

Fiscal Decentralisation and Income Inequality: An Empirical Analysis

Ms. Poonam Bamel*

PhD Scholar, Economics, CESP, Jawaharlal Nehru University, New Delhi, India.

*Corresponding Author: bamelp@gmail.com

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ABSTRACT

Income inequality has increased in many countries over recent decades, renewing interest in institutional and fiscal arrangements that may help reduce distributional disparities. Among these, fiscal decentralisation—broadly referring to how fiscal responsibilities are distributed across levels of government—has attracted growing policy attention. However, empirical evidence on its relationship with income inequality remains limited, particularly in cross-country settings where institutional heterogeneity and data limitations pose significant challenges. This paper examines the association between expenditure decentralisation and income inequality using a balanced panel of 59 countries over the period 1996–2019. In this study, fiscal decentralisation is proxied by the share of subnational government expenditure in total public expenditure, while income inequality is measured using the Gini coefficient. To account for the slow-moving nature of fiscal and distributional variables and to mitigate short-term fluctuations and data gaps, key income and expenditure variables are constructed as five-year lagged averages. The empirical analysis employs panel data techniques, with model selection guided by the Hausman specification test. The baseline estimates are obtained using a random-effects generalized least squares (GLS) framework, controlling for per capita income, trade openness, government size, and regional fixed effects. The results consistently indicate a negative and statistically significant association between expenditure decentralisation and income inequality across alternative model specifications. Higher per capita income and larger government size are also associated with lower inequality, while greater trade openness is weakly associated with higher inequality. Decomposition of the goodness-of-fit measures reveals that the explanatory power of the model is driven primarily by cross-country variation rather than within-country changes over time, highlighting the importance of long-run structural and institutional differences across countries. While the analysis does not establish a causal relationship, the findings suggest that greater decentralisation of public expenditure responsibilities is systematically associated with lower income inequality in the long run. The results underscore the potential relevance of decentralised fiscal structures in shaping distributional outcomes and contribute to the ongoing debate on the equity implications of fiscal decentralisation in a global context.

Keywords: Fiscal Decentralisation, Income Inequality, Panel Data, Subnational Expenditure, Cross-Country Analysis.

Introduction

Income inequality has increased across many countries over the past few decades. A substantial body of research documents the long-run rise in income and wealth disparities in both advanced and developing economies, as well as widening global and within-country inequality driven by uneven growth and globalisation (see, for example, Piketty, 2014; Milanovic, 2016). Higher disparities in income distribution have been linked to adverse economic and social outcomes for countries. Beyond concerns of fairness, persistent inequality has been linked to adverse economic and social

consequences, including weaker social mobility, reduced inclusiveness of growth, and pressures on political stability. These concerns have renewed interest in the role of public policy and institutional design in shaping distributional outcomes.

Among the policy instruments under discussion, fiscal decentralisation has received increasing attention. Oates (1972) provides the foundational framework defining fiscal decentralisation as the assignment of expenditure and revenue responsibilities across levels of government. From an efficiency perspective, decentralisation can improve allocative efficiency by aligning public spending more closely with local preferences. Decentralisation may also enhance accountability and citizen participation by strengthening local political incentives. Beyond efficiency considerations, decentralised fiscal systems may influence income distribution through redistributive public spending.

From a theoretical standpoint, fiscal decentralisation is often viewed as having the potential to reduce income inequality by enabling subnational governments to align public services more closely with local needs and preferences. When lower tiers of government have adequate fiscal capacity and administrative competence, decentralised spending on sectors such as education, health, and social protection can enhance access to essential services and strengthen redistributive outcomes. At the same time, the distributional implications of decentralisation are not inherently progressive. Significant disparities in regional fiscal capacity may lead to uneven provision of public services, potentially widening interregional inequalities. Moreover, where local institutions are weak or governance structures are vulnerable to elite influence; decentralised systems may fail to translate fiscal autonomy into equitable outcomes. Taken together, these contrasting theoretical channels suggest that the relationship between fiscal decentralisation and income inequality is inherently ambiguous, making its overall effect an empirical question rather than a predetermined outcome.

Empirical evidence on the relationship between fiscal decentralisation and income inequality remains mixed. Some studies find that greater decentralisation is associated with lower income inequality in cross-country settings, particularly among advanced economies (Akai & Sakata, 2005; Vo, 2009). In contrast, other research suggests that the distributional effects of decentralisation depend critically on institutional quality and regional disparities. For example, decentralisation may increase interpersonal inequality in countries with weak institutions, while its inequality-reducing effects appear conditional on the presence of fiscal equalisation mechanisms and balanced regional development (Rodríguez-Pose & Ezcurra, 2010; Lessmann, 2012).

These divergent findings likely reflect differences in country coverage, time periods, decentralisation measures, and empirical strategies. Cross-country analyses face additional challenges related to data comparability and institutional heterogeneity. Measuring fiscal decentralisation consistently across countries is inherently complex given variation in intergovernmental arrangements (Rodden, 2004). Moreover, fiscal and distributional variables evolve gradually over time, making it difficult to identify short-run effects in panel frameworks.

This paper contributes to the literature by examining the association between expenditure decentralisation and income inequality using a balanced panel of 59 countries over the period 1996–2019. Fiscal decentralisation is measured as the share of subnational government expenditure in total government expenditure, a proxy widely used in cross-country analyses due to its availability and comparability, as discussed by Akai and Sakata (2005) and Vo (2009). Income inequality is proxied by the Gini coefficient. To capture medium-term fiscal dynamics and mitigate the influence of short-term fluctuations and data gaps, key income and expenditure variables are constructed as five-year lagged averages, following the approach adopted by Rodríguez-Pose and Ezcurra (2010).

The empirical analysis employs panel data methods and tries to account for unobserved country-specific heterogeneity. The baseline specifications control for per capita income, trade openness, overall government size, and regional characteristics. Rather than seeking to establish causality, the analysis focuses on identifying robust cross-country associations between fiscal decentralisation and income inequality.

Due to data limitations and cross-country comparability constraints, India is not included in the econometric analysis conducted here. However, the cross-country evidence presented in this study offers conceptually and policy-relevant insights for India where concerns regarding rising income inequality and widening inter-state disparities continue to exist prominently in policy debates.

The results in the analysis indicate a consistent negative association between expenditure decentralisation and income inequality across alternative model specifications. The findings suggest that countries with a higher degree of decentralised public spending tend to exhibit lower levels of income inequality, after accounting for key economic and structural factors. Importantly, the explanatory power of the models is driven largely by cross-country variation rather than within-country changes over time, highlighting the role of long-run institutional and structural differences.

The rest of the paper is organised as follows. Section 2 reviews the related literature. Section 3 describes the data and empirical methodology. Section 4 presents and discusses the empirical results. Section 5 concludes with policy implications and directions for future research.

Fiscal decentralisation and Income Inequality

Fiscal decentralisation has emerged as one of the most widely adopted institutional reforms in public finance, particularly in the context of improving government responsiveness and accountability. Early policy-oriented work, notably by the World Bank (1997), presents decentralisation as a mechanism to enhance the proximity of government to citizens, strengthen accountability, and improve the alignment of public service provision with local needs.

The theoretical foundations of fiscal decentralisation are rooted in the Musgravian framework of public finance, which classifies government responsibilities into three core functions: allocation, redistribution, and macroeconomic stabilization (Musgrave, 1959). The allocative function concerns the efficient provision of public goods. In this context, Oates (1972) argues that decentralisation can improve efficiency by allowing subnational governments to tailor spending decisions to heterogeneous local preferences. This argument is further reinforced by Tiebout's (1956) model of "voting with one's feet," which suggests that inter-jurisdictional competition can lead to efficient outcomes when individuals sort themselves across jurisdictions according to their preferred mix of taxes and public goods.

The redistributive implications of fiscal decentralisation, however, are theoretically ambiguous. While decentralisation may enable locally targeted redistribution and pro-poor spending, it may also exacerbate inequality if poorer regions lack adequate fiscal capacity or administrative strength. Vo (2010) highlights this ambiguity, emphasizing that decentralisation can either promote equity through context-specific policies or widen disparities when fiscal resources are unevenly distributed across regions. Early critics such as Bahl and Nath (1986) caution that in an increasingly globalized and volatile economic environment, decentralisation may weaken a government's capacity to respond to macroeconomic shocks, thereby undermining both stabilization and redistribution objectives.

In contrast, proponents of decentralisation argue that well-designed intergovernmental systems can enhance institutional resilience. Bird and Vaillancourt (1998) contend that decentralisation can foster innovation, responsiveness, and accountability at the local level, provided that appropriate fiscal rules and transfer mechanisms are in place. From this perspective, decentralisation is not inherently detrimental to redistribution, but its outcomes depend critically on institutional design and fiscal coordination.

These debates are further developed in the second-generation theory of fiscal federalism, which relaxes the strong assumptions of perfect mobility, benevolent governments, and complete information embedded in first-generation models. Prud'homme (1995) and Weingast (2009) argue that subnational governments may face significant constraints in practice, including limited administrative capacity, weak accountability mechanisms, and susceptibility to rent-seeking and elite capture. Such institutional weaknesses may undermine both efficiency and equity objectives, particularly in developing and transition economies. Relatedly, Tarkan and Dincer (2015) emphasize that economies of scale, spillover effects, and common-pool resource problems can limit the effectiveness of decentralised fiscal systems, suggesting that central governments may retain comparative advantages in redistribution and macroeconomic management.

At the same time, decentralisation may create opportunities for more context-specific and inclusive policy design. Faguet (2004) shows that when subnational governments are granted meaningful expenditure autonomy, they may prioritize policies that reflect local development needs, including social sector investments, employment programs, and targeted welfare schemes. However, greater fiscal autonomy—particularly over mobile tax bases—may also generate adverse incentives. Bardhan (2002) argues that decentralisation of major tax instruments can induce tax competition across jurisdictions; potentially leading to a "race to the bottom" that constrains redistributive capacity.

Empirical evidence on the distributional consequences of decentralisation reflects these theoretical ambiguities. Several studies report neutral or negative effects of decentralisation on public service delivery and pro-poor outcomes, particularly in contexts characterized by weak institutions. West and Wong (1995) document uneven service provision following decentralisation reforms, while Ravallion (1998) highlights failures in targeting anti-poverty programs at the local level. Azfar and Livingston (2002) further show that inadequate oversight and accountability can limit the effectiveness of decentralised governance structures.

Offering a more nuanced assessment, Padovano (2007) argues that while centralized systems may facilitate greater aggregate redistribution, decentralised systems can enhance the efficiency and targeting of redistributive policies. This suggests that the equity effects of fiscal decentralisation are contingent on institutional capacity, intergovernmental transfer systems, and the broader political and economic context.

In the Indian context, the literature has extensively examined fiscal federal arrangements, intergovernmental transfers, and vertical and horizontal imbalances (Rao and Singh, 2005; Rao, 2017). At the same time, a growing body of work documents rising income and wealth inequality in India (Himanshu, 2015; Pal and Ghosh, 2007). However, relatively limited attention has been paid to the relationship between expenditure decentralisation and income inequality within a comparative cross-country framework. Situating India within such a framework allows for an assessment of whether its evolving fiscal architecture aligns with broader international patterns linking decentralised expenditure responsibilities to distributional outcomes.

Beyond the Indian experience, however, the broader literature offers no clear consensus on the relationship between fiscal decentralisation and income inequality. Theoretical predictions are ambiguous, and empirical findings vary with institutional context, measurement choices, and empirical strategies. Against this background, the present study provides additional cross-country evidence on the association between expenditure decentralisation and income inequality using a balanced panel of countries over the period 1996–2019.

Data and Methodology

This study examines the relationship between fiscal decentralisation—measured in terms of public expenditure assignment—and income inequality across countries. The theoretical discussion in the preceding section highlights several potential channels through which expenditure decentralisation may be linked to inequality, including differences in the prioritisation of social sector spending, improvements in expenditure targeting, and variations in the effectiveness of public service delivery at the subnational level. Importantly, public expenditure, particularly on education, health, and social infrastructure, is not expected to influence income distribution instantaneously. Instead, such expenditures are likely to have cumulative and lagged effects, with benefits accruing over multiple years.

To account for this dynamic, the empirical strategy is designed to capture medium-term fiscal effects rather than short-run fluctuations. Specifically, all explanatory variables related to income and public expenditure are constructed as averages over the preceding five-year period, while income inequality is measured using contemporaneous values. The five-year averaging approach serves two purposes. First, it allows the analysis to reflect the cumulative impact of fiscal and economic conditions on inequality. Second, it mitigates the influence of short-term volatility and data gaps that are common in cross-country fiscal datasets. This approach is consistent with the slow-moving nature of institutional and distributional variables and is commonly employed in cross-country panel studies examining long-run associations.

Data for the analysis are drawn from several internationally comparable sources. Income inequality, measured by the Gini coefficient, is obtained from the Standardized World Income Inequality Database (SWIID), which provides harmonised estimates designed to improve cross-country comparability by standardising inequality measures derived from both income- and consumption-based surveys. Data on subnational government expenditure are sourced from the IMF Fiscal Decentralization Dataset, while information on total general government expenditure is obtained from the World Economic Outlook Database published by the International Monetary Fund. Gross national income per capita is drawn from the Human Development Report 2020 published by the United Nations Development Programme, and trade data are taken from the World Development Indicators compiled by the World Bank.

Formally, the functional relationship examined in the study can be expressed as:

$$\text{Gini}_{it} = f(\text{sn_exp}_{it}, \text{govt_exp}_{it}, \text{gnipc}_{it}, \text{trade}_{it})$$

where Gini_{it} denotes the Gini coefficient measuring income inequality in country i at time t . The explanatory variables are defined as follows: sn_exp_{it} is the ratio of subnational government expenditure to total general government expenditure and serves as the primary proxy for expenditure decentralisation; govt_exp_{it} represents total general government expenditure as a percentage of GDP; gnipc_{it} is real per capita gross national income measured in constant 2017 PPP dollars; and trade_{it} is trade openness, defined as the sum of exports and imports of goods and services as a percentage of GDP.

All explanatory variables are measured as averages over the preceding five-year period, while the dependent variable, the Gini coefficient, is measured contemporaneously. Due to substantial data limitations in the early years, the analysis is restricted to the post-1995 period. Accordingly, independent variable values for 1996–2000 are averaged and related to the Gini coefficient observed in 2000; values for 2001–2005 are averaged and related to inequality in 2005; and this procedure is repeated for subsequent five-year intervals. This transformation yields a panel with five time periods for each country. A regional dummy for Europe and a country-specific dummy for South Africa are included to account for time-invariant structural differences in inequality levels within the sample.

The baseline regression specification is given by:

$$\text{Gini}_{it} = \beta_0 + \beta_1 \text{sn_exp}_{it} + \beta_2 \text{govt_exp}_{it} + \beta_3 \text{gnipc}_{it} + \beta_4 \text{trade}_{it} + \beta_5 \text{deurope}_{it} + \beta_6 \text{dsouthafrica}_{it} + u_{it}$$

where deurope_{it} and dsouthafrica_{it} are regional dummy variables included to account for broad structural and institutional differences across regions, and u_{it} is the composite error term. The empirical analysis is conducted using panel data techniques, with model selection between fixed and random effects guided by Hausman specification test. Given the limited number of time periods and the emphasis on cross-country variation, the preferred specifications are estimated using a random effect generalized least squares framework.

Results and Discussion

Table A reports the estimates from both fixed effects (FE) and random effects (RE) panel regressions examining the relationship between income inequality and expenditure decentralisation. In the fixed effects specification (Column 1), the share of subnational government expenditure in total government expenditure exhibits a negative and statistically significant association with the Gini coefficient. This suggests that, within countries over time, higher expenditure decentralisation is associated with lower levels of inequality. Per capita income, measured as the logarithm of five-year averaged real GNI per capita, is also negatively and strongly significant, indicating lower inequality at higher income levels.

The random effect estimates (Column 2), which additionally control for regional and country-specific characteristics through dummy variables for Europe and South Africa, yield qualitatively similar results. The coefficient on subnational expenditure remains negative and statistically significant, and the magnitude is comparable to that obtained under fixed effects. Likewise, per capita income continues to display a strong negative relationship with inequality. The regional dummy for Europe is negative and significant, while the South Africa dummy is positive and significant, reflecting persistent structural differences in inequality levels across these units.

A comparison of model fit indicates that the random effects specification explains a substantially larger share of the between-country variation in inequality, as reflected in the higher between and overall R-squared values. In contrast, the within R-squared remains modest in both models, suggesting that the primary source of variation exploited in the analysis is cross-sectional rather than purely time-series in nature. This pattern is consistent with the use of five-year averaged explanatory variables and relatively limited time variation in inequality.

Table 1: Results from Fixed and Random- Effect Models

	FE	RE
Variables	(1)	(2)
sn_exp	-5.58*	-4.47*
	(3.36)	(2.60)
ln_gni	-3.55***	-3.20***
	(0.56)	(0.46)

deurope		-7.15*** (1.37)
dsouthafrica		23.19*** (5.24)
Constant	72.33*** (5.72)	71.72*** (4.42)
Observations	216	216
R-squared overall	0.25	0.66
within	0.21	0.21
between	0.23	0.61
Time periods	5	5
Number of countries	59	59

Note: Dependent variable is gini coefficient in both the columns measured on a scale of 0-100; Standard errors in parentheses; *** p<0.01, * p<0.1

To assess the appropriateness of the random effects specification, a Hausman specification test is conducted, with results reported in Table B. The null hypothesis of the test—that the unobserved country-specific effects are uncorrelated with the regressors—cannot be rejected ($\chi^2 = 1.17$, $p = 0.556$). This indicates no systematic difference between the fixed and random effects estimates and provides statistical support for the use of the random effects model in the subsequent analysis.

Table 2: Results of Hausman- specification test

	Coefficients			
	(b)	(B)	(b-B)	sqrt(diag(V_b - V_B))
	fixed	random	Difference	Std. err
sn_exp	-5.577	-4.468	-1.109	2.128
ln_gni	-3.550	-3.203	-0.347	0.320
b = Consistent under H0 and Ha; obtained from xtreg				
B = Inconsistent under Ha, efficient under H0; obtained from xtreg				
chi2 (3) = 1.17				
Prob. > chi2 = 0.556				

Table C presents the results from the panel random effects GLS estimations examining the relationship between expenditure decentralisation and income inequality under alternative model specifications. Column (1) reports the benchmark results, including the share of subnational government expenditure in total government expenditure and per capita income. The coefficient on subnational expenditure is negative and statistically significant, indicating that higher expenditure decentralisation is associated with lower levels of income inequality. Per capita income also exhibits a negative and highly significant relationship with inequality, consistent with standard development–inequality dynamics.

Column (2) extends the benchmark specification by incorporating trade openness. The coefficient on trade is positive and weakly significant, suggesting that greater integration with international markets is associated with higher inequality levels. Importantly, the inclusion of trade does not alter the sign or significance of the expenditure decentralisation variable, indicating that the inequality-reducing association of subnational spending is robust to openness-related effects.

In Column (3), the size of government—measured as aggregate government expenditure as a share of GDP—is added to the model. The estimated coefficient is negative and statistically significant, implying that larger public sectors are associated with lower inequality. This result is consistent with the redistributive role of government spending. The coefficient on subnational expenditure remains negative and statistically significant, reinforcing the stability of the decentralisation effect across specifications.

Column (4) includes both trade openness and government size simultaneously, alongside the benchmark variables. The results remain qualitatively unchanged: expenditure decentralisation continues to display a negative and statistically significant relationship with inequality, while trade openness retains a positive association and government size maintains a negative effect. The regional and country dummy variables also remain significant across all specifications, capturing persistent structural differences in inequality levels. Model fit improves progressively from Columns (1) to (4), as reflected in higher overall and adjusted R-squared values. Across all specifications, the between R-squared is substantially larger than the within R-squared, indicating that the explanatory power of the model is driven primarily by cross-country variation rather than within-country changes over time. Although the inclusion of trade openness

modestly improves the within R-squared, a sizeable gap between within and between measures persists. Overall, the models explain more than 66 percent of the total variation in inequality in all cases.

Table C: Regression results based on Random effect GLS

Variables	(1)	(2)	(3)	(4)
sn_exp	-4.47*	-4.69*	-5.18**	-5.29**
	(2.60)	(2.53)	(2.62)	(2.53)
ln_gni	-3.20***	-3.66***	-2.84***	-3.25***
	(0.46)	(0.47)	(0.50)	(0.50)
govt_exp			-0.09**	-0.10**
			(0.04)	(0.04)
trade		0.017*		0.02*
		(0.009)		(0.009)
deurope	-7.15***	-7.77***	-6.36***	-6.75***
	(1.37)	(1.28)	(1.42)	(1.33)
dsouthafrica	23.19***	23.12***	23.25***	23.20***
	(5.24)	(4.76)	(5.18)	(4.67)
Constant	71.72***	75.26***	70.84***	74.34***
	(4.42)	(4.37)	(4.50)	(4.43)
Observations	216	212	214	210
R- squared overall	0.66	0.69	0.68	0.71
within	0.21	0.26	0.21	0.26
between	0.61	0.65	0.63	0.67
Time periods	5	5	5	5
Number of countries	59	57	59	57

Note: Dependent variable is gini coefficient in all the columns measured on a scale of 0-100; Standard errors in parentheses; *** p<0.01, ** p<0.05, * p<0.1

Conclusion

This paper examined the relationship between expenditure decentralisation and income inequality using panel data for 59 countries over 1996–2019. The results show a consistent negative association between the share of subnational expenditure and income inequality across specifications. While the analysis does not establish causality, the findings suggest that countries with a larger role for subnational governments in public spending tend to exhibit lower levels of inequality. The explanatory power of the model is driven largely by cross-country differences, pointing to the importance of institutional and structural characteristics that vary across countries.

For India, these findings are particularly relevant. As a country with substantial expenditure responsibilities assigned to state governments, India's fiscal architecture plays a central role in shaping access to public services and redistribution. Rising concerns about income inequality and regional disparities make the design and functioning of intergovernmental fiscal arrangements especially important. The results of this study suggest that strengthening the capacity, accountability, and effectiveness of state-level spending play an important role in shaping distributional outcomes, alongside central redistribution policies.

Decentralisation, however, is not a uniform remedy. Its distributive implications depend on institutional quality, administrative capacity, and the structure of intergovernmental transfers. Understanding how these factors operate within India remains an important area for further research.

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