they are governed.

Worldwide policy experimentation has been accompanied by a huge outpouring of research attempting to ascertain the effects of decentralisation on different aspects of economic, political, and social development. These studies often find contradictory outcomes across different countries, and even within countries. From the late 1980s onwards, study after study bemoaned the decentralisation literature as indeterminate, confusing, and of limited use to policy reformers. Policymakers were left little wiser about whether they should pursue reforms, or how they should proceed if they did. But recently, more sophisticated empirical approaches have combined with fundamental methodological insights to find a way through this tangle of apparently contradictory evidence.

What relevance does decentralisation have for developing countries with comparatively poor infrastructure and weak state capacity? Many such countries have made tentative steps towards decentralising that are partial and still incomplete. What role, if any, should further decentralisation play in their attempts to improve public sector effectiveness and the provision of local goods and services? The question is particularly important because so much of the decentralisation literature focuses on high-income countries. This is for understandable reasons: many of the earliest decentralisations happened there, where data are comparatively high-quality and abundant, facilitating empirical study further.

But, at a minimum, policy lessons from this literature need translation before being applied to developing countries. The reasons for that are similarly straightforward. High-income countries tend to enjoy stronger tax revenues and higher levels of human capital. These combine to produce governments that are more capable, with more policy options and greater policy

flexibility, than less well-off countries. But, interestingly, many developing countries have stronger traditions of self-government at the local level, especially in rural areas, than more urbanised high-income countries. This may give them certain countervailing advantages that well-designed decentralisation programmes can take advantage of.

In sum, decentralisation is not the same for developing and developed countries. The purpose of this chapter is to provide some 'translation' by reviewing theory and international evidence on the ability of decentralisation to address state weaknesses in ways that promote human and economic development in middle- and low-income countries. In the sections that follow we first review the various definitions of decentralisation that researchers have put forward and examine the key theoretical arguments in favour of decentralisation that are most relevant for developing countries. We then outline the methodological advances that have allowed researchers to put order into this previously confused literature. We use these insights as a lens through which to review international evidence on decentralisation's ability to overcome some of the key obstacles holding back a country's development. And we draw lessons from the fiscal federalism literature on how best to assign powers and responsibilities over expenditure and taxation among different levels of government, and how to structure intergovernmental transfer systems to solve the problems that inevitably result.

2.1 Understanding decentralisation

What is decentralisation? What is its underpinning rationale? Why might it matter for a low- or middle-income country? This section briefly reviews the most important definitions of decentralisation in the academic literature, along with the underlying logic of each, in order to arrive at the most relevant definition. We then briefly outline the principal arguments in favour of this kind of reform, which have to do with deepening democracy and improving accountability of public officials to the governed.

The huge scale of policy experimentation with decentralisation has provoked an equally huge research literature examining its effects. This includes literally hundreds of published academic papers in peer-reviewed journals; if to this we add rigorous 'grey literature' studies conducted by multilateral organisations such as the World Bank, IMF, and IDB, as well as reputable think tanks, NGOs, and government agencies, the number ascends into the many thousands. But attempts to summarise the lessons of this research have left many scholars frustrated. The empirical literature appears to be broadly inconclusive, with many contradictory findings on any specific question of importance, regardless of region or countries' level of development.

As examples, consider three prominent surveys that sought to summarise the state of knowledge on decentralisation. Litvack, Ahmad, and Bird (1998) found that 'one can prove, or disprove, almost any proposition about

decentralization by throwing together some set of cases or data.' A follow-on study by Shah, Thompson, and Zou (2004), which reviewed 56 newer, more quantitative studies, found that decentralisation sometimes improved, but other times worsened, service delivery, corruption, macroeconomic stability, and growth across a large range of countries. Most pessimistically of all, Treisman (2007) found that the empirical literature's results are inconclusive, weak and contradictory. 'To date,' he concludes, 'there are almost no solidly established, general empirical findings about the consequences of decentralization.' This leaves us in a bizarre paradox: after 50 years of policy experimentation and hundreds or even thousands of studies, we appeared to know very little about whether decentralisation is good or bad for any policy outcome that we care about. And yet enthusiasm for policy reform not only persists but continues to grow.

More recent research has found a way through the empirical and conceptual thicket that has characterised the decentralisation literature (Faguet 2014). The solution contains three components: (i) definitional, (ii) empirical, and (iii) conceptual. On the definitional side, much of the literature's indeterminacy arises from the word's very different meanings. Slater (1989), Faguet (2012), and others have pointed out that 'decentralisation' is polysemic, meaning very different things to different people and in different countries where it has been implemented. A number of studies, particularly from the 1980s, begin by delineating different kinds of decentralisation, as if they were variants of the same underlying product. The typical taxonomy would include: deconcentration, delegation, devolution, and privatisation.

As we shall see below, the distinctions between these 'decentralisation variants' are crucial on both theoretical and empirical grounds, and hence it is important to consider them in more detail. *Deconcentration* is when central government shifts personnel, equipment, and offices from the capital city to cities and towns elsewhere in the country. Chains of command, reporting, and accountability, as well as fiscal flows in terms of expenditure and taxation, remain largely unchanged. The main point is to get public officials out of the centre and into the periphery. This can be beneficial when it brings more accurate and detailed information on local needs and conditions to bear on government decision-making. By spreading central government salaries and expenditures more evenly around the country, it can also be politically popular, and may contribute to reducing centre-periphery inequalities.

Delegation is when central government shifts managerial responsibilities for certain expenditures or service provision to organisations outside the regular bureaucratic structure, such as quasi-autonomous public agencies. Chains of command, reporting, and accountability are somewhat altered for the services in question, but public officials' incentives continue to point upwards, and the central government monolith may not be overly disturbed.

By contrast, *devolution* (or sometimes 'democratic devolution'; see Manor 1999) is a much more fundamental reform. It shifts power and resources from central government officials to local government officials with independent

mandates whom the centre cannot control. Its effect is to fundamentally change authority over, and accountability for, those resources and responsibilities that are decentralised. Instead of the central Ministry of Education being responsible for the operation of a particular primary school, for example, authority over that school passes to an elected local government. Rather than petitioning distant central bureaucrats, parents and other local citizens seeking to improve the school's operation can take their demands to local officials, whose electoral prospects they hold in their hands. The incentives of education-providing officials are thus shifted from upward-pointing, towards senior officials in the ministry, to downward-pointing, to voters.

Lastly, *privatisation* is the divestiture of public functions to the private sector via the sale or transfer of related assets. It is justified on the basis of improved innovation and managerial efficiency, which should result from the reorganisation of public services on a for-profit basis. Public goods and services that are privatised are typically subjected to careful regulation, as they may constitute essential services (for example, health, water) or natural monopolies (for example, water, electricity). Privatisation is the most radical of these four 'types of decentralisation'. Without elaborating further for lack of space, I will simply assert that privatisation – while an interesting and important phenomenon in its own right, and certainly worthy of study – is sufficiently different from the other three types that it should not, in my view, be classed as a form of decentralisation. It is better understood as one of a menu of additional measures often undertaken alongside decentralisation by reformers eager to reduce the size of the central state or radically alter organisational incentives, rather than as a reform that is analytically comparable to deconcentration or devolution.

The deeper problem with this definitional dissonance is that the literature has often treated these measures as if they were minor variants of the same underlying reform, akin to different flavours of ice cream. But, in fact, deconcentration, delegation, and devolution differ fundamentally in organisational terms. They establish incentives that are fundamentally different from one another, which public officials – being rational – respond to in fundamentally different ways. We should not expect their effects to be similar, and indeed they are not. Studies that compare countries that deconcentrated with others that devolved or delegated are committing a basic methodological error. It is no wonder that their empirical findings are indeterminate – the studies themselves are confused. Happily, the solution to this problem is straightforward: pick one form of reform and compare only examples of that. This is the first key to making sense of the cacophony of decentralisation results.

Henceforth we define decentralisation in a restrictive way that is clear and conceptually discrete, so as to facilitate analytical precision. *Decentralisation is the devolution by central (that is, national) government of specific functions, with all of the administrative, political and economic attributes that these entail, to democratic local (that is, municipal) governments that are independent of the centre within a legally delimited geographic and functional domain.*

With respect to *empirical evidence*, Channa and Faguet (2016) point out that not all empirical evidence is created equal. Studies differ significantly in terms of the sectors they examine, the questions they ask, and the strength of their empirical identification. By classifying empirical results according to these three criteria, the authors show that the evidence does indeed speak with a more unified, less confused voice. Higher-quality evidence indicates that decentralisation increases technical efficiency across a variety of public services, from student test scores to infant mortality rates. Decentralisation also improves preference matching in education, and can do so in health under certain conditions, although the evidence for the latter two is somewhat weaker at this stage.

The third key to making sense of our evidence is *conceptual*. For too long, we have asked the wrong questions of our evidence, along the lines of ‘Is decentralisation good or bad for X?’ where X may be any policy output or outcome of interest, such as primary education provision or PISA scores. The problem with this approach is that it assumes decentralisation is a relatively simple reform with symmetric effects across different subnational units. This misunderstands the nature of decentralisation, which involves the transfer of power and resources to subnational jurisdictions that differ from each other in important ways. We should expect such jurisdictions to behave in ways that are as different to one another as are their underlying characteristics.

Put another way, the correct answer to the question ‘Is decentralisation good for primary education?’ is ‘Yes, of course it is.’ And the correct answer to the question ‘Is decentralisation *bad* for primary education?’, in the same country at the same time, under the same decentralisation reform, is ‘Yes, of course it is.’ In the presence of decentralisation, some municipalities will behave in ways that improve primary education outcomes. But other municipalities will behave in ways that worsen it, and many other municipalities will muddle along without great improvement or decay compared to centralised provision. Such heterogeneity is in the very nature of decentralisation; it is built into the reform.

A better class of decentralisation research question admits heterogeneity from the start, and asks ‘Why are the good cases good and the bad ones bad?’ And, more importantly, ‘How can we shift the balance of outcomes away from bad realisations, towards good ones?’ To do so is to acknowledge that the outcomes of decentralisation are simply the aggregation of hundreds or thousands of local dynamics across a country. Hence, to understand the effects of decentralisation at the national level, we must first understand how local government works. Faguet (2009; 2012) provides a theoretical model of local government, with quantitative and qualitative empirical tests.

2.2 The benefits of decentralisation

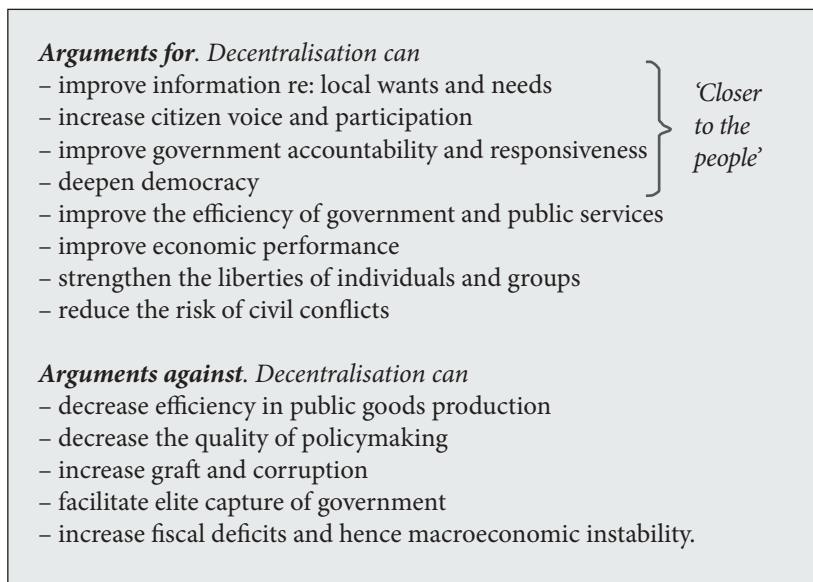
Why might decentralisation be a good idea? What are the key opportunities and constraints around which it should be designed to best suit a

developing country? How might it help a country overcome some of its biggest development challenges? This section examines key arguments in favour of decentralisation through the lens of some of the social and political-economic characteristics typical of many developing countries. We then review empirical evidence on the extent to which reform has helped overcome key development obstacles.

Enthusiasm for decentralisation has an enviable pedigree. Arguments about the benefits of devolving authority to subnational units of government stretch at least as far back as Montesquieu (1748) and *The Federalist Papers* (Madison, Hamilton, and Jay 1788). The belief that the natural or most advantageous organisation of society involves multiple hierarchical tiers goes back much further. Aristotle (350s–340s BC) deconstructed the Greek city state ‘into a three-tier hierarchy of households, villages, and the polis, each of which aims at a different good’ (Treisman 2007, pp.7–8). Building on classical reasoning, Dante (c.1314–20) argued that ‘Only in a pyramid of different-sized, nested communities could the full multiplicity of human potential be realized all at once’ (Treisman 2007, p.8).

Modern claims about the advantages (and disadvantages) of decentralisation follow this gist but are far more numerous, typically framed in terms of economic and political variables (Figure 2.1). Although they span a number of disciplines, and use distinct terminologies and catchphrases, we can summarise them as follows. We divide them into arguments for versus arguments against decentralisation. We list arguments against for clarity and fairness, but focus the discussion that follows on the conditions associated with positive decentralisation outcomes.

Figure 2.1: Arguments for and against decentralisation



Improving democratic accountability and responsiveness

The first four arguments listed in Figure 2.1 are tightly intertwined, and can be bundled together as ‘improving democratic accountability and responsiveness’ by bringing governance and decisions ‘closer to the people’. These are, in my view, the most important and powerful of all the arguments concerning decentralisation. In various forms and with different language, Mill (1895–61), Montesquieu (1748), Rousseau (1762), and Tocqueville (1835–40) all debated these points. This is what policy advocates refer to when they claim decentralisation will take government ‘closer to the people’. The latter is more slogan than argument, although there is an unfortunate tendency in that literature to present it as an argument. The more serious version of Wallis and Oates (1988), widely cited, holds that decentralisation makes government more responsive to local needs by ‘tailoring levels of consumption to the preferences of smaller, more homogeneous groups’ (p.5). While this account is descriptively correct, it is analytically insufficient. Why does homogeneity imply responsiveness? Is the fundamental problem one of scale? It is my view that the principal sources of responsiveness lie deeper, in the incentives that officials face in decentralised versus centralised government regimes.¹

The fundamental logic is as follows: by devolving power and authority from upper (usually central) to lower (regional or local) levels of government elected by their respective constituencies, decentralisation fundamentally changes the incentives that local authorities face, and thus – not surprisingly – their behaviour. (For ease of exposition, all subnational levels of government are henceforth referred to as ‘local’ government.) Under centralisation, those who hold authority over local matters are not elected by local citizens but rather *selected* by higher-level authorities, regardless of whether they are physically located locally or in the capital. Immediate accountability for their performance is thus upwards to the central government officials who have power over their salaries, careers and broader professional prospects (Riker 1964). Accountability does not run downwards to the citizens who consume the public goods and services they are meant to produce except at one or more removes, in the sense that central government officials are ultimately beholden to national electorates. ‘Local’ officials thus face clear, strong incentives to respond to central government priorities and concerns, and weak, muffled incentives to respond to local citizens’ needs.

The most important effect of decentralisation is to reorient these incentives. ‘Local’ officials become local officials, whose tenure and career prospects are in the hands of the local citizens they serve, who elect them. The incentives that govern their performance are no longer received from on high but rather determined by those most directly affected by what they do. And accountability to local citizens is direct, no longer running through a national administration or various layers of bureaucracy.

This supply effect in the constitution of local authority generates a complementary demand effect. Citizens see the change in local officials’ performance, understand the incentive change that has occurred, and

become more involved in local politics (Faguet 2004b). They vote and exercise voice more because both tools are more powerful than before, and so more worth their while. This change will hold for both relatively homogeneous populations and those that are relatively heterogeneous, though the effect may differ in strength and type according to degree of homogeneity, as Mitra and Pal's results in this volume suggest. Elected officials, being largely rational, respond better to citizens' demands – not just because they 'should' but because it is in their interests to do so. The net effect is to shorten and tighten the loop of accountability between those who produce public goods and services and those who consume them.²

One of the main points of this chapter is that decentralisation works – if and when it works – through a fundamental effect on officials' incentives, and thence on government accountability to the governed. Surprisingly often, both enthusiasts and critics of reform omit this basic point in favour of second- and third-order arguments about whether decentralisation can increase growth or reduce ethnic conflicts, points to which we return below. Many of these things, such as inflation, the fiscal deficit, and ethnic conflicts and political stability in a nation more broadly, are important, and decentralisation may indeed affect them. But it does so via incentives and accountability; there is no direct effect. In the best cases, the new equilibrium that emerges after reform features greater citizen voice and participation and greater government responsiveness. It is one in which democracy has been both deepened and strengthened.

Boosting public sector efficiency and achieving faster economic growth

The fifth and sixth arguments in Figure 2.1 are also closely related. The case for decentralisation improving public sector efficiency follows directly from greater accountability and responsiveness. A public sector that is more responsive to citizens will tend to produce public goods and services better suited to local conditions and to citizens' needs (Khan et al. 2014). Such services will tend to be more effective in terms of solving real problems. More effective public services in areas such as education, transportation, and water and sanitation will, in turn, better support private sector activity. Private firms will find it easier to operate in such environments, and hence will be more likely to invest. This will lead to better economic performance and higher economic growth.

A separate logical chain posits that by increasing local governments' share of tax revenues, decentralisation gives them a larger stake in the performance of the local economy. This motivates local officials to implement policies that support businesses and promote growth for two reasons: (i) economic growth increases local tax receipts and hence officials' freedom of action, and (ii) growth increases officials' popularity. The effect is to make local governments compete for mobile capital by reducing public sector waste, inefficiency and corruption, and by providing infrastructure. When this happens

nationwide, efficiency rises and the economy grows faster (Brennan and Buchanan 1980; Hayek 1948; Jin, Qian, and Weingast 2005; Roland 2000).

Strengthening individual and group liberties

Scholars from Hamilton (1769–1804) to Tocqueville (1835–40) to Weingast (2014) have argued that, in a decentralised or federal system of government, strong, legitimate local governments can protect individual freedoms by checking central government abuses. They can use their resources to resist or counteract specific government actions (for example, by suing central government, or implementing a countervailing tax or credit), and can threaten the centre financially by withholding tax receipts, in defence of their citizens. Diaz-Cayeros (2006) related how, in late 19th- and early 20th-century Brazil, repeated attempts by the centre to encroach on state power and independence were resisted using such means plus the credible threat of violence. In Brazil, state-level police forces, especially of Minas Gerais and Sao Paulo, ‘constituted true armies that could effectively challenge the federal government’ (p.211).

As for individuals, so too for ethnic, religious, and other identitarian groups (Faguet 2019). Many developing states were born out of international agreements, often with arbitrarily defined borders based on colonial partition more than internal political factors, with little to hold them together beyond guarantees by the international system (for example, Englebert 2000; Herbst 2001; Jackson and Rosberg 1986). They exist *de jure* but perhaps not *de facto*. Unlike European states in which power over a territory and its population generally came first and sovereignty and international recognition followed, many developing countries have not been able to consolidate power in order to achieve the internal consent or territorial reach necessary to exert authority over the entire state (Jackson and Rosberg 1986). This is a fundamental problem facing many African leaders (Englebert 2000; Herbst 2001).

The state may instead be made up of different ethnic groups spread over sometimes vast geographic areas, each with its own customs, language, and culture. A consciousness of common nationality is often lacking. Citizens do not feel represented by the government and perceive that leaders cater mainly to people of their own tribe or region, rather than to all citizens equally. In addition, parallel or rival forms of authority (for example, traditional chiefs, religious leaders, or drug lords) may supersede the authority of the state (Myrdal 1968).

How might decentralisation affect these challenges? First, bringing locally elected subnational leaders from different segments of the country into government, and thus giving representation to people of different groups, may incite parts of the population that formerly felt excluded from the state to feel represented and included (Faguet 2019). Indeed, federal, decentralised institutions have long been recommended as a mechanism to hold together fractured, ‘multi-national states’ (Brancati 2004; Horowitz 2003; Lijphart 1977; Stepan 2001; Zuazo, Faguet, and Bonifaz 2012). Where divisions are

defined territorially, decentralisation is said to promote the formation of multiple but complementary identities where citizens can simultaneously carry both an ethnic identity and a national identity (Stepan 2001). Decentralisation can thereby act as a pressure valve for nationalist aspirations. In Canada and Spain, for example, decentralisation has been deemed a success in keeping fractious provinces like Quebec and Catalunya from seceding. In the UK, the devolution of regional powers to the Northern Ireland Assembly was the critical element that made successful peace talks with the Irish Republican Army possible.

But there are also many opposing arguments. Some claim that decentralisation will build a federalist mentality, undermining efforts to build national unity and identity. It may even deepen divides between groups and intensify conflict by reinforcing cultural or ethnic identities. Second, decentralisation may lead fractious groups to want ever more autonomy. In this vein, former British Prime Minister John Major argued against devolving powers to Scotland, claiming it was 'the Trojan horse to independence' that would lead to friction and eventually demands for full independence (Brancati 2009). With more power and independence, decentralised areas may realise they can manage their affairs better on their own. Decentralisation may give subnational leaders experience in governing. Several decentralised regions have seceded after first setting up their own decentralised institutions. South Sudan is one recent example.

The key theoretical issue is whether decentralisation will stoke centripetal or centrifugal forces. Opponents of decentralisation claim devolving power and resources will empower those who seek secession, and – if they prove reasonably competent – assuage citizens' ill-formed fear of the unknown by showing them local authorities who provide services and manage public budgets adequately. Proponents claim that the same stimulus – the devolution of power and resources to even secessionist politicians – will generate the opposite response. Like an onion, it will peel away the outer layers of support from such leaders and parties, stripping them of constituents whose demands can be satisfied by more limited measures of autonomy, such as local control over public services, minority language rights, and symbolic goods such as public art and celebration, so isolating the hard secessionist core that seeks full independence from the mass of citizens (Faguet, Fox, and Pöschl 2015a).

Which side of this argument is correct is not an issue of decentralisation per se but rather depends on the nature of the secessionist impulse and the source of such parties' and leaders' appeal. Where groups are distinct, geographically concentrated, and highly mobilised against one another through violence, it may be difficult to imagine continuing cohabitation within a single nation, barring the comprehensive defeat of one group. But where groups are harder to distinguish, or where they come together, or where mobilisations are only partial, decentralisation may offer the 'steam valve' required to satisfy those who actually demand autonomy, not full secession, and help to ultimately hold a nation together.

In practice, the more important factor is likely to be the regional specificity of elite interests. If coherent regional elites have more to gain from secession (greater control over resources at the cost of lost markets and lost influence) than autonomy (partial control over resources, continued access to national markets and policymaking), then national integrity is in much greater peril. Regional elites will have an incentive to invest in creating conditions propitious to national schism. Beyond funding political parties and campaigns, this may well extend to supporting armed insurgencies and investing in the sorts of violence against civilians that peace talks cannot later reconcile. The recent history of the Balkans richly and sadly illustrates this dynamic.

On the other hand, the evident success of both developed and developing federations that have strong regional identities but much stronger national identities, such as Brazil, Germany, India, and the United States, demonstrates that decentralised government can stitch together diverse countries in ways that lead to neither subnational tyranny nor secession. One of the keys is regionally diverse elite interests. There are undoubtedly powerful elites in Sao Paulo, North Rhine-Westphalia, Uttar Pradesh, and California. Any of these would rank as a medium-sized to large independent country in both population and GDP. It would be a perfectly respectable country of important weight in the international system. And yet secession is not seriously debated in any of these places. Why don't these states' elites agitate for secession?

Because their political and economic interests span state boundaries. Business and political leaders in California and Uttar Pradesh have more to lose than to gain from splitting from the other 49 US or 27 Indian states, despite the fact that all of them are smaller. Pulling up the drawbridges would leave elites in North Rhine-Westphalia and Sao Paulo unambiguously in control of a non-trivial country instead of a state. But, from their leading positions in these states, elites in all four exert considerable influence over much larger and more important countries. And they have access to considerably larger internal markets, and can influence international treaties that give them better access to the world economy and a stronger voice in international affairs. They benefit from the unity of a nation they can expect to sway and perhaps even lead. They would lose from its break-up. So they invest in unity, not division.

Interestingly, Stepan (1999) argued that another deciding factor in the ability of federalist states to hold together fractious groups is the timing of elections. When elections are introduced in the subunits of a new federal polity prior to countrywide elections, and in the absence of countrywide parties, the potential for subsequent secession is high compared to when national elections are held first. National elections produce a sense of common identity and purpose whereas subnational elections can generate fractious local parties. Of the nine states that once comprised communist Europe, six were unitary and three were federal. Yugoslavia, the USSR, and Czechoslovakia are examples of countries that first held subnational elections prior to national elections, and subsequently broke up into 22 independent states.

Can decentralisation be designed in ways that hold fractious groups together rather than promoting secession? Yes – by decentralising power and authority to a level *below* that of major ethnic, linguistic, or other identity groups. In this way, empowered subnational units will tend not to be identified with group identity or privilege. Rather than stoking divisive tensions, local government will instead become identified with issues of efficiency and service provision (Faguet, Fox, and Pöschl 2015a). In a country where an ethnic minority is concentrated in one region, decentralising to the regional level is far more likely, all else being equal, to reinforce ethnic divisions, and place authority and resources in the hands of those with most to gain from national break-up. Decentralising to the local level, by contrast, will create many units of any given ethnicity, and most likely others that are mixed. No level of government will be associated with any particular ethnicity, and hence not with ethnicity *per se*. Comparisons across local governments will tend to focus more on issues of competence in service provision than identity, revindication, or pride.

This is not to say that decentralisation somehow neutralises the importance of ethnic or religious identity for governance. Indeed, in this volume, Martinez-Bravo et al. (Chapter 6) find that the accountability-enhancing effects of village elections in China were larger in more homogeneous villages, and ascribe this to a greater capacity of such electorates to monitor their leaders. The leaders of homogeneous villages then implemented policies that better reflected villagers' underlying preferences. Likewise, Mitra and Pal (Chapter 7; also 2022) show in this volume that ethnically more diverse communities in Indonesia tend to use voting to choose their leaders, whereas more homogeneous communities use non-electoral, consensus-building methods. The former, furthermore, were more successful than comparable consensus-building communities in raising local income and local development. And Martinez-Bravo (2014; Martinez-Bravo, Mukherjee, and Stegmann 2017) showed differential effects of social heterogeneity on local development depending on how community leaders are chosen (elected vs nominated). These results all underline the more general point that decentralising to a level beneath that of the main ethnic or religious cleavage in a society tends to associate that identity with public investment and service provision rather than with group privilege and pride. It is not that identity ceases to matter after decentralisation, as those studies have shown, but rather that decentralisation redirects it from some of the destructive ways in which it can be activated by separatist leaders.

Complementary reforms that promote a single internal market for goods and services nationwide can also help by preventing the development of elites with regionally specific economic interests who might gain from national schism. These would instead be substituted by elites whose assets or historical bases might be in a particular region but whose economic interests are multi-regional, and who therefore have a strong interest in national integrity and growth (Faguet, Fox, and Pöschl 2015b). Specific measures such as improved

infrastructure and transport links can help bring this about, in addition to facilitating the flow of people and ideas across an economy, so binding it together from the bottom up.

Reducing the risk of conflict and facilitating power-sharing

The relationship between decentralisation and conflict has long been a topic of debate (Green 2008). Arguments overlap significantly with those on self-determination and secession, since the failure to integrate regions and minorities into the state is a key source of conflict. As argued above, decentralisation can accommodate diversity by giving territorially concentrated groups the power to make their own decisions about issues that most interest them (Lijphart 1996; Tsebelis 1990). This may diffuse social and political tensions and prevent conflict (Bardhan 2002). Giving groups control may protect them against abuse or neglect from the centre or from one another, which can cause conflict. For instance, if a group is experiencing economic disadvantage, it could be given the power to control its own resources and decide how to allocate resources. If fear of social extinction is the cause of conflict, it could be granted control over issues such as education, religion or culture in order to protect its language and customs (Brancati 2009).

Others take the view that decentralisation will instead lead to increased conflict with fractious groups. Roeder and Rothchild (2005), for example, contended that decentralisation will give subnational leaders the resources and 'institutional weapons' they need to mobilise the local population and demand more political power from the centre, thereby elevating tensions. Subnational leaders may also gain prominence and followers, and subsequently threaten the power of national political elites, again causing conflict. Some note that decentralisation has produced local leaders who discriminate against minorities in their own regions (Horowitz 2003; Lijphart 1993). Brancati (2009), for example, pointed out that allowing parts of northern Nigeria to adopt their own (Sharia) law has aggravated rather than defused tensions between Christians and Muslims, when the Christian minority was forced to comply. This underlines the importance of protecting minority rights, which theorists going back at least as far as the *Federalist Papers* (Hamilton, Madison, and Jay 1788), and including most major contributions since (see for example, Dahl 1971; Dahl 1989), have considered critical to the stability and sustainability of democracy as a form of government.

How can decentralisation be implemented so as to dampen, and not promote, conflict? Decentralised governments that are responsive to national minorities will drain tensions from the polity. But local governments that become 'little tyrannies', ignoring or oppressing local minorities, will stoke tensions, threatening not just particular governments but the notion of democracy itself. Hence decentralisation should be designed with strong local accountability mechanisms that align local leaders' incentives with the will of local citizens and allow voters to hold politicians responsible for

their decisions. And central government should enact strong safeguards of minority rights nationwide, to which individuals and groups can appeal in any locality.

How do we construct local political systems that promote responsiveness to voters and avoid little tyrannies? A well-developed political science literature on the trade-offs between descriptive vs substantive representation is relevant here. Descriptive and substantive representation are generally considered the two most important forms of electoral representation. Their main difference is that, in descriptive representation, representatives have similar backgrounds to the people they represent, whereas, in substantive representation, representatives focus on the issues most important to a particular group (Mansbridge 1999). But, beyond this distinction, lessons for policymakers are few. While some studies show that descriptive representation ensures substantive representation, others do not find a tight correspondence between the two, and so the literature is mixed in this respect (Bratton and Ray 2002; Mansbridge 2003).

In a post-conflict environment, or one where the risk of conflict is high, decentralisation can underpin power-sharing arrangements that settle power struggles and stave off violent conflict. This mechanism operates by creating or empowering subnational levels of government to which political power, responsibility, and resources, are devolved. In doing so it also creates new fora for political competition, and hence new prizes over which opposing parties can compete. This solves the winner-takes-all problem inherent to centralisation, where parties in government wield huge central government resources and reap huge rewards, and opposition parties are left to wither. In a federal system, by contrast, opposition parties can still win power over states and local governments (O'Neill 2003), and hence enhanced voice in national debates and opportunities to display competence in government. The penalty of losing national elections is much less steep, and so the temptation to win at any cost greatly lessened. This can help cement the peace in a post-conflict environment.

Decentralisation, for instance, has recently been advocated for Iraq and Afghanistan with exactly this in mind (Barfield 2011; Brinkerhoff and Johnson 2009). Green (2011) explained how Ethiopia's decentralisation process in the 1990s was part of a civil war settlement that successfully maintained the peace for three decades. The country was divided into 11 federal regions. This fragmented the political opposition, creating various new parties that competed against one another for power over the newly created regions, while preventing a return to conflict for power over central government. Peace was maintained and the government in power at the federal level remained free of coups (and electoral defeat) for three decades. Such shifts in power arrangements can be used to diffuse power struggles at the top. But, in other cases, decentralisation may merely shift conflict downward rather than eliminating it altogether. Uganda's government under President Yoweri Museveni implemented a decentralisation programme in 1986 in order to reduce national-level conflict.

While successful in this regard, Green (2008) argued that the ultimate effect was to replace conflict at the top with conflict at the local level.

Can decentralisation be designed so as to promote power-sharing? A properly operating decentralised system should naturally lead to the sharing of powers that have been devolved to different subnational levels of government. Few additional reforms are required other than the avoidance of electoral and fiscal distortions. In countries where politics is closed or captured, measures that promote open, competitive local politics will tend towards fairness and power-sharing, and away from capture and conflict. Electoral finance laws that support a level political playing field have particular importance in this regard, as one of the most powerful and prevalent ways in which democracy is distorted is through the flow of money into campaigns. Where political competition is open to new entrants and the playing field is level, elections will tend to be fought over issues of substance to local voters. In such places, political conflict and violence will tend to transform naturally into electoral contestation, which is by far the better outcome.

2.3 How to build decentralisation – a framework for development

Let us now turn to the specifics of policy design. How do we allocate powers and responsibilities across hierarchical levels of government? Which levels of government should we design in the first place? Which services and powers, and how many resources, do we devolve to which levels?

These questions are part of a different but closely related literature called fiscal federalism. Fiscal federalism focuses on two interrelated issues: who taxes and spends? That is, the division of taxing and spending responsibilities among levels of government (national, regional, local, and so on). And what is taxed and spent on? That is, the discretion given to regional and local governments to determine expenditures and revenues.

According to the fiscal federalism literature (Besley, Faguet, and Tomassi (2003) provide a useful overview), public services should be devolved to subnational levels of government when they have the following characteristics:

- Geographic specificity, meaning they are characterised by low externalities, or economic ‘spillovers’, to other regions or localities;
- Heterogeneous demand, meaning citizens across the country do not prefer the same public good or service – citizens in different locations have different preferences;
- Local information is important for their production, implying that such local information is comparatively expensive or difficult for central government to obtain; and,
- Low economies of scale, meaning it is not more efficient to produce a particular good or service in one, centralised way or location.

The broad principle of government design that fiscal federalism puts forward is the *encompassing principle*, which holds that powers and responsibilities should be assigned to levels of government such that all relevant externalities are encompassed by that level of government. Hence national externalities and public goods, such as national defence or a trunk highway system, are best dealt with by national governments, while local externalities and public goods, such as rubbish collection and street lighting, are best dealt with by local governments.

Building on this, one of the crowning achievements of fiscal federalism theory is the Oates decentralisation theorem (1972). This holds that local governments should be responsible for all forms of spending that do not inflict externalities on other jurisdictions. The level and type of such spending can be tailored to the desires of local residents. This is why services like rubbish collection, street lighting, and fire prevention are particularly well-suited to a high degree of decentralisation, that is, to local government. But it is important to note that actual political jurisdictions across most countries will rarely match the optimal scope of all the public goods and services that must be provided. Hence there will always be a need for intergovernmental cooperation among different hierarchical levels to provide a full suite of services.

How should decentralised tax systems be designed? Fiscal federalism puts forward five basic guidelines for designing revenue systems:

- local taxes should be as neutral as possible, such that they do not distort economic behaviour;
- the benefits and costs of local taxes should be clear to citizens;
- the incidence of local taxes should be equitable across taxpayers;
- administration and compliance costs should be kept low, implying that complex taxes should be retained by central tax authorities; and
- mobile tax bases should be taxed nationally, not locally.

Employing these criteria shows that the most appropriate local taxes for local governments in developing countries are property taxes and user charges. Property has the advantage of being easy to identify and assess, which is not the case for many other classes of assets or economic activity. Further, property values are linked to local prosperity and hence local policy. This provides local governments with an incentive to undertake policies that increase the size of the local economy. It also provides a channel by which local officials are encouraged to be accountable to local taxpayers. User charges include public transport fares, housing and business rents, market fees, and water and heating charges, to name a few. They help defray the costs of providing these services, and help make local officials directly accountable to the users of these services. Some highly developed countries also devolve income taxes and VAT to regional and local governments, although this is much less common in developing countries. The evidence shows that the lowest-income countries are unable to mobilise much local revenue through property taxes, partly

because citizens are not used to paying them and partly because in most localities poverty levels are high and property valuations are low.

For countries at any level of development, local taxes are likely to be greatly exceeded by local expenditure needs; this is doubly true for developing countries. How do we square this circle? The answer is intergovernmental transfers among different levels of government. In practice this tends to mean revenue-sharing by central authorities, who have significant advantages in raising taxes that are complicated or based on mobile assets, with regional and local authorities. Revenue-sharing can take one of two broad forms:

- a. *by formula*, for example on a per capita basis; or
- b. *by origin*, where tax revenues are returned to the localities where they originated, for example oil and mineral rents, or commercial taxes.

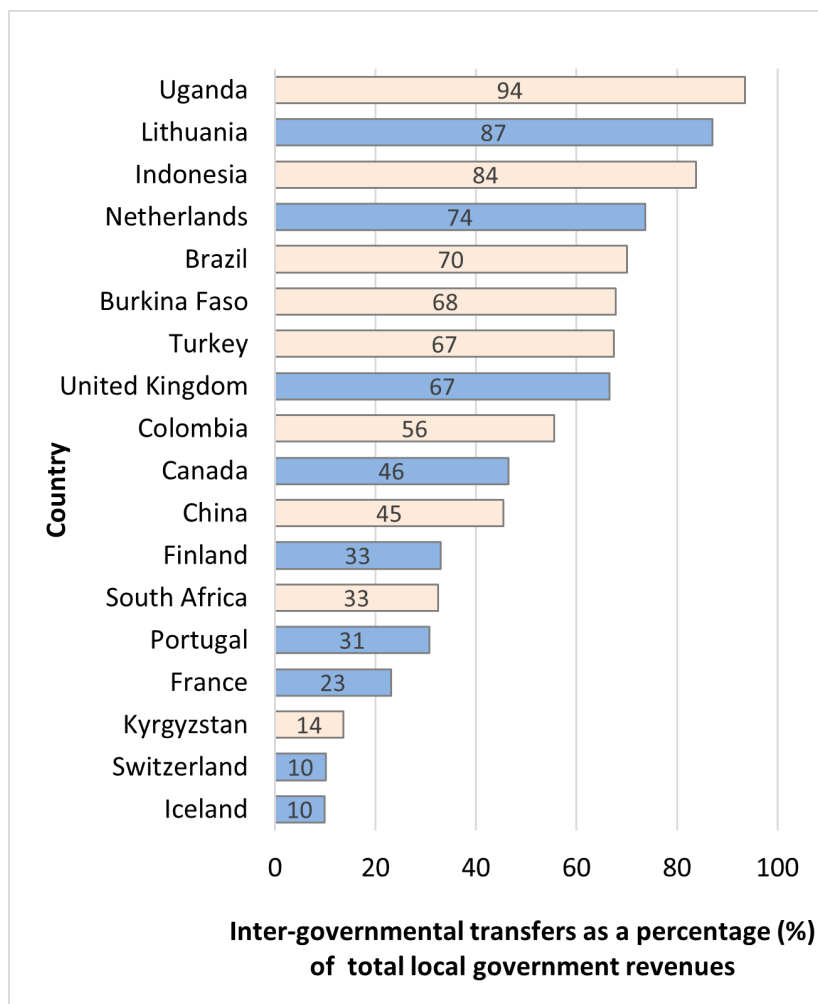
Additionally, central governments typically choose to make grants or subventions that are either:

- c. *targeted* to support specific expenditures, such as primary education; or
- d. *untargeted*, for discretionary use by local governments (for example, block grants).

Targeted grants are typically used to support priorities favoured by national government, while untargeted grants allow regions and localities to choose their own priorities. Targeted and block grants generally have two main purposes: vertical and horizontal equalisation. *Vertical equalisation* refers to attempts to close the gap between the costs of services devolved to subnational governments, and the revenues they are able to mobilise. *Horizontal equalisation* refers to the attempts to close the gap between richer and poorer districts' revenues. This is intended to ensure greater equality in public service provision, such that, for example, rich districts do not have much-better schools, roads, and water provision than poor districts, thus generating a vicious circle in which wealth begets wealth and poverty begets poverty.

How are these guidelines implemented in practice? Figure 2.2 shows the value of all intergovernmental transfers to local governments as a proportion of local government revenues for a selection of developing and developed countries. There is considerable variation among countries, from lows of 10 per cent in Iceland and Switzerland to more than 80 per cent in Indonesia and Lithuania and more than 90 per cent in Uganda. There do not seem to be any instantly obvious patterns by region or level of development. This non-pattern is broadly repeated for the larger set of countries for which data are available. It illustrates how considerably real-world practice differs from the principles of fiscal federalism outlined above, not least because many countries have implemented decentralisation only partially, a key point at the core of Deva-
rajan and Khemani's chapter in this volume.

Figure 2.2: Intergovernmental transfers as a percentage share (%) of total local government revenues, in 2020



Source: IMF Global Financial Statistics; OECD Fiscal Decentralisation Database.

Notes: Blue bars show European (or European-influenced) liberal democracies.

One of the overarching conclusions of the fiscal federalism literature, which would appear to be obvious but is seldom acknowledged and perhaps insufficiently understood, is that decentralisation does not do away with the centre. The decentralisation literature often portrays key policy options as ‘central versus local’. This is mainly a rhetorical device, and is very far from capturing what actually happens to fiscal flows and public authority in countries that decentralise. The reasons for this flow naturally from our discussion above. Decentralisation does not imply getting rid of one level of government in

favour of another but rather an increasing ‘complexification’ of public service provision in the interest of greater responsiveness, higher quality, and greater economic efficiency (in addition to a number of potential second-order benefits discussed above).

Decentralising the provision of education, for example, does not imply that budgets and authority over schools are transferred wholesale to local governments. Rather, it implies a new system in which central, regional, and local governments coordinate and cooperate intimately to mobilise revenues, hire personnel, define curricula, build infrastructure, and supply and maintain schools for the benefit of local children. A decentralised education system is far more complex than a centralised one, and will always involve multiple levels of government. But it is more sensitive, better informed, and more robust, and should produce better results (Faguet 2004a; Faguet, Khan, and Kanth 2020; Faguet and Sánchez 2008; Faguet and Sánchez 2014; Khan, Faguet, and Ambel 2017).

Conclusions

This review of decentralisation theory and evidence has found a great deal of signal in the noise within this immense literature. The ambiguous empirical literature rife with mixed results and contradictory policy advice that so many authors bemoaned for so long is actually less confusing than it initially appears. The way through this empirical and conceptual thicket involves:

- Defining decentralisation in a clear, restrictive, discrete way. I suggest democratic devolution, but others may be chosen so long as they are clear and analysts stick to them.
- Realising that all evidence is not created equal. Higher-quality evidence shows that decentralisation increases technical efficiency in public services and can improve preference matching too.
- Asking better questions about decentralisation that, in the presence of any specific reform, admit heterogeneity of response. Rather than seeking uniform or average effects, exploit instead the variation that naturally results from any decentralisation reform to explore why some subnational units perform better than others, and how we can shift the balance of outcomes from worse to better ones.

Done correctly, decentralisation can improve the democratic accountability and responsiveness of governments by changing the incentives that local officials face. Incentives shift from upward-facing in a centralised regime, where officials seek to please superiors at higher levels of the administration, to downward-facing in a decentralised regime, where officials seek to please voters. Done correctly, decentralisation can also improve public sector efficiency in ways that lead to faster economic growth. Local governments more attuned

to the needs of voters will also be more attuned to local economic conditions, and will tend to implement policies and investments that support growth in the local economy.

Perhaps less obviously, decentralisation can strengthen individual and group liberties by creating more levels of government that representatives of different social groups or minorities can use to promote their interests. In this way, decentralisation can stoke centripetal forces that help hold a diverse nation together, peeling layers of popular support away from the hard core of secessionist leaders who would split a country apart. Such dynamics are likely at play in countries like Brazil, Germany, and India, where powerful elites from important, coherent regions could invest in movements to divide their countries but choose not to. Decentralisation to a level below that of a nation's major social cleavage can help in this regard. Relatedly, decentralisation can decrease the risk of conflict and facilitate power-sharing if it is designed with accountability mechanisms that align leaders' incentives with voters', and strong safeguards for minority rights. The simple fact of creating subnational governments helps end the winner-takes-all problem inherent to centralisation that can destabilise a country by raising the cost of losing power to unacceptable levels.

How should decentralising countries allocate public powers and responsibilities across different levels of government? The fiscal federalism literature teaches us to devolve services with geographic specificity, heterogeneity in demand, low economies of scale, and where local information is important for their production to lower levels of government. Each level of government should be responsible for all forms of spending that do not inflict externalities on other jurisdictions. These services can then be tailored to the needs of local residents.

How should decentralised tax systems that pay for such services be designed? Local taxes should be neutral and non-distortionary. The benefits and costs of local taxes should be transparent to citizens. Tax incidence should be equitable across taxpayers. Administration and compliance costs of such systems should be low. And local taxes should focus on immobile tax bases. These guidelines imply that property taxes and user charges are most natural to local governments, whereas taxes on income and capital should be levied by higher-level authorities.

Subnational expenditure needs are likely to greatly exceed locally generated revenues. How do we square this circle? Revenue-sharing among levels of government by formula or according to origin, in ways that are targeted to specific priorities or untargeted, such as block grants, is the answer. But data shows that the real world diverges significantly from these ideal guidelines. The share of intergovernmental transfers in local government revenues varies remarkably among countries in the same region, or at similar levels of development.

Lastly, reformers should remember that decentralisation does not eliminate the centre, nor even debilitate it. Rather, it ushers in a new era of more complex service provision that demands coordination and cooperation among

multiple tiers of government. When such a system achieves its potential, it describes a public sector that is more responsive, more efficient, and more robust, producing outputs of higher quality for its citizens.

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Endnotes

- ¹ The degree of homogeneity of a population – ethnic, religious, or otherwise – is nonetheless important as it may affect the manner and ease with which local vs. central officials are able to aggregate public goods preferences (Alesina, Baqir, and Easterly 1999). I return to this issue in more detail in the discussion of individual and group liberties.
- ² Martinez-Bravo (2014) explored the extent to which decentralisation promoted democratisation or elite capture among local governments in Indonesia.

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