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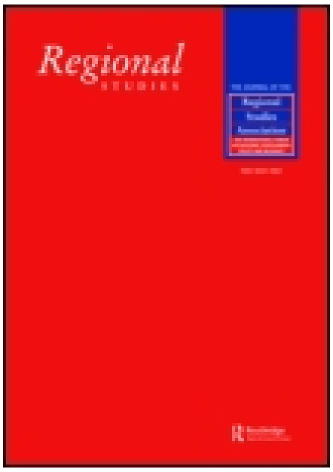

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On the 'Economic Dividend' of Devolution

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RODRÍGUEZ-POSE A. and GILL N. (2005) On the 'economic dividend' of devolution, *Regional Studies* **39**, 405–420. Recent political and academic discourse about devolution has tended to stress the economic advantages of the transfer of power from national to subnational institutions. This 'economic dividend' arises through devolved administrations' ability to tailor policies to local needs, generate innovation in service provision through inter-territorial competition, and stimulate participation and accountability by reducing the distance between those in power and their electorates. This paper, however, outlines two related caveats. First, there are many forces that accompany devolution and work in an opposite direction. Devolved governmental systems may carry negative implications in terms of national economic efficiency and equity as well as through the imposition of significant institutional burdens. Second, the economic gains, as well as the downsides, that devolution may engender are contingent, to some extent, upon which governmental tier is dominating, organizing, propagating and driving the devolutionary effort.

Devolution Economic development Efficiency Equity Institutions Economic governance

RODRÍGUEZ-POSE A. et GILL N. (2005) A propos du 'dividende économique' de la décentralisation, *Regional Studies* **39**, 405–420. Le discours récent politique et académique à propos de la décentralisation a eu tendance à souligner les atouts économiques du transfert de pouvoir des institutions nationales aux institutions sous-nationales. Ce 'dividende économique' provient de la capacité des administrations décentralisées de mettre au point des politiques locales faites sur mesure, de susciter de l'innovation dans la prestation des services par la concurrence entre les territoires, et d'encourager la participation et la responsabilité en rapprochant les décideurs de l'électorat. Cependant, cet article cherche à esquisser deux mises en garde connexes. En premier, nombreuses sont les forces qui vont de pair avec la décentralisation mais qui vont dans le sens contraire. Il se peut que des modes de gouvernement décentralisés entraînent des retombées négatives sur le plan de l'efficience économique nationale et de l'équité ainsi que par la mise en place d'importants fardeaux institutionnels. En deuxième, les atouts économiques, ainsi que les inconvénients, que pourrait entraîner la décentralisation dépendent, dans une certaine mesure, du niveau de gouvernement qui domine, organise, propage et conduit l'effort de décentralisation.

Décentralisation Développement économique Efficience Equité Institutions Gouvernement économique

RODRÍGUEZ-POSE A. und GILL N. (2005) Bemerkungen zur 'wirtschaftlichen Dividende' der Machtübertragung, *Regional Studies* **39**, 405–420. In letzter Zeit abgehaltene politische und akademische Diskussionen über Machtübertragung tendierten dazu, die wirtschaftlichen Vorteile der Machtabtretung von überregionalen auf regionale Institutionen zu betonen. Die 'wirtschaftliche Dividende' ergibt sich durch die Fähigkeit der neu ermächtigten Behörden, politische Bestrebungen auf Bedürfnisse am Orte zuzuschneiden, Innovationen bei der Bereitsstellung von Dienstleistungen mittels interterritorialem Wettbewerb einzuführen und Interesse an Mitmachen und Verantwortlichkeit durch Verringerung des Abstandes zwischen der gewählten Regierung und ihren Wählern zu wecken. Dieser Aufsatz umreißt jedoch zwei mit einander verbundene Vorbehalte: erstens gibt es vielerlei Kräfte, die eine Machtübertragung begleiten und in entgegengesetzte Richtungen streben. Übertragende Regierungssysteme können sowohl negative Implikationen enthalten, die sich in wirtschaftlicher Leistung und Fairness eines Staates auswirken, wie auch in der Auflage signifikanter institutioneller Lasten. Sodann hängen wirtschaftliche Vorteile, wie auch Nachteile, die eine Machtübertragung mit sich bringt, bis zu einem gewissen Grade davon ab, welche Regierungsstufe das Unternehmen der Machtübertragung beherrscht, organisiert, fortführt und antreibt.

Machtübertragung Wirtschaftliche Entwicklung Leistung *Fairness* Institutionen
Wirtschaftliche Regierungsgewalt

RODRÍGUEZ-POSE A. y GILL N. (2005) Sobre el 'dividendo económico' de la descentralización, *Regional Studies* **39**, 405–420. El discurso académico y político reciente sobre descentralización suele subrayar las ventajas económicas que supone la transferencia de poder de las instituciones nacionales a las subnacionales. Tal 'dividendo económico' emerge de la habilidad de

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las administraciones descentralizadas para adaptar las políticas a las necesidades locales, generar innovación en la provisión de servicios por medio de la competencia inter-territorial, y estimular la participación y responsabilidad reduciendo la distancia existente entre aquellos que están en el poder y sus electorados. Este artículo, no obstante, destaca dos factores que están relacionados entre sí. En primer lugar, la descentralización se ve acompañada de muchas fuerzas que ejercen una influencia en direcciones opuestas. Los sistemas gubernamentales descentralizados pueden acarrear implicaciones negativas en lo que atañe a la eficiencia y a la equidad económica así como cargas institucionales significativas. En segundo lugar, las ganancias de tipo económico, así como las desventajas, que la descentralización puede engendrar dependen, hasta cierto punto, de qué nivel gubernamental domine, organice, propage y dirija el esfuerzo descentralizador.

Descentralización Desarrollo económico Eficiencia Capital patrimonial Instituciones Gobernanza económica

JEL classifications: H77, O18, R51, R58

INTRODUCTION

As the global trend towards devolution[1] has accelerated over the last 30 years, the importance of understanding its consequences has greatly increased. Throughout the world, across federal and unitary states, large and small, developed and developing, the phenomenon of devolution has manifested itself to varying degrees. While some nation-states have simply witnessed a discontinuity or gradual erosion of the centre's dominance, others have experienced real and substantial shifts away from centralized policy-making, while, at the extreme, some have undergone wholesale dissolution and separation. The political rationale for devolution across the globe has also evolved, shifting from an emphasis on cultural, ethnic, linguistic or religious factors – which can be grouped under the banner of identity – to one of achieving economic and social change (KEATING, 1998). This is not to deny the importance of identity as a factor in the spread of devolution. But while ethnic, linguistic or religious fractionalization has often been present in a country for a long time, economic marginalization of ethnically, linguistically or religiously defined groups often acts as the catalyst for renewed pressure towards decentralization (AGNEW, 2001).[2] Hence, devolutionists today are often equally, if not more, concerned with economic progress and competitiveness as with issues of culture, identity and the preservation or promotion of heritage.

What is more, the perception that devolution brings about some sort of 'economic dividend' has become widespread (MORGAN, 2002). Since the works of TIEBOUT (1956) and OATES (1972), decentralized governmental systems tend to be regarded as more accountable, representative and conducive to policy innovations. They also offer greater choice, by making it possible for the individual to select, through the medium of inter-regional migration – or voting with 'one's feet' – which set of public service provision levels and mechanisms best suits his or her preferences (TIEBOUT, 1956).

The potential 'economic dividend' of devolution is, nevertheless, shaped by a series of factors. An understanding of devolution requires knowledge of the institutional geography in which economic forces seek to operate. It is, after all, *through* institutions that economics delivers its ends, so that the latter must remain contingent upon the former, with all the human and organizational complications that this entails (AMIN, 1999). By accepting institutions as important in determining the forms that devolution initiatives can assume (RODRÍGUEZ-POSE and GILL, 2003), one must also accept the social, political and cultural factors that provide the wider context for their operation (SAYER, 1985, 1995; MACLEOD, 2001). It is in this sense, then, that one understands 'economic governance' as that set of non-economic, non-formal forces that act to constrain, mould and even transform economic landscapes (MACLEOD and GOODWIN, 1999). Crucially, in combination, these concerns shed new light over the costs and benefits of devolution and can contribute towards a critique of the benefits with which devolution is traditionally and popularly associated.

Using this perspective, this paper exposes three potential economic downsides of devolution: efficiency losses, an argument which remains economic in orientation; equity concerns, which requires a political standpoint and underpins many of the drives towards devolution that have been witnessed in recent years; and institutional costs, an argument that aims to break open the 'government' and 'governance' black box and examine some of the practical ways in which devolution manifests itself.

Efficiency for the nation as a whole can be compromised under a devolved framework in which taxing and spending decisions, on the one hand, and responsibilities, on the other, are separated (as is often the case as devolution progresses), frequently resulting in spiralling debts under soft budget constraints (MCCARTEN 2003; RODDEN, 2003a). In addition, inter-territorial competition for industry is regularly driven by financial enticements at the subnational level, which can represent a dead-weight loss to the nation as a whole, as individual regions bid against each other in a zero-sum game at the national level (CHESHIRE and GORDON, 1996, 1998). In terms of equity – despite voices that claim that fiscal decentralization is linked to a reduction of regional inequalities (GIL CANALETA *et al.*, 2004) – there is growing evidence to suggest that devolution, at least in the case of large countries, may have regressive effects (Rodríguez-Pose and Gill, 2004a). As the equalization role of central governments contracts, the resulting competition between regions can strengthen the richer states at the expense of the poorer. In addition, richer regions have a greater capacity to influence government decisions and can benefit from this influence (Dillinger, 2002). Lastly, decentralization may also impose institutional burdens by increasing bureaucracy, complicating the assignment of responsibilities between governmental tiers, leading subnational governments to spend resources lobbying the centre and creating conditions conducive to additional corruption.

Furthermore, whether the economic pitfalls of devolution outweigh its possible benefits will largely depend upon which government tier is dominating, organizing, propagating and driving the devolutionary effort, which represents a second caveat to the 'economic dividend' that devolution is often expected to engender. The recent devolutionary trend should not be viewed as uniform. As Donahue (1997) underlines, devolution entails the decentralization of governmental responsibilities as well as resources. Consequently, different levels of government may have varying preferences over the form and content of devolutionary initiatives. Given that different forms of devolution hold very different economic implications, the relative influence governmental tiers have over the form and content of the decentralization process becomes an important determinant of the economic benefit, or cost, that devolution is likely to bring about.

With the objective of assessing the potential economic implications of devolution, this paper is structured around five further sections. The first section examines the extent to which discourse about devolution has shifted away from traditional cultural, ethnic, linguistic, and religious arguments towards economic ones. The second section reviews the theoretical support in favour of the notion of an 'economic dividend' of devolution, which underpins much of the emerging economic discourse. Subsequently, however, the two related caveats are explored. With detailed reference to countries throughout the world, the third section develops the possible economic downsides of devolution. And in the fourth section, the effect that different institutional drivers of devolution can have over the economic implications of decentralization initiatives is examined. The fifth section concludes.

ECONOMIC DISCOURSE OF DEVOLUTION

Historically, calls for the decentralization of power and the granting of subnational autonomy were centred on cultural, ethnic, linguistic and religious arguments. This discourse held up the value of preserving and promoting cultural and ethnic identity, reflected in subnational differences in lifestyle and modes of interaction. Devolutionists were often concerned that nationally and internationally defined identities, and the ceding of power to higher-tier authorities, meant compromising the uniqueness of regions and localities. Localities were seen as threatened places, under pressure from a plethora of influences, that were acting to undermine the 'nexus of interactions' that defined local spaces (Castells, 1996; Storper, 1997; Massey, 1999). Frequently, preservation of this uniqueness was to be achieved through resistance to changes that suggested convergence, uniformity or compromised autonomy. Hence, nationalist and regionalist forces tended to reject aspects of national control, first, and globalization in general, later, that attempted to integrate localities and regions into the culturally, politically and socially homogenous emerging world order that they often perceived.

More recently, however, devolutionists have found voices in the economic discourse, which has complemented their former support for regional continuity. Where identity per se once underpinned pressure towards devolution, economic marginalization of groups with a well-defined identity now underwrites similar arguments (Agnew, 2001). This shift towards a 'new regionalism' (Keating, 1998) has elevated the goals of economic change, faster growth and policy innovation to among the highest aspirations of decentralization protagonists (MacLeod and Jones, 2001; Morgan, 2002). In this new discourse, devolution is a means towards achieving local and regional autonomy and of 'fashioning complex economic and political endeavours' (MacLeod and Goodwin, 1999, p. 724), which can allow localities and regions to adapt to the new economic environment introduced through globalization, with less interference or encumbrance from above. Hence, instead of a rejection of economic globalization, the tendency recently has been to accept the new economic environment in order to establish firmly the role of the locality within it.

Moreover, changes are invariably necessary in order to establish a locality successfully. Recognition that regions must compete for their place in the international hierarchy has brought with it a more accepting attitude towards institutional and policy-oriented change in order to promote competitiveness (Agnew, 2001). Likewise the identification of the region as an adequate scale for the genesis of knowledge, innovation and economic networks has raised the profile of regional institutions as a vehicle to reduce a supposed 'economic deficit' (Jones, 2001, p. 1186). The devolutionist discourse has thus shifted from the promotion of decentralization as a means to preserve local uniqueness to decentralization as a way to adapt to, and therefore embrace, economic globalization. Put simply, 20 years ago, devolution was seen as a way to avoid homogenization and economic change – with all the socio-cultural disruption this implied – and today it is seen as a method to achieve it.

It is also through the rise of economic discourses to justify devolution that one can appreciate the increasing importance of economic governance, referring to the non-economic and non-formal factors that constrain and mould economic mechanisms. While economic regionalists enthusiastically tout the advantages of decentralized systems, other accounts recognize the importance of creating systems of governance that can bring these advantages about. Storper (1997), for example, suggests that information sharing and networking are replacing traditional market-based competition, and that regions are in a unique position to foster the private sector's mastery of these skills. Similarly, Storper's 'un-traded interdependencies' refer to region-specific assets that emerge from particular cultures: locally derived rules of action, social and institutional conventions, customs, understandings and values (MacLeod and Goodwin, 1999). In addition, devolution is often associated with specific political projects, as 'a particular territorial scale may lend itself to particular strategies for class relations' (Gough, 2004, p. 202). Again, these features of localities imply a role for the local state – a role for economic governance – in maintaining and fostering these advantages.

The evolution of the discourse of devolution has evidenced itself in numerous countries. During the 1970s and 1980s, cultural, ethnic, linguistic and religious concerns dominated the agendum. In Spain, for example, regions and nationalities with their own cultural and historical identity, such as Catalonia and the Basque country, led the devolution movement during the framing of the country's Constitution. For them, Spain had never been a homogenous country, and devolution was seen as a solution to the age-old problem of cohesion in a state where regions with strong political identities coexisted (Fossas, 1999; Viñuela, 2000). Similarly, in India, a high level of decentralization characterized post-independence development, as a reflection of its ethnic, linguistic and regional complexity (McCarten, 2003). And in Britain (where powers have been devolved to the Scottish and Welsh assemblies), as well as in France (where, despite the loss of a referendum, a large percentage of Corsicans still demand independence), it has been the cultural fault-lines that have steered and driven political decentralization in the past.

More recently, though, without entirely renouncing the traditional cultural, linguistic or ethnic arguments, devolutionary efforts are frequently legitimated through a consensus over the necessity for economic renewal and development. The Northern Italian Leagues were some of the first to base their devolutionary demands on economic criteria, after their relative failure to achieve a meaningful breakthrough using traditional ethnic or linguistic arguments (Segatti, 1992; Diamanti, 1993; Torpey, 1994). In the USA, calls for the decentralization of economic resources to accompany the increased authority granted under Reagan's New Federalism were based on the perceived inefficiency of the federal government (Powers, 1999). The UK government has recently made much of the potential economic advantages of decentralization in order to try unsuccessfully to convince voters to support devolution to the English regions (Tomaney and Ward 2000; Morgan 2002; Tomaney 2002). 'England's regions [were] being presented as part of a package capable of learning and innovating, in the hope of establishing a competitive advantage for economic growth in the global arena' (Jones, 2001, p. 1187). And even the traditionally more ethno-centric pro-devolution movements in Spain and Mexico are increasingly resorting to similar arguments (see Keating, 2001, on Spain; and Morton, 2002, on Mexico). As the economic discourse of devolution has emerged as a central justification for the decentralization of power, it has become more important to understand its logic, as well as its potential flaws. The following section therefore outlines the theory that underpins the shift in the economic discourse.

'ECONOMIC DIVIDEND' OF DEVOLUTION

The potential economic rewards from devolution draw upon three related areas. First, in a centralized system, policy-makers take decisions that are designed to reflect the interests of the entire country. This can be inefficient if those interests differ between regions, meaning that some regions may not benefit from the national policy. For example, different regions can have different preferences for the degree and form of the public sector service provision they receive, and the taxes they pay (Tiebout, 1956). If these preferences differ geographically then it is efficient to change the public sector's provision of goods and services across space to reflect this, and this is best achieved through decentralization. Moreover, if any particular individual finds him or herself in an area that does not cater to their preferred level of public sector provision, they can migrate to any area that does, improving their welfare, along with that of the nation as a whole, as they do so. In theory, this movement of people eventually ensures a closer match between national preferences and service provision, and therefore a more efficient delivery of public services (Tiebout, 1956; Ebel and Yilmaz, 2002). This matching of preferences to public services could not be achieved if only one level of services were available, making decentralized systems more efficient than centralized ones in this case.

There is evidence that regions alter their provision of public services following devolution initiatives, indicating that their preferences differed from those of the rest of the country, and that devolution could therefore be efficiency enhancing. For example, consider the provision of personal care in the UK. While in England the cost of providing free personal care is considered prohibitively expensive, the elderly (over 65) in Scotland have enjoyed free personal care since July 2002, following the formation of the Scottish parliament in 1999, which has sovereign power over healthcare (PADDISON, 2003). This distinction between publicly provided levels of service represents differences in preferences between England and Scotland that a uniform level of services could not accommodate.

Similarly, Northern Ireland and Wales have capitalized on the opportunities offered by devolution to strengthen their employment policies. In Northern Ireland, while the Department of Enterprise, Trade and Investment effectively replaced the previous Department for Economic Development, a new department, the Department for Employment and Learning, represents additional concerns for higher and further education, vocational training employment services, labour relations, and training grants that were underrepresented under the previous, more centralized system (DEL, 2001). And in Wales, the newly created Ministry for Education and Lifelong Learning reflects a similar concern for long-term structural development, undertaking additional responsibilities for publicly funded education, training, skills development, and employment policies that were not explicitly managed for Wales under the previous system (GOODWIN *et al.*, 2002, p. 209).

The second source of economic gains that devolution can engender is through policy innovations (TIEBOUT, 1956; OATES, 1994). If subnational units are made more responsible for their own welfare, this can give rise to creative attempts to improve their own revenues. Conversely, under a centralized system, fewer incentives to respond creatively to economic conditions are typically provided for subnational governments because their welfare is dependent largely upon the central government and not their own economic situation. Perhaps the best illustration of this is in the area of tax appropriation (RAO, 1997). At the end of the 1970s in China, for example, all taxes and profits were collected by local governments, remitted to the centre and then transferred back to the provinces according to expenditure needs (JIN and ZOU, 2003, p. 1). It became clear, however, that this provided few incentives for provinces to tax effectively, since an individual provinces' tax revenue did not depend on its own tax effort. Decentralizing reforms during the 1980s, in the form of a reduced role for the centre so that provinces retained a large proportion of their own tax revenues, greatly increased tax efficiency (MA, 1996). Similar effects can be seen elsewhere. For example, in Spain, it was the two regions with fully devolved fiscal powers, Navarre and the Basque Country, which have persistently spent the most per capita since the beginning of the 1980s. And in Italy, the more decentralized special statute regions spend on average much more per inhabitant than ordinary statute regions (PIPERNO, 2000, p. 11).

Nor do revenue collection and expenditure constitute the only areas of potential innovation. In Denmark, labour market policies have benefited from moves towards a decentralized structure during the mid-1990s, making the regions in charge of their own decision-making and confining the central government to a relatively passive role (ETHERINGTON and JONES, 2004). The Regional Labour Market Councils bring together local social partners – regional and local government, trade unions, and employers – in order to form labour market targets and priorities for each of the separate 14 regional jurisdictions. These are subject to approval by the centre but it is the region-specific knowledge of the local actors that facilitates the original plan formation, constituting a rejection of 'top-down', state-driven regional policy-making in favour of a 'new spatial order' (FOSGAARD and JORGENSEN, 1996). The key successes of this new order include better coordination between various local actors, strengthened involvement of the private sector, the development of local democratic structures and participation, and the production of a more inclusive labour market programme.

Furthermore, the attraction of mobile investment is becoming a central tenet of typical regional aspirations (CHESHIRE and GORDON, 1996, 1998), and labour market competitiveness, infrastructure development, and financial enticements all provide opportunities to innovate that may not be available under more centralized systems. Alongside the immediate income and employment advantages that competitive innovation can engender, countries can also experiment with far more ideas at the regional level – exposing the nation to less risk and making nation-wide policy improvements more likely (BRETON, 1983; TANZI, 1995; THIEßEN, 2003).

The third set of advantages that devolution can give rise to lie in the political realm. First, decentralization of decision-making can increase transparency and accountability by reducing the distance between politicians and their electorates (PUTNAM, 1993; AZFAR *et al.*, 1999; EBEL and YILMAZ, 2002). This said, in investigating the link between decentralization and the degree to which local governments take on the agenda of poverty in developing countries, CROOK and SVERRISSON (2000) found mixed evidence of this claim. Of 12 devolution programmes examined, only one provided a clear-cut case in which decentralization had led to improved accountability and better anti-poverty measures. On the other hand, six countries showed a worsening of accountability with four of these – Bangladesh, Nigeria, Mexico and Kenya – being judged 'unambiguously disastrous' in terms of accountability. They consequently conclude that local, case-specific politics is as important as technical programme characteristics in determining the impact of devolution on accountability. Second, however, regional and local governments may have advantages in information collection (assuming information gathering and diffusion is not costless), especially if local politicians are elected (KLUGMAN, 1994). For example, in West Bengal in 1978, the incumbent Left Front party involved village councils in the construction and implementation of pro-poor initiatives for the first time (CROOK and SVERRISSON, 2000). This resulted in the incorporation of women's viewpoints into institutionalized politics, as well as the legally enforceable representation of the Scheduled Castes and Tribes – two sources of information that had previously not informed policy-making. Following the success of this scheme, the innovation precipitated the 73rd amendment to the Indian Constitution in 1993 that made similar reforms a national requirement (MEENAKSHISUNDARAM, 1994). Third, the political payoff available through decentralization can be significant, although this leverage can be abused. In Mexico, decentralization as a populist strategy helped to prolong the term of the then incumbent Partido Revolucionario Institucional (PRI) during the 1990s (RODRÍGUEZ, 1997). And in Nigeria, the motive behind generous allocations of power and resources to local governments by the Federal Military since 1993 (Federal funds now account for over 90% of local government revenues) was not to empower local government but to by-pass and weaken the possible challenge from state-based (meso-level) political and ethnic elites (AWOTOKUN, 1995; OLUWU, 1997).

The 'economic dividend' of devolution generally draws upon the operation of these three factors in some combination. The increased efficiency that may be available through the more accurate geographic matching of public service provision to preferences, the policy innovations devolution can engender, and the enhanced accountability and transparency devolution may bring about, present some significant potential economic benefits (RODRÍGUEZ-POSE and BWIRE, 2004). Nevertheless, this is not the only side to devolution. While there are undeniable potential benefits that are made available under a devolved system, there can also be significant costs. The following section examines some of the risks of decentralization.

ECONOMIC RISKS OF DEVOLUTION

Inefficiency and devolution

Agency problems. The economic risks of devolution fall roughly into three categories: inefficiencies, inequalities and institutional burdens. In terms of inefficiency, devolution often results in a separation between those governmental units that take expenditure decisions and those responsible for financing. In such circumstances, and in the absence of hard budget constraints, decision-makers may fail fully to internalize the social costs of their spending decisions, making their marginal outlays suboptimal in terms of national welfare (INMAN, 2000). For example, if central governments increase the autonomy of subnational units, while simultaneously committing to finance their expenditure – either explicitly or implicitly – the incentive for subnational governments to exercise due discretion in spending decisions is compromised, since they can be confident of not having to pay the full cost of their own outlays. Hence, subnational governments can over-spend, so that the marginal cost of their expenditure can exceed the marginal benefit to the nation as a whole, even though individual subnational governments have acted rationally. The ability of central governments to control subnational expenditure under devolved systems of government therefore becomes a crucial determinant of the inefficiency that can arise through decentralization. Most importantly, if the central government can commit to not bailing out subnational governments when they generate debts through over-spending, so that they bear the full responsibility for their own expenditures, then this sort of inefficiency can be minimized (INMAN, 2000; RODDEN, 2003a).

The importance of establishing a culture of hard budget constraints with subnational governments is exemplified in the Central and Eastern European case, where most of national governments during the transition period were keen to set a strict precedent of subnational austerity from the outset. Hence, in Slovakia, central bail-outs became illegal; in Romania municipalities have been allowed to borrow but the loans must be repaid from locally generated revenue; in Turkey local governments are not allowed to borrow at all; in Hungary local governments are subject to strict and wide-ranging bankruptcy and insolvency laws; and in Estonia loans to local government must not exceed 15% of (shared, state and local) revenue (EBEL and YILMAZ, 2002). In total, 14 of 17 Central and Eastern European countries have a regulatory framework that controls sub-national borrowing, while only two – the Czech Republic and Slovakia – do not impose limitations. These regulations indicate the seriousness of the agency problems that a separation of spending responsibilities and financing introduces.

Similar concerns are evident in the US case, where the central government has traditionally all but disregarded pleas for financial aid from the states (see INMAN, 2000, for a detailed case history). 'When Philadelphia faced a fiscal crisis in August 1990, state politicians did not even consider federal relief as a policy option' (INMAN, 2000, p. 31), because of the strict precedent and reputation of the centre. One of the very few exceptions to this rule arose in 1975 when New York City experienced a fiscal crisis (see below). In general, however, 'on most dimensions, the U.S. performance has been a success. Most local governments live within their means' (INMAN, 2000, p. 32). This is the result of a strong culture of saying 'no' to federal handouts.

Unfortunately, the ability of other countries to establish a similar culture has not been particularly strong. Perhaps the most notable case is Brazil, where the culture of subnational government extraction from the centre has become ingrained since the framing of its Constitution in 1988, partly due to weak presidential power and partly due to the lack of strong national political parties that help to internalize the national interest at the regional level (DILLINGER, 2002; RODDEN, 2003a). The states' political dominance throughout the 1990s enabled them – especially the larger states – to issue bonds that resulted in deficits large enough to have serious macroeconomic repercussions, forcing the central government to bail out the states repeatedly. The contemporary concern is that the central government has lost so much legitimacy that it can no longer credibly commit to a tough budget constraint, increasing the likelihood of continuing debt crises in the future (RODRÍGUEZ-POSE and GILL, 2004b). The current Fiscal Responsibility Law, for example, was established in 2001 under the authority of the IMF, not the central government, indicating the helplessness of the latter to initiate much-needed reforms (IMF, 2001).

Furthermore, Brazil is by no means alone in experiencing these problems. In Germany, the *Länder* have extensive expenditure responsibilities but possess little freedom to raise their own revenue (RODDEN, 2003b). As a result, the dependency of the poor states on central assistance finds legitimacy, embodied in the Constitutional concern for 'equivalence of living conditions'. This has led to a culture of central underwriting of *Länder* expenditures so that *Länder* have had the freedom to continue to increase spending, run large deficits, and rely heavily on debt to fund current expenditures throughout the 1980s and 1990s (RODDEN, 2003b). Similar problems have occurred in Mexico, where the federal government had to bail out the states during the 1995 financial crisis (GIUGALE *et al.*, 2000). Furthermore, in Italy, radical steps had to be taken to deal with the soft budget constraint problem. The culture of subnational borrowing was endemic during the 1980s and the resulting financial crisis in 1992 prompted the Italian government to devolve substantial revenue-raising responsibilities to the regions – the ratio of own tax resources to total expenditure at the regional level increased from 3% in 1992 to over 50% in 1994 (BORDIGNON *et al.*, 2002) – in an attempt to equalize expenditure freedoms and financial accountability. And in China, JIN and ZOU (2003) expose various ways in which the Chinese provinces routinely over-spend, through indirect and foreign borrowing, as well as extraction from the centre through the use of 'extra-budgetary funds' that are largely unaccountable, and yet comprised almost half of total government revenue in 1996.

The agency problems that a separation between those government units responsible for payment and those responsible for spending can cause are widespread. Devolution can exacerbate these problems if it does not preserve the balance between fiscal freedoms and responsibilities, or introduce accompanying checks and balances to ensure that any new autonomy is not abused.

Territorial competition. Moreover, there is a second, separate source of inefficiency that devolution can entail. One of the central tenets of the devolutionary discourse is that increased regional autonomy provides the freedom that regions and localities need in order to compete effectively for mobile international industry. As devolution has progressed, therefore, there has been an increasing tendency for subnational governments to engage in competition for the attraction of foreign direct investment (FDI) (SCOTT, 1998; VERNON, 1998). Territorial competition per se can be beneficial when regions are forced to mobilize their local potential in order to attract investment. However, when subnational governments attempt to attract mobile industry through financial enticements, inviting private firms to choose between the most attractive packages offered by the states, the impact upon national efficiency can be damaging. The situation can be thought of as a zero-sum game, where the aggregate payoff of the game is independent of the final outcome across the players (CHESHIRE and GORDON, 1998). Specifically, the total national benefit of a firm arriving in a country will be the same, or very similar, no matter where within the country the firm chooses to locate. But there are costs involved in trying to affect the locational decisions of firms, because regions spend resources on tax grants, marketing, subsidies and favourable loan conditions in order to make themselves more attractive (RODRÍGUEZ-POSE and GILL, 2004a). These costs can therefore represent deadweight losses to the nation as a whole – a source of inefficiency that results from the territorial competition that devolution can promote.

Territorially competitive behaviour is in evidence in numerous countries around the world. In their study of the Brazilian automobile industry, RODRÍGUEZ-POSE and ARBIX (2001) found that fierce rivalry for FDI tended to generate wasteful bidding wars between Brazilian states. Concessions often included the offering of tax breaks and favourable loan agreements, the donation of land, and a series of financial cautions and guarantees, each of which add very little to the national economy. In India, MCCARTEN (2003, p. 6) draws attention to the 'interstate competition to attract private investment' that emerged alongside a greater influence by the private sector since the late 1980s.

Furthermore, in China, the development of areas where normal tax rules do not necessarily apply has resulted from, and promoted, intense degrees of territorial competition.[3] In these 'zones', it is normal to find corporation tax reduced from the usual 33% to as low as 15%, export tax reduced from 15 to 10%, tax exemption on profits and further tax reductions, as well as many activities enjoying total exemption from China's import tariff (MA, 1996; JIN and ZOU, 2003). The number of these 'special zones' in existence across China has grown exponentially, from 14 in 1984 to 8700 by mid-1993. They impose costs on domestic industry, because they favour international industry (JIN and ZOU, 2003) and they impose costs in terms of tax revenue, both through the reduced rates and exemptions that they offer (MA, 1996), and through the lack of accountability to government, whose task in collecting tax revenues from the zones is virtually impossible (MCKENNEY, 1993).

Nor is territorial competition confined to the developing world. There are numerous examples of this sort of zero-sum competition, with a large literature focusing of the competition for automobile plants across Europe (MYTELKA, 2000) as well as in the USA (FLORIDA, 1996; DONAHUE, 1997). For example, MORGAN (2002) details how the English regions saw themselves as disadvantaged during the 1980s and 1990s because they felt the Celtic nations were 'able to use their devolved governance systems to mobilize more substantial incentive packages ... which gave them an edge in attracting [FDI]' (MORGAN, 2002, p. 801). The pressure that asymmetric devolution can put upon central government to devolve further, in order to equalize competitive capabilities, is illustrated here. This may have been a factor in the creation of regional development agencies (RDAs) in England in 1999.

Inequality and devolution

Efficiency losses are not the only negative implications that devolution can carry. Insofar as the redistribution of income and wealth, in order to safeguard minimum welfare standards, remains a role of central government, this section argues that devolution can compromise the ability of the state to achieve its redistributive aspirations and hence perturb PETERSON's (1981) balance between a redistributive central or federal state and distributive and regulatory local and regional governments. To what extent this is a problem depends upon the value each nation attaches to equality in living standards, or progress towards it. It is not the present authors' intention to make that value judgement here, but rather to make clear the implicit trade-off between economic growth and equality that devolution can engender. What becomes apparent is that there are tangible equity implications of devolution, and, therefore, that there are difficult value judgements to be made. These equity concerns arise from two sources: the differing degrees of influence regions have over the central government and the differing competitive and fiscal capacities they enjoy, both during and after the devolution process.

Equality and influence. Once a certain degree of political power has been devolved, subnational governments begin to have more influence over central policy-making. Most importantly, the distribution of finances flowing from the centre to the states becomes partially subject to the demands of the states themselves, especially when subnational governments are well represented in political fora at the central level. Yet, this influence can pose a problem when the set of subnational governments are highly heterogeneous, and may therefore have different, perhaps opposing, interests. In these situations, the centre can find itself exposed to the conflicting demands of states that are competing for its patronage. As a rational actor, the centre is likely to appease those subnational governments that carry the greatest threats, and present the greatest opportunities, to its own political legitimacy, i.e. those states with the largest electorates, political representation, industrial shares, income per capita, tax revenues and media influence. This can leave poorer and less influential states less well protected by the central government as devolution evolves, while richer and more powerful states might well benefit from the process. For example, while acknowledging room for further research, RAO and SINGH (2001) find that state domestic product per capita, among other political variables, was a consistent and robust determinant of grant aid per capita to the states in India.

Of course, there are mediating influences over this mechanism. One of the most important is the existence of a strong central government and/or president (INMAN, 2000). Since the framing of Brazil's Constitution in 1988, the influence of the presidential office has been diluted considerably. This has been the result of highly dissipated forms of democracy, where regional governors and mayors owe very little allegiance to national level political parties.[4] Consequently, the President is forced to struggle to construct very broad coalitions with each new policy proposal (SAMUELS, 2002), endowing the states with a lot of bargaining power over the centre. This negotiating strength is disproportionately concentrated into the hands of the bigger, more populous and richer states in Brazil, since they carry the greatest threats, and offer the greatest opportunities, to the central government. For example, in 1997, the rich states were negotiating debt repayment contracts with the centre after over-borrowing in the early 1990s. If they defaulted, they could have caused an economy-wide disaster by alarming the international financial community, and precipitating a process of capital flight that would have been very difficult to reverse. They were consequently seen as too big to fail, and were therefore able to extract very forgiving contracts from the centre (DILLINGER and WEBB, 1999), while the poorer states, which on the whole had not borrowed as much initially, did not benefit equally from the forgiving conditions as a result. If the central government had been able to take a stronger line, or had commanded stronger bargaining power during debt renegotiations from 1997 onwards, this regressive effect might have been mediated.

The importance of strong national party politics, as well as strong central government legitimacy, is underscored in the US case. INMAN (2000) details how the central government's reputation for refusing federal aid to the states was nurtured carefully through various state crises during the 19th and 20th centuries, citing the importance of 'strong presidents and/or strong national parties' (p. 32) in establishing this tradition, which has promoted cautionary state financial management. Nevertheless, the 1975 New York City crisis mentioned above indicates the fallibility of even the strongest central governments. Since New York was so big and financially interconnected, the threat of default in this city had repercussions throughout the country. Large cities across the US began to face higher interest rates as the crisis came to a head (INMAN, 2000). This afforded New York a degree of leverage over the centre that smaller cities or areas in a similar state of financial distress, such as Philadelphia, Bridgeport or the Orange County, could not match. Philadelphia (1990) eventually had to make do with the help of a state-created borrowing agency, while Bridgeport (1991) was not allowed to go into bankruptcy, and the Orange County (1994) was refused a state bailout. In contrast, New York was eventually offered US$2.3 billion in relief funding over 3 years (INMAN, 2000). Again, even in the USA, the disproportionate bargaining power held by richer and more influential subnational units can result in a regressive effect.

A second important determinant of the degree to which states can influence the centre, alongside the strength of the central government, is the method used to decide how revenue is shared among the states. If funds from the centre are allocated on a discretionary basis, this leaves far more room for states to influence central decisions than if revenue is shared based on a predetermined formula. While the formula may be subject to some initial bargaining, as well as occasional reviews, it is generally a better indicator of assured progressiveness because it signals a commitment on the part of the central government to this end.

An illustration of this comes from Mexico – a country with acute, and increasing, regional disparities. The decentralization of resources from the centre, which accounted for 58% of total state expenditures in 2001, has taken two forms. *Participaciones* or unconditional transfers are formula based and calculated according to per capita income, improvements in tax collection and poverty (DÍAZ *et al.*, 2002). The distribution of these transfers is consequently highly progressive. However, in 2000, 51% of transfers were not unconditional. *Aportaciones* or conditional transfers are sourced from a separate budget line that is not subject to formula sharing – the central government decides which projects warrant conditional transfer support. Although the aim is to support poorer states, these funds are subject to central discretion and a high degree of earmarking, and therefore open to abuse through coercion of the centre. Conditional education spending, for example, which accounted for 63% of conditional transfers in 2000 (DÍAZ *et al.*, 2002), was earmarked by the central government for teacher salaries alone, emphasizing the subsidy of existing schools and teacher labour markets rather than the creation of new ones. Of course, it was the richer states that benefited, because they had better-established education systems (CABRERO MENDOZA and MARTÍNEZ-VÁZQUEZ, 2000). Whether implicitly or explicitly, therefore, the introduction of discretionary transfers can compromise the likelihood that central assistance to subnational governments will be progressive.

Inequality and competitive capacities. Devolution can impose further, disproportionate, costs upon poorer and less powerful states by promoting the sort of territorial competition described above. Arguments in favour of devolution point to the incentivizing effect autonomy can have upon policy innovations, tax appropriation (however, see BIRD and SMART, 2002) and the attraction of FDI. However, there may be automatic and capacity constraints that prevent poorer, smaller and less influential states from competing on level terms. Poorer infrastructure, as well as smaller tax bases, less access to financial markets, less influence over the discretionary aspect of central government finances and fewer, or smaller, input and output markets, may lose the battle for some states before it has even begun. A contraction of the role of central government and devolution of autonomy to subnational levels is an implicit refutation of the traditional protective role of the national level. As a partial substitute, by exposing every state to the risk of losing in the international competition for FDI, and the national competition for industry, workers and perhaps central resources, it is hoped that necessity will breed sufficient innovation to guarantee minimum welfare standards. However, there is a risk that necessity will not be enough, and there are therefore often losers, especially in zero-sum contexts such as those created by territorial competition. Moreover, it is frequently the smaller and poorer states that are most likely to lose out, rendering the devolution of autonomy itself a potentially regressive government policy.

Examples of this effect are widespread. For instance, in Italy, despite the efforts of the central government to provide progressive transfers, devolution has accompanied a divergence in standardized subnational government expenditure per capita, as richer regions retain more of their own tax revenues (RODRÍGUEZ-POSE and BWIRE, 2004). In the USA, the introduction of block grants for welfare (under the Temporary Assistance of Needy Families fund) has 'shifted state reimbursement from a system based on strict federal rules of eligibility and entitlement to a single state block grant system based on historical funding levels' (NASBO, 1999, p. 42). In the event of increasing caseloads, therefore, states will have to find their own way out of trouble, through increasing taxes, reducing spending per person or, as devolutionists expect, through increasing efficiency. However, it is clear that those states with less financial and fiscal capacity are exposed to greater downside risk under the new system than more prosperous states, because their ability to meet the demands of greater caseloads is more limited. In India, McCarten (2003, p. 17) points out that following the marketization of investment patterns in India, 'poorer states appeared to be attracting proportionately less investment because of their deficient infrastructure endowments'.

According to Parker and Serrano (2000, p. viii), 'Having enough capacity to get the job done is one of the biggest challenges confronting local institutions as a well as managers designing and implementing programs of local development'. They trace the efforts of various countries intent upon breaking the mould of regressive devolutionary efforts. Hence, in Zambia, efforts have been made to link the degree of decentralization to the level of institutional capacity so as not to over-burden local administrations. To this end, the devolutionary Zambia Social Investment Fund identifies five different levels of institutional competence, the attainment of which allows a locality to control a larger share of its own social funding. In Bolivia, associations of municipalities are gaining importance in an attempt to ameliorate the negative effects that institutional and financial isolation can have upon poorer local administrations. Moreover, Bolivia has made an attempt to ensure that administrative training, e.g. accountancy and computer literacy, accompany financial devolution or increasingly administrative remits at local levels. Similarly, the devolutionary Honduran Social Investment Fund (a World Bank-supported project) has been accompanied by a series of mass consultations provided by the Fund itself in order to equip localities for their increasing responsibilities (Parker and Serrano, 2000).

What is clear from these efforts, therefore, is the high degree of risk that devolution can entail. By exposing ill-equipped, under-skilled local administrations to competitive forces devolutionary projects that do not balance responsibility with administrative development may hold negative implications for equality, since poorer and less influential subnational governments are likely to lose out.[5]

Institutional burdens and devolution

The institutional impact of decentralized administrations can generate a third set of costs, or economic downsides, to devolution. The reproduction of some administrative functions within every subnational unit of a country may raise the total cost of service provision relative to a centralized system, due to wasteful duplication of basic functions. As Prud'homme (1995) points out, such duplication may force the nation to forfeit any gains from economies of scale or scope that centralized service provision may have enjoyed, by reducing the average size of administrative units and thereby reducing the potential for specialization and the division of labour. China, India and Brazil, for example, have each suffered increasing bureaucratic costs in recent years, coinciding with devolutionary efforts. Furthermore, the introduction of various tiers of government in the absence of a clear demarcation of responsibilities can be confusing or at worse result in free riding by some governmental tiers or in an over- or under-supply of public goods. In the case of the English regions, for example, Jones (2001, p. 1201) states that 'it would appear that RDAs are adding to the complexity and problems of economic governance', rather than simplifying them. Although, it should also be remembered that devolution can offer a solution to confusing, complicated or over-populated institutional spaces as well (Morgan, 2002).

Moreover, the costs that a lack of clearly assigned responsibilities can give rise to are well documented. For example, Agarwala (1992) reports how the responsibilities of central and provincial governments in China overlap considerably, with negative implications for the efficient use of resources. In Spain, the concurrency of responsibilities defined under Article 148 of the Constitution provides for central intervention in regional affairs, so that 'there is almost no sphere in which [Autonomous Communities] can establish their own policies in an unconditional way' (Fossas, 1999, p. 7). In Mexico, Cabrero Mendoza and Martínez-Vázquez (2000) document how decentralization of responsibility for education engendered some forms of competition for human and financial resources between the federal and subnational education systems. And in Brazil, the recognition of both state and municipal governments as equally legitimate levels of government has resulted in a lack of any clear demarcation of responsibilities between them. This omission poses a threat because each can attempt to divest itself of responsibilities in deference to the other. 'With no clearly defined roles, neither states nor municipalities can be held accountable for shortfalls in specific services' (Dillinger, 2002, p. iv).

At least two further costs can arise through the decentralization of administrative functions. First, much like the territorial competition for mobile industry that devolution can engender in the private sector, in the public sector similar incentives to compete for central government patronage are created. When participation in these competitions demands resources, this can represent a dead-weight loss to the nation as regional governments waste resources attempting to win a prize that the nation as a whole cannot lose. These lobbying costs are in evidence in India, for example, where Finance Commissions make plans every 5 years to redistribute funds across states in order to ensure balanced accounts or surpluses in every state over the proceeding 5 years. This system creates strong disincentives for the states to balance their own budgets during the fiscal years upon which finance plans are based. Consequently, 'with a view to maximizing their share in the central transfers, it is not unusual to see states tending to incur a large amount of expenditure in the base year prior to a Finance Commission' (Gurumurthi, 1995, p. 35, cited in McCarten, 2003, p. 10). These perverse effects represent inefficiencies brought about by the resources states spend lobbying the central government, which does very little for the nation as a whole.

Finally, decentralization can also promote conditions that are conducive to corruption (Das-Gupta and Mookherjee, 1997).[6] Local-level politicians are often subject to less scrutiny than at the national level, perhaps because they are surrounded by civil servants with generally fewer skills, so that internal monitoring is reduced (Prud'homme, 1995; Bennett, 1997; Azfar *et al.*, 1999; Thießen, 2003) or perhaps because the media and pressure groups can be less active at lower government levels. Furthermore, local politicians may find themselves under more pressure from political elites in their jurisdictions than their national-level counterparts because a smaller number of local interests at this level may find it easier to organize themselves, agree upon their goals and cooperate in efforts towards coercion (Lambsdorff, 1999). Finally, local politicians can also have stronger personal ties with interest groups as a result of their proximity to their electorates (Tanzi, 1995; Bardhan and Mookherjee, 1998; Blanchard and Shleifer, 2000; De Mello and Barenstein, 2001).

ECONOMIC EFFECTS OF THE DRIVERS OF DEVOLUTION

The previous two sections discussed, respectively, some of the commonly cited economic advantages of devolution as well as some of the potential downsides, including the inefficiencies, inequalities and institutional burdens that devolution can introduce. This section, however, addresses the simplicity of this approach, arguing that the advantages and disadvantages of devolution are themselves contingent, to some extent, upon which governmental bodies are driving the devolutionary efforts and on the politics, economics and sociology of every space (Smith, 1985). As a result, a basic list-based approach to the merits and demerits of decentralization initiatives is not sufficient to understand fully its implications (Morgan, 2002; Rodríguez-Pose and Gill, 2003).

Devolution entails the decentralization of resources and/or responsibilities, and its form (i.e. the balance between these two components) can be influenced by actors at both national and subnational levels of government (Donahue, 1997). The aspirations of these actors are likely to differ if they act in a self-interested way. For example, from the perspective of the central government, the most attractive form of devolution may be a decentralization of expenditure commitments (responsibilities) to lower government levels, in order to relieve fiscal pressure at the national level. Conversely, subnational governments may be more supportive of initiatives that involve the decentralization of resources, which might ease fiscal pressure on their own budgets. More generally, each government tier may have its own agenda, and the relative strength of its influence over the decentralization process will mould the final policy outcomes that devolution entails (Rodríguez-Pose and Gill, 2003). Since different decentralization policies can have very different economic implications, the relative strength, or, in political terms, 'legitimacy',[7] of government tiers can therefore largely determine the size of the 'economic dividend' of decentralization. The paper will examine various examples of this effect.

Consider first a situation in which there is a dominant central government that may rationally favour the devolution of expenditure responsibilities over resources if it acts in a self-interested way. For example, Morgan (2002, p. 802) draws attention to the English case in this regard, where 'miniscule budgets, modest powers and a raft of responsibilities, straddling economic development, social regeneration, rural renewal, environmental enhancement and possibly planning . . .' characterize the English devolution project (see also Jones, 2001, on this issue). In such cases there are at least three ways in which the potential economic benefits that devolution can engender could be compromised. First, the transfer of mandates without sufficient budgetary capacity for subnational governments to fulfil them properly can render the matching of policies to local preferences – a key economic dividend of devolution – a pipe dream.[8] Subnational governments can simply find themselves with insufficient budgets to address properly many local policy priorities. In the USA, for example, some states feel that the transfer of parts of Medicare and welfare programmes without the equivalent transfer of resources has rendered them incapable of coping with other policy priorities, since the bulk of new resources has been directed to these areas.

Second, a dominant centre can also compromise the likelihood of innovations – another key tenet of the devolutionist discourse. Without the adequate resources, many economically sound ideas cannot be implemented. Innovation necessitates some degree of experimentation, and in turn, this requires the acceptance of a certain degree of risk. If many of the spare resources and capital in the public sector are confined to the central level, subnational governments are likely to be far more risk averse, in the knowledge that a greater proportion of the costs of failure will have to be borne through services foregone, rather than through savings or capital spent. This can undermine the potential engine of experimentation that devolution could otherwise generate.

Third, the stunted capacity of regional governments when resources tend to accumulate at the centre may ultimately undermine the possible political benefits of devolution, as regional governments become increasingly regarded as bureaucratic layers without any real capacity to solve local problems. One of the most commonly cited disadvantages that devolution can entail is the introduction and reproduction of cumbersome administration and red tape, unaccompanied by real powers or financing. In some sense, the decentralization of 'responsibilities' without accompanying power, authority, autonomy or resources, offers perfect conditions for the fostering of spare, unproductive, or even wasteful governmental capacity.[9]

The economic dividend of devolution can therefore be significantly compromised in situations where the central government is driving, defining and propagating devolutionary initiatives. Strengthening subnational governments, in these cases, can lead to some equalization of the balance between devolved responsibilities and the ability to meet those responsibilities – a necessary component to any successful devolution project. Nevertheless, strong central authority over subnational regions can bring with it separate positive effects.

Equivalently, if subnational governments dominate a central government, this can exacerbate some of the economic downsides outlined in the third section. For example, soft budget constraints, such as those evidenced in Brazil, where the states have been dominant and have overspent, and in China, where a temporarily impoverished centre during the mid-1980s and early 1990s was forced to cede too much authority to the provinces, can result in spiralling debts at both levels of government (Dillinger and Webb, 1999; Yi and Chusheng, 2001). Given that soft budget constraints arise from a central government's inability to dictate and enforce a maximum spending (or borrowing) limit on subnational units, or credibly commit to refuse to bail them out after they have exceeded such limits, a stronger centre could be expected to reduce the likelihood of soft budget constraint problems because they are capable of being more credible and less prone to coercion.

Similarly, in the case of territorial competition, Cheshire and Gordon (1998) note the possibility that strong regulatory bodies can mediate the welfare costs that zero-sum competition for industry can engender. A credible decision-maker can decide upon, and impose, the allocation of mobile industry across subnational regions, or at least place some limits on the magnitude of the financial incentives that competing regions can legally offer, before nationally wasteful bidding between them spirals out of control. Where the central government is incapable of doing this, however, its lack of strength can exacerbate the economic cost of devolution borne through territorial competition. One such examples is China, where 'the establishment of unauthorized SEZs [special economic zones] weakened the ability of the central government to set and control macroeconomic policy' (Jin and Zou, 2003, p. 31), and the central government also lost, and continues to lose, a great deal of revenue from unauthorized economic zones. Furthermore, the lack of an official standard of concessions has led to highly intense competition, arising from the central government's inability to impose its authority and place limits on the number, and intensity, of the economic zones (Ma, 1996).

Moreover, just as a strong central government can provide a credible decision-making service to reduce territorial competition, it may also use this authority to minimize overlapping responsibilities by assigning specific service provision duties to specific tiers. Furthermore, inequalities that result from differences in the amount of influence rich and poor states hold over the centre may be exacerbated if the centre is weak, because the richer states hold greater threats and offer more potentialities to a poorer and less influential centre. And a stronger centre may also have more ability to mediate the effect of fiscal and competitive capacity constraints in poorer states, by encouraging the fostering of greater capacities, for example in infrastructure, ensuring fair access to capital markets, and providing some compensating transfers to account for smaller tax bases. Consequently, again, the economic costs that devolution can impose seem contingent upon the relative strength of the actors involved. It can be concluded that the economic rewards available through devolution, as well as the risks and costs it imposes, depend, to some extent, upon which government tiers are dominating, organizing, propagating, and driving the devolutionary effort.

CONCLUSIONS

The shift in the emphasis of the devolutionary discourse, from cultural, ethnic, linguistic and religious arguments, towards economic concerns, has elevated the importance of understanding the economic consequences of devolution. This 'new regionalist' discourse (Keating, 1998) emphasizes the economic benefits that devolution can bring about and is substantiated in many ways by a strong theoretical and increasingly empirical economic literature (Tiebout, 1956; Oates 1972; Thießen, 2003). Given the multiplicity of devolutionary initiatives in progress around the world – a reflection of the support decentralization commands – it can be difficult to remain dispassionate about the pros and cons that devolution entails (Rodríguez-Pose and Gill, 2003). This is especially true when one considers the incentives to propagate decentralization that devolution protagonists often face.

In response, this paper has outlined two caveats that underscore the economic complexity of devolution. First, it is clear that devolution can carry negative as well as positive economic implications. The various experiences around the world mentioned in this paper exemplify different aspects of the economic burdens decentralization can impose, which fall roughly into three categories: efficiency disadvantages, equity-related drawbacks and institutional burdens. Second, many of the economic downsides of devolution are contingent upon which actors are driving devolutionary policies. The size of any potential economic dividend of devolution may therefore be affected by whom has the upper hand in the devolutionary efforts. The carefully consideration of each of the actors involved in devolution – their aspirations, incentives and constraints – is therefore critical to an accurate policy appraisal.

More generally, it is important for academics and policy-makers alike to be aware of the complexities, advantages and problems that devolution can entail. Devolution is a highly complex and heterogeneous process that operates at many different government levels, involves disparate actors and can take on a multitude of diverse forms. The contemporary shift towards an economic discourse of devolution has highlighted these issues, and one can expect them to take on even greater significance in the future, as the full extent of the devolutionary movement unravels. A thorough assessment of the economic impact of decentralization initiatives is therefore becoming increasingly important, and can be bolstered through an awareness of the drawbacks, drivers and contradictory implications that devolution frequently entails.

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NOTES

1. Devolution is a form of decentralization that implies the transfer of powers and resources to independent and often directly elected subnational governments (PRUD'HOMME, 1994, p. 2). Other forms of decentralization include deconcentration (redistribution of powers among different levels of the central administration) and delegation (transfer of powers to semi-autonomous bodies) (PRUD'HOMME, 1994). In the present paper, only devolution is considered, implying that subnational governments have autonomous powers and a certain leeway to implement their own policies.
2. AGNEW (2001) cites the experience of the Celtic fringe of the British Isles, the Palestinians in disadvantaged areas of Israel, the poverty of minority-occupied Western China, and the economic isolation of local Tamils in Sri Lanka to support this point.
3. There are various types of economic zone. For example, special economic zones, coastal economic zones, economic and technology zones, and high/new technology development zones (JIN and ZOU, 2003).
4. In 2002, for example, despite winning over 60% of the popular vote in the presidential election, the Workers' Party secured only 14/81 seats in the Senate and only 91/513 seats in the Chamber of Deputies. In fact, fully eleven different parties are represented in Congress (the Senate and Chamber collectively) with no single party commanding over 18% of seats, while four command more than 13% (CIA, 2004).
5. This view is, however, not shared by all. GIL CANALETA *et al.* (2004), using several indicators of fiscal decentralization for 16 OECD countries, report that regions in decentralized states converge at a faster pace than those in centralized states.
6. LAMBSDORFF (1999) presents conflicting empirical evidence on the relationship between devolution and corruption. While TRIESMAN (1999) finds that federal states are more corrupt than centralised ones, FISMAN and GATTI (1999) find that the share of subnational expenditure in total public expenditure is positively associated with good governance. Also, their quantitative measurement of both decentralization (expenditure shares) and corruption (using Transparency International's Corruption Perception Index) might omit important qualitative factors that affect the relationship, such as the responsibilities that devolution programmes delegate to the sub-national level.
7. DONAHUE (1997) conceptualizes legitimacy as incorporating 'popular support' and citizen's co-operation'. He states that 'Ultimately the most important asset that government can command . . . is not legal authority, or fiscal resources, or even talented personnel, but *legitimacy*' (p. 12).
8. ETHERINGTON and JONES (2004) see this as one source of tension within New Labour's approach to local state restructuring. Promising urban regeneration partnership groups that represent the demands of the urban poor have achieved only limited success due to the 'imposition of tight performance targets and externally defined strategies' (p. 140).
9. It is along these lines that STOKER (2002) criticizes the British devolution programme for introducing new players into regional governance, such as lottery authorities, while failing to empower them to make meaningful changes. This results in a circular system of audit, inspection and challenge that achieves few concrete outcomes.

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