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Decentralization and

Its Implications for

Urban Service Delivery



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**Urban Management and Municipal Finance**

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**Decentralization and its Implications  
for Service Delivery**

**William Dillinger**

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The Urban Management Programme (UMP) represents a major approach by the United Nations family of organizations, together with external support agencies (ESAs), to strengthen the contribution that cities and towns in developing countries make toward economic growth, social development, and the alleviation of poverty. The program seeks to develop and promote appropriate policies and tools for municipal finance and administration, land management, infrastructure management, and environmental management. Through a capacity building component, the UMP plans to establish an effective partnership with national, regional, and global networks and ESAs in applied research, dissemination of information, and experiences of best practices and promising options.

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# CONTENTS

<b>EXECUTIVE SUMMARY</b>	<b>1</b>
<b>I. INTRODUCTION</b>	<b>5</b>
The Context	5
The Management Problem	7
<b>II. A FRAMEWORK FOR ANALYSIS</b>	<b>11</b>
Defining the Problem	11
Defining the Instruments	13
A Typology of Intergovernmental Relations	16
<b>III. DIRECTIONS FOR REFORM</b>	<b>24</b>
Linking Services to Levels of Government	24
Linking Revenues to Expenditures	26
Balancing Regulation with Political Accountability	33
Synchronizing the Elements of Reform	37
<b>REFERENCES</b>	<b>38</b>
<b>BOXES</b>	
Box 1. A typology of decentralization	7
Box 2. Contrasting approaches to capital allocation	23
Box 3. Choosing among local benefit taxes	29
Box 4. Improving the performance of MCIs	34
<b>TABLES</b>	
Table 1. Trends in world urbanization	5
Table 2. Sectoral composition of economic growth	5
Table 3. Structure of political accountability in major LDC cities	18
Table 4. Sources of tax revenue in major LDC cities	19
Table 5. Municipal lending organizations	33
<b>FIGURE</b>	
Figure 1. Local share of public expenditure	17

## FOREWORD

This paper has been prepared for the Municipal Finance component of the joint UNDP/ UNCHS/World Bank–Urban Management Programme (UMP). The UMP represents a major approach by the United Nations family of organizations, together with external support agencies (ESAs), to strengthen the contribution that cities and towns in developing countries make towards economic growth, social development, and the alleviation of poverty. The program seeks to develop and promote appropriate policies and tools for municipal finance and administration, land management, infrastructure management, environmental management, and poverty alleviation. Through a capacity building component, the UMP plans to establish an effective partnership with national, regional, and global networks and ESAs in applied research, dissemination of information, and experiences of best practices and promising options.

This paper is one in a series of discussion papers and management tools to be produced by the UMP municipal finance component. As a whole the municipal finance component is intended to address three questions: 1) how to mobilize resources to finance the delivery of urban services; 2) how to improve the financial management of those resources; and 3) how to organize municipal institutions to promote greater efficiency and responsiveness in urban service delivery. Work during the initial phase of the Urban Management Programme has focused on the first of these questions—focusing specifically on local tax reform, intergovernmental transfers, and local access to long-term credit. Case studies and background papers on the latter questions—documenting issues in local financial management and the organization of municipal government—have also been prepared, and will provide the basis for publications to be issued under this series in the future.

Phase 2 of the UMP (1992-96) is concerned with capacity building at both the country and regional levels and with facilitating national and municipal dialogues on policy and program options. It emphasizes a participatory structure that draws on the strengths of developing country experts and expedites the dissemination of that expertise at the local, national, regional, and global levels.

Through its regional offices in Africa, the Arab States, Asia and the Pacific, and Latin America and the Caribbean, the UMP seeks to strengthen urban management by harnessing the skills and strategies of regional experts, communities, and organizations in the private sector.

Regional coordinators use these networks to address the five program themes in two ways:

- **City and country consultations.** The UMP brings together national and local authorities, private-sector networks, community representatives, and other actors to discuss specific problems within the UMP's subject areas and to propose reasoned solutions. Consultations are held at the request of a country or city, and often provide a forum for discussion of a cross-section of issues.

- **Technical cooperation.** To sustain follow-up to the consultations, the UMP uses its regional networks of expertise to provide technical advice and cooperation.

Through its nucleus team in Nairobi and Washington, D.C., the UMP supports its regional program and networks by synthesizing lessons learned, conducting state-of-the-art research, and supporting dissemination of program related materials.

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## **ABSTRACT**

**This paper reviews efforts to improve the efficiency and responsiveness of urban service delivery in developing countries. It argues that failures in urban service delivery are not merely the result of a lack of technical knowledge on the part of local government staff, but also reflect constraints and perverse incentives confronting local personnel and their political leadership, and that these, in turn, are often the inadvertent result of problems in the relationship between central and local government.**

**In this respect, the report views the spread of decentralization as a potentially fortuitous phenomenon. As a political phenomenon, decentralization is widespread. Out of the 75 developing and transitional countries with populations greater than 5 million, all but 12 claim to be embarked on some form of transfer of political power to local units of government. But the objectives of decentralization—as it is observed in practice—appear only tangentially related to administrative performance. The decentralization now occurring is not a carefully designed sequence of reforms aimed at improving the efficiency of public service delivery; it appears to be a reluctant and disorderly series of concessions by central governments attempting to maintain political stability.**

**Nevertheless, it presents reformers—both domestic and in the donor community—with an opportunity to promote the kinds of fundamental reforms that have proven frustrating in the past. Because decentralization has introduced a high degree of fluidity into the structure of intergovernmental relations, it has brought flexibility into what had appeared to be an immutable system of governance.**

**The stakes are high. Decentralization affects not only urban services, but also social sectors, non-urban infrastructure, and—conceivably—the stability of national economies and the effectiveness of poverty-alleviation efforts. As the present degree of fluidity in intergovernmental relations is presumably transitory, it is an opportunity that should be seized.**

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This paper builds upon two decades of work by World Bank staff in the field of municipal development. It has drawn extensively on the work on urban public finance by Johannes Linn and Roy Bahl, the work on institutional development by Arturo Israel, Samuel Paul, and Elinor Ostrom and on the more recent studies on decentralization and intergovernmental fiscal relations by Jerry Silverman, Tim Campbell, Don Winkler, and Anna Haines. A major source of information—both on past practice and on current innovations—has been project officers directly involved in urban lending operations.



## **EXECUTIVE SUMMARY**

### **Introduction**

i. This paper reviews efforts to improve the efficiency and responsiveness of urban service delivery in developing countries. It argues that failures in urban service delivery are not merely the result of a lack of technical knowledge on the part of local government staff, but also reflect constraints and perverse incentives confronting local personnel and their political leadership, and that these, in turn, are often the inadvertent result of problems in the relationship between central and local government.

ii. In this respect, the report views the spread of decentralization as a potentially fortuitous phenomenon. As a political phenomenon, decentralization is widespread. Out of the 75 developing and transitional countries with populations greater than 5 million, all but 12 claim to be embarked on some form of transfer of political power to local units of government. But the objectives of decentralization—as it is observed in practice—appear only tangentially related to administrative performance. The decentralization now occurring is not a carefully designed sequence of reforms aimed at improving the efficiency of public service delivery; it appears to be a reluctant and disorderly series of concessions by central governments attempting to maintain political stability.

iii. Nevertheless, it presents reformers—both domestic and in the donor community—with an opportunity to promote the kinds of fundamental reforms that have proven frustrating in the past. Because decentralization has introduced a high degree of fluidity into the structure of intergovernmental relations, it has brought flexibility into what had appeared to be an immutable system of governance.

iv. The stakes are high. Decentralization affects not only urban services, but also social sectors, non-urban infrastructure, and—conceivably—the stability of national economies and the effectiveness of poverty-alleviation efforts. As the present degree of fluidity in intergovernmental relations is presumably transitory, it is an opportunity that should be seized.

### **Directions for Reform**

v. The basis for making recommendations on the structure of urban service delivery is necessarily polyglot. The academic literature provides a useful conceptual framework. The public economics literature, for example, provides a basic prescription for expenditure and revenue assignment, arguing that responsibility for discrete public services should be assigned to the level of government whose boundaries incorporate the affected beneficiaries—along with a corresponding revenue source with which to ascertain demand. The institutional analysis literature contributes a more extensive list of policy handles, a view that the performance of organizations is not only determined by their nominal powers and responsibilities, but by the motivations of the people who work within them. This directs attention to such issues as whether the mayor is appointed or elected (and what sort of career trajectory confronts a successful mayor), and the mechanisms by which interest groups can make their wishes known.

vi. The most persuasive basis for recommendations is empirical evidence, but the empirical evidence that exists is not decisive. Evidence from developed countries—which might be presumed to provide models—provides some common sense of direction but is characterized by considerable variety and frequent experimentation. The past experience from developing countries appears largely to be a source of negative lessons. The most relevant body of evidence is emerging from the countries that are now in the process of decentralization. But these reforms are still in their initial stages. There are no before-and-after cases of LDC decentralization on which to base normative advice.

vii. The evidence nevertheless suggests that there are three elements to reform in the structure of urban service delivery: (a) the clarification of functional responsibilities between levels of government; (b) the authorization of revenue sources corresponding to functional responsibilities, and (c) the institution of a system of accountability that encompasses both regulation by central government and incentives for responsiveness to local constituents.

### *Linking services to government*

viii. Clarity in the division of functional responsibilities between levels of government would appear to be an essential condition of any reform in the structure of urban service delivery. A clear linkage between a unit of government and a specific service seems to be essential to enable constituents to hold local governments accountable for specific functions and to eliminate the soft budget constraint implied by the otherwise open-ended nature of central government participation. Such clarity requires, *inter alia*, a system of revenue assignment and budgetary discretion that permits local governments to perform the roles that have been assigned to them. But it may first require governments to legislate more geographic specificity into their municipal organic laws.

### *Revenue reform*

ix. Reform in revenue assignments is needed if a clear division of functional responsibilities is to be workable. The particular structure of local revenues—the mix of user charges, taxes, transfers, and loans—that is appropriate in a given context depends, first and foremost, on the functions that have been assigned to local government. Where the benefits of a service are largely confined to individual consumers, user charges are an attractive means of financing municipal services. Local taxes, in principle, are an appropriate means of financing services whose benefits cannot be confined to individual consumers, but nevertheless do not extend beyond the municipal boundaries.

x. Any attempt to reform the structure of urban service delivery, however, must address the largest source of local revenue: intergovernmental transfers. Transfers can serve several important positive roles in the financing of municipal services, permitting central governments to induce local governments to undertake sectoral expenditures that are of national—rather than local—interest, and to use local governments as agents of national income redistribution policies. But reform is required both to increase the effectiveness of transfers in achieving these sectoral and distributional objectives and to reduce the adverse side effects of badly targeted or badly administered transfers.

xi. Perhaps the most important measure developing countries can take is to reduce the unnecessary adverse side effects of existing transfer programs—to reduce the uncertainty and

bargaining that now accompanies intergovernmental financial flows and remove incentives for strategic behavior. But countries also need to expand transfer programs to adequately finance the expenditures they have assigned to local government—particularly if these include primary education and preventive health care—and to target them more effectively.

xii. Reform is also needed in the arrangements by which municipal governments obtain access to financing for capital investment. To an extent, improvements in allocation can be achieved by improving the targeting of grant programs—particularly where the preconditions for allocation by lending do not exist. But there is also a case for replacing grant financing with loan financing. Municipal credit institutions (MCIs) are an increasingly popular means of administering such programs. The performance of these organizations is mixed, however, and while some legal and organizational steps may enhance their viability, experience suggests that what matters most is the government's commitment to the MCI's independence and its willingness to provide a supportive financial environment.

### *Balancing regulation and electoral accountability*

xiii. How much a system of urban service delivery should rely on accountability upward to central government—through regulation—or downward to constituents—through political participation—is not an issue that lends itself to universal prescription. Neither extreme is advisable.

xiv. Some degree of accountability to central government through a national regulatory framework appears to be appropriate to any structure of urban service delivery. Central regulation is clearly appropriate where local government behavior can affect national monetary, trade, or fiscal policy. It is also clearly appropriate where local governments are carrying out functions on behalf of central government. But where impact of local government behavior is largely localized, and regulation requires detailed knowledge of local conditions and priorities, the case for central regulation is more difficult to justify.

xv. The counterpart to central regulation is local political accountability—the reliance on voters to regulate the behavior of their political leaders. The view that local elections perform impeccably in this role does not stand up well to scrutiny. The validity of elections after long periods of authoritarian rule appears particularly questionable. The advent of local democracy, while increasingly common, is therefore no panacea. There is nevertheless some evidence that specific changes in election rules can influence the degree to which local elections function as referenda on local government performance. And there are alternative, and supplementary, means of holding local municipal leaders accountable.

### **Synchronization**

xvi. While there is clearly no one way to organize the delivery of urban services, what does appear evident is that the various pieces of the intergovernmental relationship have to fit together. This has become increasingly evident in countries that are undergoing political decentralization. The political impetus behind decentralization has prompted central governments to make political concessions hastily. But granting local elections is a step that can be taken quickly. What is slow and

difficult is the working through of new regulatory relationships between central government and local government; the conversion of what had been annual budgetary transfers within a central government into intergovernmental transfers that are transparent and predictable, and the development of credible local political systems. Many of the problems associated with the current wave of decentralization arise from the failure to match the pace of political decentralization to the pace of regulatory and other organizational reforms.

## I. INTRODUCTION

### The Context

1.1 Over the past 25 years, the developing world has been transformed from a world of rural villages to a world of cities and towns. In 1965, less than one quarter of the population of low- and middle-income countries was urban. By 1990, that proportion had increased to roughly half. The urbanization of the developing world is a global phenomenon. As shown in Table 1, all the major regions of the world have experienced dramatic increases in their degree of urbanization in the last quarter century. By the year 2025, it is estimated that more than two thirds of the population of developing countries will be urban.

Table 1. Trends in world urbanization

Region	% urban 1965	% urban 1990
Sub-Saharan Africa	14%	29%
East Asia	19	50
South Asia	18	26
Europe	40	60
MENA	35	51
Latin America	53	71

Source: 1992 World Development Report

1.2 National economies are also increasingly urban. Although figures on the geographic origin of GDP are difficult to obtain, sectoral data is indicative of the importance of cities in national economies. In 1990, more than 80 percent of the GDP of the low- and middle-income countries was produced in the nonagricultural sectors—largely in manufacturing and services. And data on the sectoral composition of economic growth suggests that the urban sector is a principal engine of development. As shown in Table 2, growth rates in manufacturing and services consistently exceeded those in agriculture in virtually all regions of the world during the last decade. Even in regions undergoing severe adjustment during the 1980s, growth rates in manufacturing and services far exceeded those in agriculture.

Table 2. Sectoral composition of economic growth  
(Average annual GDP growth, 1980–90)

Region	Agriculture	Manufacturing	Services
Sub-Saharan Africa	2.1%	3.1%	2.5%
East Asia	4.8	12.4	8.0
South Asia	3.0	6.8	6.3
Europe	1.0		2.7
MENA	4.3	3.4	1.9
Latin America	1.0	1.7	1.7

Source: 1992 World Development Report

1.3 The demographic growth of cities and their contribution to national economies suggest that cities work. Urban population growth is fueled by the prospects for jobs and higher incomes. The available evidence suggests that these expectations have largely been met. The personal income of rural-to-urban migrants is consistently higher in the place of destination than in the place of origin. Higher incomes in cities in turn reflect the greater productivity of labor in cities: studies of labor productivity suggest that urban-rural wage differentials largely reflect spatial variations in labor productivity.

1.4 Yet cities do not deliver on the promise of a better quality of life to the extent that they could. Despite the relatively high incomes of urban populations, the quality of services in major cities is poor. At least 170 million people in urban areas lack a source of potable water near their homes, and in many cases, the water that is supplied to those who have access is polluted (World Bank 1992). Nearly 350 million people in urban areas lack access to basic sanitation (a figure that is believed to have increased in absolute terms over the last decade (World Bank 1992)). In many large cities in developing countries, less than 70 percent of municipal solid wastes are collected and only 50 percent of households served (Bartone, Bernstein, and Wright 1990). In Mexico City, it is estimated that the average time required for a journey to work is between 2.5 and 3.5 hours (Legorreta 1989). While data on the coverage of education and health services in urban areas are not available, the aggregate statistics for Third World countries are disturbing: in half of low-income countries, fewer than half of school age children are enrolled in primary schools (World Bank 1990a).

1.5 These service failures have wider economic and distributional implications. Christine Kessides' discussion paper notes that a lack of access to, or unreliability of, infrastructure services can have adverse effects on growth, forcing firms to seek higher cost alternatives, which may in turn have unfavorable impacts on profits and levels of production and consequently on investment and job growth (Kessides 1993). A 1988 study of manufacturing establishments in Nigeria found that costs of private substitutes for public infrastructure services (generators, boreholes, vehicles for personnel and freight transport, and radio communications equipment) constituted 15 percent of the total machinery and equipment costs of small firms, and 15 percent of those costs in large firms.

1.6 Service failures also have distributional implications. The economic benefits of urbanization have not been uniformly distributed. As countries have urbanized, poverty has urbanized as well. It is estimated that by the end of this century, 90 percent of the absolute poor in Latin America will be living in cities, as will about 40 percent of the poorest in Africa and 45 percent of those in Asia (Rondinelli 1990). Where the formal system of services delivery fails to reach the poor, these households must resort to alternatives that often imply not only lower quality but higher costs. In the absence of piped water supply systems, for example, households are forced to rely on purchases from water vendors. A survey of water vending in 16 LDC cities demonstrated that the unit cost of water sold by vendors is, on average, 12 times higher than that of piped water systems (World Bank 1992).

## The Management Problem

1.7 Failures in the coverage and quality of services reflect, in part, aggregate resource constraints. The ability of an economy to provide convenient, reliable urban services is constrained by the demands of other fundamental needs—food, clothing, basic shelter, security—in extremely poor countries. But the available evidence suggests that the constraint on improved service delivery is not merely one of resources. The level of resources already devoted to urban service delivery is substantial. There is evidence, for example, that in the absence of conventional service delivery systems, households commonly resort to more expensive alternative sources. In Jakarta, Indonesia, 800,000 households have installed septic tanks, at a cost equal to three times the amount that would have been required to provide connections to piped sewerage systems. Moreover, there is evidence that governments—particularly central governments—already spend a significant amount on urban services. While statistics on the sectoral and geographical pattern of government expenditure are scarce (particularly in developing countries), estimates of the annual level of central government expenditure on urban services<sup>1</sup> in the developing and transitional economies range from \$100 to \$200 billion—approximately 2.5 percent to 5 percent of GDP.

1.8 The deficiencies in urban services in the cities of developing countries are therefore not merely a reflection of absolute resource constraints, but also of problems of management. Defining management in a policy-relevant manner is difficult. Management analysis is an evolving field in which even the definition of the relevant variables continues to expand. While the traditional focus of management has been the application of good technique—accounting, organization planning, financial analysis—recent frustration with this approach<sup>2</sup> has prompted a change in strategy; a shift in the focus of analysis from internal procedural issues to the incentive structure; to the various rewards and penalties confronting the individuals involved in the delivery of urban services. In part this represents a shift in the way internal operations of an organization are addressed, a change in focus from administrative procedures to the factors motivating individuals within the organization. But it has also directed attention to the role played by individuals *outside* the organization: to the consumer interest groups, unions, and central government regulators whose behavior also influences the performance of service delivery systems (Ostrom, Schroeder, and Wynne 1993).<sup>3</sup> While this

### Box 1. A typology of decentralization

D. Rondinelli's classic typology identifies four different categories of decentralization. All represent transfers of power from central government administration. The typology distinguishes types of decentralization on the basis of the organization to which power is transferred:

*Deconcentration* is defined as a transfer of power to local administrative offices of the central government;

*Delegation* as the transfer of power to parastatals;

*Devolution* as the transfer of power to subnational political entities; and

*Privatization* as the transfer of power (and responsibility) to private entities.

1. Defined as water supply, sewerage, intra-city roads, drainage, subsidies to urban mass transit, primary education and health.

2. The inability of the traditional analytic framework to yield effective normative conclusions is summarized in A. Israel's *Institutional Development*.

3. While not denying the importance of administrative procedures, this view would argue that procedural reforms are only effective if the incentive structure is supportive; that what matters in the first instance, for example, is not accounting system, but the motivation of the staff to use it.

approach seems to promise a more robust model of organizational behavior, it makes for a complicated analysis. It argues that to understand organizational results, one must understand the motivations of the myriad of individuals who play some role in the provision of urban services.

1.9 One product of this perspective is the view that problems in service delivery in part arise from the perverse relationships between political leaders at the central and local levels and their constituents. Critics of the present, often centralized, structure of government in developing countries argue that such structures are inherently incapable of responsive administration. Because the concerns of central government become increasingly predominant as the locus of decisionmaking moves away from beneficiaries, because the costs of influence become increasingly high as decisions are centralized, and because the quality of information about local conditions becomes increasingly distorted as it moves from field officers to central administration, centralized political systems are (according to this line of reasoning) inherently unresponsive. Rondinelli, for example, argues that "rarely do incentives exist for central government ministries to perceive citizens as their clientele" (Rondinelli 1990).

1.10 Whatever the merits of these arguments, they were largely of academic interest until the mid 1980s. The internal political structures of most developing countries were stable. Centralized, often authoritarian regimes, prevailed. Whatever the merits of decentralization, existing intergovernmental relationships appeared to be immutable. But during the 1980s, the situation began to change. Political decentralization is now, in fact, a very widespread phenomenon. Out of the 75 developing and transitional countries with populations greater than 5 million (World Bank 1992), all but 12 claim to be embarked on some form of transfer of political power to local units of government. The form and extent of decentralization varies. In parts of Africa, national governments are creating local political entities in territories that were formerly solely under the administration of central government. In Eastern Europe, what were formerly local administrative units of the central government have been transformed into separate political entities, with leadership chosen by local election rather than by appointment through the party structure. In Latin America, decentralization has meant a shift from centrally appointed mayors to mayors chosen by election. (In some Latin American and African countries, the most significant aspect of decentralization is central governments' tolerance of local victories by opposition parties.) In some countries, particularly in Latin America, political decentralization has been accompanied by increases in revenue sharing or by nominal changes in the legal definition of local functional responsibilities.

1.11 The motivations for decentralization—as it is observed in practice—appear only tangentially related to administrative reform. Political analysts have, in fact, suggested that decentralization stems from a more fundamental cause: the need of national political leaders to accommodate or deflect increasingly strident demands for power sharing by groups that have traditionally been excluded from it. Prud'homme, for example (referring to the Third World in general), has characterized decentralization as "a political strategy by ruling elites to retain most of their power by relinquishing some of it" (Prud'homme 1992). Davey, referring to Africa, has characterized decentralization as an attempt by bankrupt central governments to create a new target for political dissatisfaction (again without relinquishing real power). In Eastern Europe, where the concessions came too late, decentralization was (again in Prud'homme's words) "a hasty effort by newly victorious political forces to consolidate their positions" (Prud'homme 1993). Various analysts have speculated on the underlying causes of this rise in the stridency of political opposition.



It has been attributed to the conspicuous economic failure of the centralized state (in the ex-Eastern bloc, but also in Africa) (Hall 1993), to the relative absence of war and civil unrest (with the consequent decline in acceptance of strong authoritarian government) (Potter 1993), and to the emergence of educated urban middle classes—and the consequent decline of traditional patron-client relationships between the government and governed (Fukuyama 1992). Whatever the underlying cause, it is clear that the decentralization now occurring is not a carefully designed sequence of reforms aimed at improving public sector performance. It more often takes the form of a reluctant and disorderly series of concessions by central governments attempting to maintain political stability.

1.12 As a result, while decentralization has brought change in the structure of urban service delivery, it has not necessarily brought improvement. Unfortunate administrative consequences of decentralization are evident in a variety of contexts:

- **In Hungary**, the concession of local political autonomy preceded the separation of local budgets from the central government budgeting system. As a result, local governments lack a financially sustainable revenue base and have been forced to sell assets to cover recurrent costs (raising the prospect that the social safety net—for which local governments bear major responsibility—will run out of funds in the near future).
- **In Brazil**, where decentralization was reportedly motivated by the political repudiation of two decades of military rule, decentralization has taken the form of a substantial increase in revenue sharing and in the taxing powers of local government. It was not, however, accompanied by a corresponding delineation of local expenditure responsibilities. Thus, although local governments have more money to spend, they are no more accountable for the quality of their services than they were before the reforms.
- **In Ghana**, decentralization appears to be merely the attempt of a beleaguered central government to push the political (and financial) costs of government onto alternative levels of government, without actually relinquishing power (interview with Ken Davey). Political decentralization has not, so far, been accompanied by a commensurate decentralization of authority: the creation of locally elected legislative bodies has not been accompanied by a transfer of significant decisionmaking authority to local government. The Ghanaian government continues to appoint the municipal executive and the heads of municipal departments and effectively control local spending decisions.

1.13 Despite its political dimensions, decentralization still presents reformers—both domestic and in the donor community—with an opportunity to promote administrative reform. Political pressure for decentralization has resulted in a high degree of fluidity in the structure of the public sector. With governments forced to make fundamental changes in the structure of the public sector, it presents an opportunity to promote the kinds of fundamental changes in intergovernmental relations that have tended to be frustrated in the past. This opportunity is presumably a transitory one, and one that should be grasped.

1.14 The potential impacts of such reforms may extend beyond sectors that are considered urban. Changes in the allocation of power between levels of government have implications for national efforts to reduce poverty and manage the macro economy (particularly to the extent they

reduce central control over the instruments of fiscal policy (Prud'homme 1993)). Decentralization also affects the delivery of social services—primary education and health—as well as nonurban infrastructure. Decentralization is in fact already the subject of World Bank sector work in education, transport, and health.

1.15 There is no road map here. The world now consists of more than 200 ongoing experiments. Of the countries that have embarked on decentralization, none yet has the length of history that would permit an *ex post* evaluation. The developed, Western economies—which might be assumed to offer models—have themselves adopted different approaches to the organization of their subnational governments and several are in a constant state of experimentation. The objective of this paper is therefore modest: to document past approaches to the development of (urban) local governments, to derive lessons from that experience, to assess the implications of decentralization for these efforts, and to propose an approach (derived from both theory and such experience as exists) that might be used in the future.

## II. A FRAMEWORK FOR ANALYSIS

### Defining the Problem

#### *The problem is not municipal government*

2.1 Much of the early work on urban service delivery systems—particularly by the donor community—focused on the internal administration of municipal government. Urban service failures were defined as a problem of internal administration—specifically a problem of poor tax administration, poor accounting, and poor capital investment budgeting. As described in a recent survey of institutional development components in World Bank urban projects (Haines 1992), approximately two thirds of the identifiable targets of World Bank municipal development projects during this period were aimed at local taxation, accounting, or capital budgeting. This pattern was characteristic of other multilateral aid organizations and bilateral donors.

2.2 In retrospect, this now appears to be too narrow a definition of the problem. First, in many developing countries, municipal *governments* did not exist in the sense that was often assumed. While units of local administration existed, these were not distinct political bodies, drawing their legitimacy from local—rather than national—political constituencies, and possessing significant autonomy. As a result, the assumption that local political leaders had either the motivation or the authority to respond to their constituents in the same manner as their counterparts in industrial democracies was often misplaced.

2.3 Moreover, the assumption that municipal governments in developing countries had clearly defined responsibilities—and that these were the functions typically assigned to local governments in the industrial world—was also often erroneous. Despite the provisions of national constitutions, the sectoral responsibilities of municipal government were very limited and reflected the ad hoc accretion of past practices and political accommodations. Central governments (in federal countries, large states) would control major capital investment decisions in water supply, sewerage, road construction, or public education and health, leaving the municipal government responsible for operations and maintenance of these services. In some countries, local government functions were largely limited to the maintenance of public order and the cleaning of public streets. In Juarez, Mexico, for example, “strengthening local government” would be largely tantamount to expanding the municipal police force.<sup>1</sup>

2.4 The assumption that finance—the lack of resources—was a key constraint was also misplaced. Although municipal governments were poor—both in terms of absolute revenues per capita and in terms of the share of total public expenditures (relative to their counterparts in industrial countries), local government functional responsibilities were correspondingly limited. Moreover, given the absence of clearly defined local responsibilities, little assurance existed that increases in local revenues would be devoted to functions that (in the view of donors) represented high priorities.

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1. In 1988, nearly half of Juarez' budget (excluding transfers to the municipally-owned water parastatal) was, directly or indirectly, devoted to the police.

2.5 Finally, the assumption that problems in internal administration could be addressed through the transfer of technical knowledge was also misplaced. Donors tended to operate as if the constraints on administrative improvement were constraints of knowledge. Thus technical advice on property valuation techniques were prescribed as the solution to low property tax yields; technical advisory services were similarly prescribed as the solution to problems in accounting and capital budgeting. Subsequent evaluation reports and sector work, however, suggest that technical advisors were often marginalized and their advice ignored; and that problems in internal administration were not due to a lack of knowledge but instead reflected rational responses to firmly established, if perverse, institutional incentives.

*The problem is the system of urban service delivery*

2.6 The conclusion that emerges from this experience is clear. Urban service delivery appears to be a problem that cannot be addressed by taking the organizational context as a given and attempting to change the behavior of one organization—municipal government—within it. Instead, it appears to be a problem of the public sector as a whole, and one that must be addressed by looking at the variety of factors that influence the performance of the public sector and those factors' implications for urban service delivery. Constraints on urban service delivery are not only the level of the property tax or the sophistication of the accounting system, but also the broader set of perverse incentives embedded in the relationship between central and local governments. In failing to address the incentive structure, reform efforts not only undermine the prospects for achieving administrative targets; they also appear, in retrospect, to be the most significant constraints on the performance of urban service delivery systems (World Bank 1993a).<sup>2</sup>

2.7 **Efficiency and responsiveness.** In a sense, the problem of urban service delivery is best defined in terms of characteristics of the delivery system, rather than the problems of a discrete organization. The objective of reform is not "strong local government" but an efficient and responsive system of urban service delivery. Efficient in a technical sense—in the application of production technology so as to produce the maximum amount of output from a fixed quantity of inputs—and efficient (or responsive) in an economic sense—in its terms of its effectiveness in producing the *mix* of products that corresponds to the varying preferences of consumers.<sup>3</sup> The performance of a service delivery system can thus be evaluated both in terms of its efficiency in the transformation of inputs into products and of its efficiency in producing the mix of products that matches the effective demand of consumers.

2.8 **Equity and economic stability.** Efficiency is not the sole criterion by which a municipal service delivery system should be evaluated. While technical efficiency and responsiveness may be the paramount objectives, municipal service delivery cannot be isolated from other objectives of the

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2. These conclusions are based on a 100 percent survey of all OED project audits and PCRs on urban development projects through December 31, 1992. (See table in Annex). It should nevertheless be noted that (1) OED audits cover a early period in Bank interventions; and therefore do not reflect the impact of changes in the Bank's approach, if any; and (2) that the time frame covered by the audit (the disbursement period) is often too short to permit an assessment of the sustainability of a intervention's impact.

3. In the decentralization literature, the two categories are variously referred to as "production efficiency and demand efficiency" (Campbell, Peterson); or efficiency and effectiveness (Randinelli, Ostrom).

public sector. Decisions on the level and financing of municipal services have important distributional implications: expenditures on education and health, for example, are often the most significant forms of income transfers in developing countries. Moreover, to the extent that central governments effectively concede control over fiscal policy to local governments, certain financing arrangements can have adverse implications for the stability of the macroeconomy. The implications of a given structure of service delivery for poverty reduction and macroeconomic stability are therefore also important considerations.

## **Defining the Instruments**

### ***Public economics perspective***

2.9        What are the means by which these objectives are to be achieved? Several academic traditions contribute different parts of the answer to this question. The public economics literature provides a useful organizing framework. Public economics sees this as an assignment issue: a question of dividing functional responsibilities between levels of government, and allocating corresponding revenue sources. In the classic formulation (Musgrave and Musgrave 1984) the public economics literature assigns three roles to the public sector as a whole: (a) macro stabilization—the provision of a stable economic environment for the private sector, (b) income redistribution—the reduction of poverty, and (c) resource allocation—influencing the allocation of resources where markets fail to do so efficiently. The public economics model conventionally assigns the first two of these roles to central government. Central government has responsibility for stabilization policy, largely on the grounds that local economies are too open to permit countercyclical measures to be implemented effectively. Income redistribution policy, similarly, is considered to be the prerogative of central government, on the grounds that local attempts to address income disparities are likely to induce inefficient migration. Subnational governments enter the picture only with respect to the third role of government—resource allocation. Noting that tastes and preferences for public services vary among populations, this framework argues that if the benefits of particular services are largely confined to local jurisdictions, welfare gains can be achieved by permitting the level and mix of such services to vary accordingly. If local consumers are confronted with the costs of alternative levels of service (according to this viewpoint), constituents can be forced to reveal their preferences (through voting for rival political candidates, voting on tax initiatives, or similar means). In this respect, local politics can approximate the efficiencies of a market in the allocation of these local public services; “pricing” municipal services and relying upon the local political process to clear the market.

2.10        The organizational implications of the public economics framework are straightforward. Responsibility for discrete public services should be assigned to the level of government whose boundaries incorporate the affected beneficiaries. That level of government should then be assigned a corresponding pricing instrument—a tax with a corresponding incidence—with which to ascertain demand.

### ***Institutional analysis perspective***

2.11        Although useful as a starting point, the public economics framework is not an agenda for action. In effect, it assumes away certain behavioral and technical factors that appear to be

important. It assumes that local politicians and the people who work for them are solely interested in serving the interests of their constituents, and that constituents have both the means and the incentives to make their interests known. The public economics framework also assumes away certain practical considerations. It ignores the high administrative costs that would be associated with assigning each function of the public sector to a distinct unit of government with its own field administration. And it ignores economies of scale in service production and thus the potential conflict between an organizational solution that would be most responsive, and one that would be most efficient in a technical sense.

2.12 The behavioral implications of alternative organizational arrangements are addressed in what has been called the institutional analysis perspective. This is a framework that explains the behavior of politicians not as altruism, but as the rational pursuit of self-interest—the behaviors required for advancement in a political career—and where the behavior of bureaucrats is similarly explained as a rational, self-interested response to the working rules that allocate rewards and costs within the organization. As Ostrom argues, “individuals—politicians and bureaucrats—are boundedly rational and make choices according to their preferences. Individuals are not assumed *a priori* to be encapsulated by their organizations, nor to find organizationally rational behavior necessarily consistent with individually rational behavior” (Ostrom, Schroeder, Wynne 1992).

2.13 Proceeding from this framework, the institutional economics literature argues that the way to change the performance of an organization is to change the incentives of the people who work in it. One of the normative conclusions arising from this field is its advocacy of organizational rules that would render service providers more vulnerable to client groups. This is elegantly summarized in Hirshman’s phrase “exit and voice,” in which he argues for organizational arrangements that will offer consumers the option of either taking their business elsewhere (exit), or increasing their influence over providers through “voice”—enhancing the lines of communication between providers and constituents—through formal electoral processes and alternative means of articulating preferences, including the use of local taxes and charges as a means of testing beneficiaries’ willingness to pay.<sup>4</sup>

2.14 Other contributors to this field have noted the preconditions that affect the articulation of voice. Israel has contributed the term “specificity” to this glossary, noting that constituents have greater success articulating voice when the entity to which they are addressing themselves has a clearly defined output for which it is responsible (Israel 1987). Ostrom has emphasized the importance of minimizing transaction costs in the articulation of voice, noting that constituents are unlikely to participate unless they perceive the expected benefits to exceed the costs (Ostrom et. al 1992).

2.15 The normative prescriptions arising from this framework are compatible with the framework proposed by public economics. (Ostrom in fact incorporates the public economic framework into her normative model of “polycentric institutional arrangements”.) What the

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4. The literature on “exit” has been extensively covered elsewhere—and will not be further examined here.

institutional analysis literature contributes is a more extensive list of policy handles: a view that the performance of organizations is not only determined by their nominal powers and responsibilities, but by the motivations of the people who work within them. This directs attention to such issues as whether the mayor is appointed or elected (and what sort of career trajectory confronts a successful—or unsuccessful mayor), and the mechanisms by which interest groups can make their wishes known to local governments and exert pressure to have them fulfilled.

### *Administrative distinctions*

2.16 A third strain in the literature addresses—or at least provides a framework for addressing—the technical problems raised but not addressed in the public economics framework. The literature has long recognized a distinction between the “provision” and “production” aspects of service delivery—a distinction between the role of deciding how much is to be produced and the role of producing it (Musgrave and Musgrave 1984). This distinction is useful in addressing the apparent conflict between the demand-responsiveness of decentralized decisionmaking and the presumed economies of scale of centralized production. As Silverman, among others, has recently noted, production can be organizationally separated from provision; the entity that decides how much to produce need not be the entity that undertakes the production (Silverman 1992). Such a separation allows the responsiveness benefits of local decisionmaking to be captured by assigning the provision role to local government, while allowing economies of scale to be captured by permitting larger entities of government (or private firms) to be responsible for production.

2.17 A parallel distinction is useful in addressing the high administrative costs that would result from assigning each function of government to a separate public entity. As Campbell has noted, a single tier of government can act in multiple capacities. The local government can act as both the provider of local public services—clearing the market in local public goods in response to local expressions of demand—and as an administrative agent of higher levels of government (Campbell 1992). In this respect, a single level of government can assume functional responsibility for multiple services, thus reducing the aggregate administrative costs of the public sector.

2.18 Evidence from the industrial countries suggests that these distinctions are not merely academic. The industrial countries (which may be assumed to be relatively successful in this regard) all have complex structures of service delivery in which these distinctions play a role. The separation of provision from production is commonly observed in the G5 countries, particularly in the execution of capital works. Although local governments play a large role in the delivery of infrastructure services in the G5 countries, little construction is done by municipal employees. Major off-site capital works are typically constructed by private contracting firms. Residential infrastructure in developed countries is almost entirely produced by private-sector developers (prodded by local development regulations.) The production of such services as water supply (in the case of France and the United Kingdom), solid waste management (in the U.S.) and bus transit is also assigned to private firms in the G5. Similarly, the use of local governments in an agency role is widespread in the G5 countries. In the U.S., for example, the federal government relies on local government to implement some of its major income-distribution policies, including the administration of AFDC (Aid to Families with Dependent Children) and food stamps.

2.19 Overall, the conclusion of this literature is that there is no single institutional arrangement that can be universally prescribed for the delivery of urban services, that what is important are not the organizational labels, but rather the relationships—the rules that govern the transactions between national government political leaders, local government leaders, staff, and consumers. A “good” arrangement is likely to be a very complicated one and one that is not defined merely by the designation of municipal responsibilities and revenue sources. It is one in which the interests of national political bodies and local interest groups are incorporated in different ways, with municipal governments performing as agents of central government in some capacities, and as independent decisionmaking bodies in others. But while the system can be organized in a variety of ways so as to yield a relatively efficient, responsive structure of governance, not all such arrangements work equally well. Evidence from developing countries illustrates a variety of suboptimal arrangements, as discussed below.

### **A Typology of Intergovernmental Relations**

2.20 The intergovernmental relations of a country are difficult to know. The official rules—the legal framework—are at best only an indicator of the actual locus of decisionmaking power and the influences that bear on decisionmakers. It is useful nevertheless to attempt to articulate common patterns in intergovernmental relations, to illustrate the variety of circumstances that exist.

2.21 Three patterns are discernable. The first might be called the overcontrolled local sector, where subnational governments are in effect merely administrative arms of the central government. Its obverse is the undercontrolled local sector, in which each tier of subnational government is almost sovereign and competes with other levels of government. The third might be called the perversely regulated local sector, where local governments have some degree of political autonomy but where the relationship with central political leadership is characterized by perverse incentives.

#### ***The overcontrolled local sector***

2.22 This is historically the classic pattern in developing countries. It has two typical characteristics. First, a very high proportion of total public expenditure is made directly by the central government (or in federal countries, by large states). Second, local government, even within its circumscribed expenditure role, functions largely as an administrative arm of the central government, with the central government appointing the municipal executive, and dictating virtually all expenditure and revenue decisions.

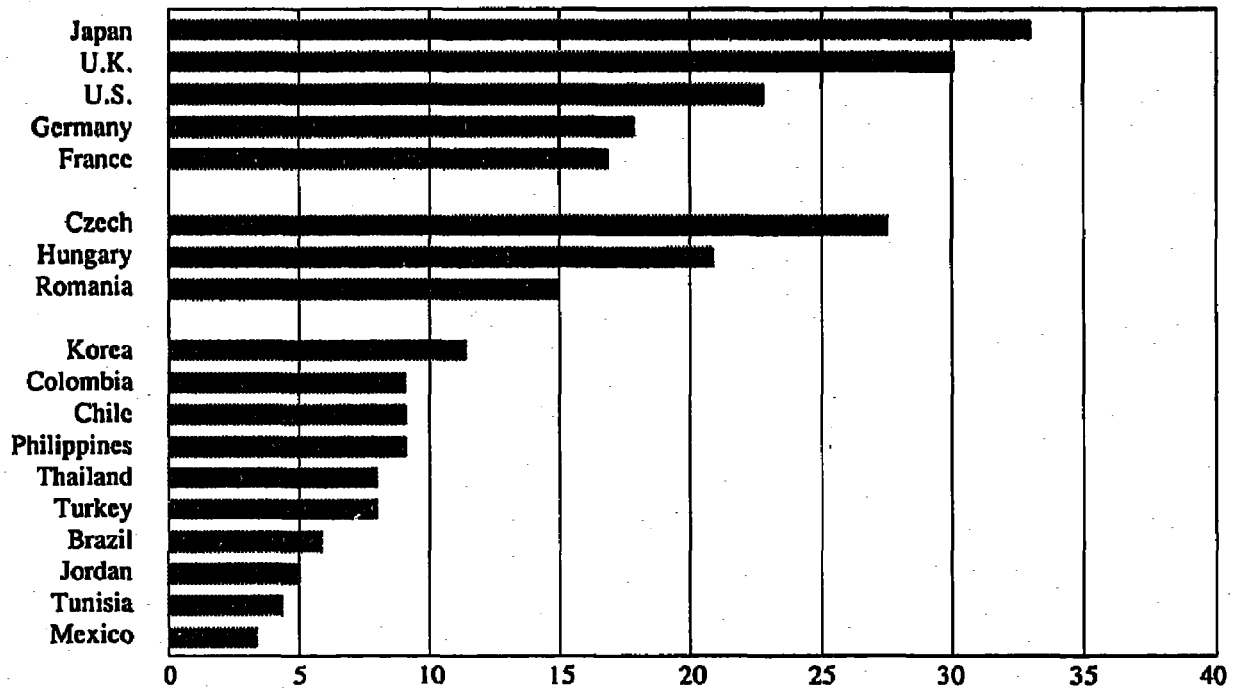
2.23 Central government’s dominance of total public sector expenditure is the common pattern in developing countries. As shown in Figure 1, the local share of total public sector expenditure in developing countries—even large countries like Mexico—is well below 10 percent. This is in contrast to the G5 countries, where the local share ranges from 17 percent (France) to 33 percent (Japan).<sup>5</sup>

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5. These statistics, based on the IMF Government Finance Statistics Yearbook, are at best crude indicators of the degree of centralization in these countries. As noted later in the text, they do not, for example, reflect the degree to which local expenditures are controlled by central government. Certain statistical conventions and data constraints in the IMF data



Figure 1. Local share of public expenditure



2.24 Local governments in these countries, moreover, bear no resemblance to autonomous political entities envisioned in the public finance literature. To begin with, central governments, rather than local voters, choose the municipal political executive. (Elected councils are often permitted, but function in a purely advisory role.) As shown in Table 3, direct appointment of municipal executives is still the pattern in many large LDC cities. Elsewhere, central control over local political outcomes is discretionary but is widely used. In India, for example, state governments possess the legal authority to dismiss mayors whose performance they find unsatisfactory. Since independence, at any given time, 40–50 percent of the local authorities have been under state supersession. Bombay's current mayor is, for example, a state appointee.<sup>6</sup>

also tend to understate the degree of public service decentralization in the G5 countries, and the consequent contrast between G5 and developing country patterns. First, the IMF data do not include the self-financed expenditures of public utilities (recording instead only tax-financed subsidies to parastatals). To the extent local public utilities in industrial countries are largely self-financing (and those in developing countries are not) this convention would tend to understate the difference between the two groups of countries. Second, IMF data do not permit the disaggregation of government expenditure by function (except for the industrial countries and a small number of developing countries.) As a result, it is not possible to identify the proportion of central government expenditure in urban service delivery. It can be surmised that such a comparison would indicate that the local share of urban service expenditure in industrial countries is much higher than in developing countries. IMF statistics do indicate, for example, that in the industrial countries, local governments account for the 40–60 percent of public expenditure on capital investment, which anecdotal evidence would suggest is not the case in developing countries. In the G5 countries, central government expenditures are dominated by direct transfers to individuals—essentially social safety net expenditures—whereas in developing countries (judging from a small sample), a larger proportion of central government expenditure is devoted to capital works. If data on the aggregate expenditure on urban services (including self-financed utilities) were available for both developing and developed countries, it can be surmised that the contrast in this indicator of decentralization would be greater than is shown by the available statistics.

6. Recent legislation has restricted, but not eliminated, states' power to supersede local elected officials.

**Table 3. Structure of political accountability in major LDC cities**

City	Mayor	Council
Bombay	appointed by state	temporarily dissolved
Jakarta	appointed by government	directly elected, no legislative power
Mexico D.F.	appointed by government	directly elected, no legislative power
Sao Paulo	directly elected	directly elected at large, legislative power
Seoul	appointed by government	directly elected, no legislative power
Budapest	directly elected	elected, 1/4 directly by district; 3/4 at large by party list
Lagos	directly elected	elected
Shanghai	elected by council	elected from one-party slate

2.25 Central governments also directly control the allocation of municipal expenditure in this group of countries. Personnel is typically the largest single item of local government expenditure, and the ability of local government to recruit, retain, and motivate staff is critical to its ability to provide municipal services efficiently. In many developing countries, control over local personnel management decisions rests with central government. Central governments often control the number of positions local governments are allowed to maintain at each grade, the starting salaries and pay differentials between grades; the level of cost of living increases; and the appeals process for dismissal. In Turkey, for example, the staff list of each municipality is fixed by the government, along with the corresponding salary scale. Any amendments to the staff list have to be approved by the central government in a laborious process involving the Ministry of Interior, the State Personnel Organization, and the Council of Ministers. In some countries, central governments are directly involved in individual recruitment and promotion decisions. In Ghana, for example, local government staff are directly recruited, promoted, and paid by sectoral ministries of the central government. In the Philippines, municipal treasurers and tax assessors (until recent reforms) were directly recruited, supervised, and paid by the central government ministry of finance. In Indonesia, all full-time staffing positions are subject to central government recruitment and promotion and are paid directly by central government.

2.26 Central governments also control the sectoral composition and size of local government budgets. In Morocco, for example, each municipality's budget must be approved by the Ministry of Interior before the funds can be disbursed against it—an approval process that includes a verification that all centrally mandated expenditures are in the budget and a verification that personnel expenditure aggregates agree with the *Loi de Cadres* for each year, the payroll of authorized grades and positions and with the Treasury allocation for municipal personnel expenditures. In Senegal,

similarly, the annual budget review process includes a line-by-line negotiation of the expenditure estimates of each local authority. In the Philippines (also until recent reforms), the overall size of each local government's budget was determined by the local representative of the finance ministry. In addition, central budget regulations required that municipalities allocate 20 percent of their revenue sharing for development projects approved by the government, 18 percent of their general fund for the national police, and 5 percent for aid to hospitals within the province; and that municipalities limit the proportion of the budget spent on personnel to 45 percent. (One study estimated that an average of 46 percent of all local expenditures in the Philippines were made under central government mandate.)

2.27 Municipal revenue levels are also regulated. In five of the eight LDC cities listed in Table 4, for example, local governments have no discretion over the rate of their principal tax. Governments use this control to keep the rates of local taxes extremely low. In Jakarta, for example, the government of Indonesia limits the property tax rate to 0.1 percent of assessed value. Even where local governments have some nominal discretion over the rate, central governments control the factors that determine how much these sources yield. In the Philippines, municipal governments are permitted to impose a rate on the property tax between 0.5 percent and 2 percent of assessed value—but the regulations governing assessments are such that the maximum effective rate is less than 0.1 percent of market value. In India, the combination of state-imposed rent control and Supreme Court interpretations of property tax legislation have resulted in the virtual exemption of all but the city's most recently constructed housing stock. In Mexico—in an environment in which annual inflation has ranged as high as 150 percent—local governments are forbidden to adjust assessments for inflation unless they obtain the simultaneous concurrence of the mayor, the council, the governor, and the state legislature.

Table 4. Sources of tax revenue in major LDC cities

City	Largest Local Tax			Other Major Tax	
	Name	Rate control	% of tax revenue	Name	% of tax revenue
Bombay	octroi	local	66%	property	13%
Budapest	income	central	95		
Jakarta	automobile (1)	central	72	property	11
Lagos	property	local	90+		
Mexico D.F.	payroll	central	58	property	21
Sao Paulo	services	local	80	property	17
Seoul	property	central	25	tobacco	21
Shanghai	business profit (2)	central	50	industry	30

(1) includes separate taxes on purchase and ownership

(2) amount of tax to be shared with central is negotiated

2.28 The performance of the overcontrolled system cannot be evaluated or faulted on empirical grounds. Some students of organization have in fact argued that the centralized, vertically integrated bureaucracy is in fact the most efficient form of organization.<sup>7</sup> But it can be argued that a system that concentrates such a large proportion of expenditure decisions in the hands of ministers

7. Max Weber, a pioneer of modern management science, was an advocate of this point of view.

whose constituencies are national, and permits so few channels of demand expression through influence over local political leadership, would have difficulty responding to its constituents—particularly where the central government revenue structure is also centralized (with heavy reliance on indirect taxes and little use of user charges) and thus cut off from price-related indicators of demand.

2.29 Anecdotal evidence from political observers also tends to cast doubts on the centralized system. As one observer of the local political scene has noted, “the practice of appointing municipal executives has often resulted in the mayor’s position being held by individuals with only short-term interests in municipal affairs. Where careers are dependent on the fortunes of political sponsors, officials are more likely to adhere to national policies at the expense of local circumstances” (Lowder 1986).

2.30 There is also evidence that the administrative demands of this tight system of regulation overloads the administrative abilities of the public sector in some developing countries. Central governments thus find they lack the information required to exercise this control intelligently. In Turkey, for example, governors are permitted one week to approve or modify a budget once it has been passed by the municipal council. Approval is therefore virtually automatic. The fact that revenue estimates have been inflated unrealistically to satisfy the central budgetary regulations goes unexamined. In Kenya, similarly, the Ministry of Local Government is required to approve or modify all local budgets before the commencement of the fiscal year, but lacks the basic information (such as data on actual income and expenditures of any previous year) on which to base its approvals. Under these conditions, the overcentralized system is perhaps the worst of both worlds, in the sense that there is neither a clear bureaucratic chain of command nor a clearly defined scope of local discretion. Under these conditions, central regulation merely obfuscates responsibility.

### *The undercontrolled local sector*

2.31 The obverse case is the undercontrolled local sector, in which there are multiple levels of government, each with political autonomy and autonomy over expenditure and revenue, but without any clearly defined functional responsibility. Brazil is perhaps the extreme example of this pattern. Brazilian *municípios* have historically enjoyed complete political autonomy—with councils and mayors chosen through competitive local elections (except during a short interruption during the military regime of the 1960s). They have complete expenditure autonomy and freedom over the rates of the taxes that have been assigned to them. When the extremely productive value-added tax was introduced (at the state level) in Brazil, the *municípios* were assigned a fixed 20 percent share of the proceeds, without restrictions on its use. No attempt is made, however, to define the functional responsibilities of each tier of government in Brazil. Brazilian legislation, while designating an extensive list of functions in which municipal government may choose to act, assigns the same functions concurrently to state government. (Only one function—natural gas—is exclusively assigned to the state level, and only one—urban transport—is assigned to municipalities.) As a result, both state and municipal governments may operate primary schools, health services, road construction and maintenance programs, or any other public service simultaneously within the same jurisdiction. In Brazil, the *de facto* division of labor between levels of government reflects a pattern of historical bargains and ongoing negotiations.

2.32 Again, the impact of this arrangement on the efficiency and responsiveness of urban service delivery has never been tested empirically. It would seem, nevertheless, to set up two kinds of perverse incentives. First, it would seem to obscure the accountability of local governments to their constituents. Without clearly defined functional responsibilities, local government could not easily be held responsible for the outcomes of any particular service by their constituents. Second, it would seem to set up a perverse set of relationships between local government politicians and their counterparts at the state (and central government) level. Without a clear distinction between the functions of each tier—in effect without a hard budget constraint on the extent of state participation in functions that a mayor is under pressure to provide—the extent of state participation is likely to be determined through bargaining. Where state government resources are allocated on this basis, they are unlikely to reflect either the priorities of local consumers, nor those of the state government, but rather the lobbying skills of local politicians.

*The perversely regulated local sector*

2.33 While Brazil is an extreme example, it provides the polar case for the set of intermediate cases that constitute the more prevalent pattern; countries in which there is some degree (*de facto* if not *de jure*) of local political autonomy, and where there is some (*de jure*) assignment of functional responsibilities, but there is a built-in vertical gap—a lack of correspondence between the revenue authority of local government and its expenditure responsibilities—that is addressed in undesirable ways.

2.34 There are two undesirable ways in which the vertical gap is closed. Perhaps the most common is through direct, but *ad hoc*, expenditures by central government ministries. The practice of direct intervention by central ministries is often the legacy of past crises. As Lowder describes it, central intervention is often provoked by disasters—outbreaks of communicable disease, for example—and the perceived failure of local government to respond. “In response to these crises, specialized technical agencies are introduced to manage utilities such as potable water, electricity, housing for the poor...these are usually autonomous or responsible directly to a minister, and empowered to override both the spheres of action and the territorial jurisdiction of other authorities” (Lowder 1986). In South Asia, the government’s intervention tends to be permanent. Central (or in India, state) public works ministries and development authorities take on responsibility for municipal capital works, leaving only the task of operations and maintenance to local government. In Latin America, the participation is more *ad hoc*. In Venezuela, for example, although municipal governments have the legal responsibility to provide water supply, sewerage, urban roads, and power distribution, agencies of the central government intervene in the provision of these services at will (and in fact account for the vast majority of public sector expenditure on these services).

2.35 The pattern of open-ended participation by central government ministries would appear to set up the same perverse incentives as prevail in the under-controlled (Brazilian) model: a structure in which constituents would have difficulty holding local governments accountable for any specific function, and where the mayor would be encouraged to act as a lobbyist before the central government ministries, rather than as an individual ultimately responsible for specific functions. The more stable South Asian approach contributes an additional nuance. With responsibility for capital investment

assigned to state agencies, but operations and maintenance left to the municipal level, disputes over debt liabilities and refusals to assume maintenance obligations on new assets are common. Given the revenue advantage that states have over local governments, overinvestment in capital (relative to operation and maintenance) is also characteristic of South Asia.

2.36 Countries also fill the vertical gap through intergovernmental transfers. As described in Chapter III, transfers have an important role in virtually any system of multitiered government finance. The problem is not transfers, but the terms and conditions on which transfers are provided. Intergovernmental transfers take various undesirable forms. First, in some countries, the level of transfers is itself unpredictable or largely determined by negotiation. In Kenya, for example, the central government is legally obligated to make an annual payment to local government in lieu of property taxes owed on government-owned property. It has often failed to do so, a failure that has set off a cycle of mutual default, such that local governments no longer service their debt to the government loans authority, the government hospitals fail to pay their bills to the municipal water authorities, and the water authorities refuse to pay their income taxes to the government.

2.37 Even where recurrent transfers are distributed according to formula, transfers may have perverse incentives effects. Dearness allowances in some Indian states and the SDO grants in Indonesia both fund part or all of local personnel costs, for example. This encourages local governments to lobby for more positions, regardless of need. Transfers based on the size of revenue gaps similarly encourage municipal governments to exaggerate expenditures or reduce local tax effort. In Morocco, for example, the size of a municipality's transfer is based on the gap between its estimated revenues and expenditures. Although both revenue and expenditure estimates must be approved by government—limiting the scope for local strategic behavior—debt service is automatically included as an element in approved expenditure. Even unconditional transfers, such as Brazil's, may embody arbitrary interjurisdictional subsidies. Brazil's largest transfer, for example, is distributed on the basis of the "origin" of value-added tax collections. But the value-added tax is collected at the point of production—from major manufacturing enterprises—not at the point of consumption where much of the incidence presumably falls. The result is a cross subsidy from consumers throughout Brazil to the residents of industrial enclaves—a transfer that, for example, enables the *município* of Sao Bernardo (the site of Volkswagen do Brasil) to operate a municipal symphony, courtesy of Volkswagen buyers throughout the country.

2.38 In developing countries, transfers are also used to finance capital investment. And again, while this may be an appropriate role for central government (particularly where long-term capital markets are not well developed), the allocation mechanism for capital financing is one that tends to be more responsive to the political interests of central government rather than local expressions of effective demand.

2.39 Capital allocation systems vary considerably among countries. In Pakistan, for example, the official system of capital allocation (described in Box 2) is one that in principle permits every project to be evaluated on both technical and economic grounds, in the light of the nation's investment priorities and the availability of financing. It nevertheless results in project selections being made by people far removed from beneficiaries, with little information about projects and less idea of beneficiary priorities. The Mexican PRONASOL program, in contrast, is said to institutionalize a high degree of beneficiary involvement but tends to bypass the capital budgeting process of sectoral

### **Box 2. Contrasting approaches to capital allocation**

**ADP:** Pakistan's Annual Development Plan (ADP) process typifies a highly centralized system that permits every project to be evaluated in the light of the nation's investment priorities and the availability of financing—but results in project selections being made by people far removed from the beneficiaries, with little information about projects, and less idea of beneficiary priorities. The ADP process begins with a municipality's submission of a project proposal to the provincial government, where it is subjected to technical review. If technically approved, it is then included in a larger pool of projects eligible for financing. Financing decisions are made annually, and begin with an estimate of overall resource availability by the central government's Ministry of Finance. Once an overall division of funds between government and provinces is made, the provincial government makes a tentative match of resources with projects; it then forwards its recommendations to the central government's annual plan coordinating committee which approves size and sectoral allocation of the overall package, and then submits it to a national economic council, presided over by the president. This lengthy process succeeds in eliminating technically unsound projects, and matches resources to projects, but incorporates no mechanism for weighing the degree of local commitment to investment projects.

**PRONASOL:** Mexico's National Solidarity Program (PRONASOL) represents only the current stage in Mexico's gradual process of decentralizing its project allocation system (starting from a system in which 94 percent of public sector capital investment decisions were made by sectoral ministries at the federal level). The program is funded from an earmarked share of the national budget (carved out of what used to be sectoral ministry budgets). Allocations are distributed among states by formula, with a fixed proportion earmarked for allocation by mayors. Allocations of the municipal share among a state's municipalities are based in part on political considerations. But within a given recipient municipio, the allocation of funds among projects draws on a well developed system of negotiation between the mayor and community groups, in which PRONASOL funding is made conditional on the community's willingness to provide counterpart contributions in cash or in kind. While mayors have the latitude to vary the terms of each project agreement, the matching requirement is universal. While PRONASOL, as a grant program, still embodies inter-jurisdictional subsidies, the explicit inclusion of mayors in the allocation process, and the program's use of counterpart matching contribution as a rationing device are, for Mexico, significant reforms.

ministries at the central and state level. In Turkey, the central government's public works agency, Iller Bank, is responsible for both financing and construction of municipal public works. Its investment choices, similarly, are said to reflect the technical preferences of its engineers, and the political interests of the central government.

### III. DIRECTIONS FOR REFORM

3.1 The basis for making recommendations on the reform of intergovernmental relations is not strong. While the academic literature is useful conceptually, it is not specifically prescriptive. The approach of the developed countries—which might be presumed to demonstrate successful models—provides some common sense of direction, but is still one of considerable variety and frequent experimentation. The past experience from developing countries appears largely to be a source of negative lessons. The most relevant body of evidence is emerging from the countries that are now in the process of decentralization. But these reforms are still in their initial stages. There are no before-and-after cases of LDC decentralization on which to base normative advice. The conclusions presented in this chapter are therefore subject to these limitations. They convey more confidence in what to avoid than what to pursue, but serve to provide an overall sense of the direction for reform.

3.2 The evidence, such as it is, suggests that there are three elements to reform in the structure of municipal service delivery: (a) the clarification of functional responsibilities between levels of government; (b) the authorization of revenue sources corresponding to functional responsibilities, and (c) the institution of a system of accountability that encompasses both regulation by central government, and incentives for responsiveness to local constituents.

#### Linking Services to Levels of Government

3.3 Clarity in the division of functional responsibilities between levels of government is an essential condition of any reform in the structure of urban service delivery. Judging from the institutional development literature and the anecdotal evidence from developing countries, a clear linkage between a unit of government and a specific service seems to be critical, in enabling constituents to hold local governments accountable for specific functions, and in eliminating the soft budget constraint that encourages mayors to act as lobbyists before the central government ministries, rather than as individuals ultimately responsible for the performance of specific services.

3.4 Where this clarity does not exist, it would appear to be the first priority for reform, an essential precondition for progress on the other two elements of reform. There can be no correspondence between revenue and expenditure assignments unless expenditure responsibilities are known. And any attempt to improve accountability through regulation and constituent access is undermined if the function for which the entity is responsible is undefined.

3.5 Clarity is not achieved by a mere act of legislation or a constitutional demarcation of functions between tiers of government. The developing world is full of such documents, and they are routinely ignored or violated. Clarity, above all, requires the central government to refrain from *ad hoc* interventions in responsibilities that have been nominally assigned to local government—to observe the hard budget constraint with respect to local functions, no matter how disagreeable the outcomes. And this, in turn, requires a structure of subnational government that renders such *ad hoc* interventions unnecessary; that obviates the crises that provoke central government intervention.<sup>1</sup>

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1. There is no definitive prescription setting out the functions that should be assigned to local government, or any standard practice, even among the developed, industrial countries. This is not surprising, given the variety of forms of



### ***Geographical specificity***

3.6 Such an arrangement requires, *inter alia*, a system of revenue assignment and budgetary discretion that permits local governments to perform the roles that have been assigned to them. But it may first require governments to legislate more geographic specificity into their municipal organic laws. One of the traditional justifications for the lack of any rigid division of functions between government levels is the great variety of circumstances in which local government operates: the concern that a rigid division of functions—a hard budget constraint applied to all situations—would work to the detriment of poor, weak, or otherwise exceptional, jurisdictions.

3.7 In some countries, the organic laws governing local government are a cause rather than a solution to this situation. The organic laws of many developing countries fail to legally recognize the different circumstances of different jurisdictions, making no distinction between urban or rural municipalities or between urban municipalities of different sizes. In Brazil, for example, the rules that apply to Sao Paulo (population 11.2 million) apply equally to Pirapora de Bom Jesus (population 4,585). Similarly, Mexico, Colombia, and Chile all make no distinctions between urban and rural areas or between urban areas of different sizes in the formal structure of local government. (The one-size-fits-all approach is also used in some Anglophone African countries, such as Nigeria and Ghana.) Under these conditions, functional specificity is difficult. The functions—such as secondary education—that could be comfortably assigned to the municipal governments of large metropolitan areas—cannot be because they cannot also be performed by the governments of tiny villages.

3.8 Geographical distinctions are already made in some parts of the world. The enabling laws of subnational governments in most of the Magrheb and South Asia, for example, make legal distinctions between urban and rural government and provide for varying degrees of autonomy for cities of different sizes. (In India, however, the graduation process appears to lag behind the rate of urban growth: places that were villages at the time of their initial designation are now cities, but retain the limitations of their former status). Geographical distinctions are also characteristic of the industrial countries. The British structure of local government distinguishes between metropolitan areas—where the full line of municipal services is assigned to district governments—and nonmetropolitan areas, where services that are needed in both urban and rural areas (education, personal social services, police and fire protection) are provided by county government—and those

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local government that exist: All the G5 countries, for example, recognize more than one level of local government. In France, Germany, and Japan, the two levels represent increasingly small subdivisions of the national territory as a whole. (French departments are divided into communes; German Landkreis into Gemeinden, Japanese prefectures into municipalities.) In the U.K. and U.S. (except Virginia), urban governments are “islands” in a county “sea”, with rural areas having only one tier of government—the county. All the G5 countries also permit the creation of sector specific entities of local government for the provision of education, water supply, parks, or similar services. In the U.S., 43,169 of the 82,341 units of local government are sector-specific special districts.

The public economics framework would argue that local government should be assigned responsibility for services whose impacts are confined to their jurisdictions. This would suggest that urban local governments should be assigned responsibility for residential infrastructure and secondary distribution systems (water supply, sewerage, secondary and tertiary road networks, and associated drainage, regulation of mass transit, parks, public lighting, solid waste management) although as noted earlier, this is not a prescription for municipal production of any of these services, but only for their provision. But as noted earlier, local governments may also function as agents of central government, and in this role may perform virtually any functional responsibility that is appropriate to the public sector.

that are specifically urban (housing, public transport, refuse collection) are assigned to separate urban (district) governments. The German structure of local government, similarly, provides for a two-tier system of local government in non-metropolitan areas, with combined responsibilities in large cities.

### Linking Revenues to Expenditures

3.9 Reform in revenue assignments is needed if a clear division of functional responsibilities is to be workable. Local governments need the revenue authority to perform the responsibilities that have been assigned to them, without appeals for direct expenditure to central government. While revenue reform does not imply a severance of intergovernmental transfers, it does imply the replacement of *ad hoc* grants with transfers based on clearly defined rules.

#### *Finance follows function*

3.10 The particular structure of local revenues—the mix of user charges, taxes, transfers, and loans—that is appropriate in a given context depends, first and foremost, on the functions that have been assigned to local government. Different kinds of revenue have different impacts on behavior and different patterns of incidence: user charges impose costs on individuals and can thereby ration consumption by price; benefit taxes can impose costs more broadly on the taxpayers within a jurisdiction, but can only ration through the local political process. Transfers make it possible to move money across jurisdictions, enabling central government to influence the behavior of local government and to redistribute income between constituents of different local jurisdictions. The choice of instruments depends on the objectives, and the objectives vary according to the function that is being financed.

#### *User charges*

3.11 Where the benefits of a service are largely confined to individual consumers, and where there are no major adverse distributional consequences (and where it is administratively feasible), user charges are an attractive means of financing municipal services. In effect, user charges are a means of rationing consumption according to willingness to pay: to extract information about consumer preferences directly, by moving the consumption decision beyond the local government, directly to the consumer. To the extent that price can be varied with quantity, user charges can function as a pricing mechanism, confronting beneficiaries with a choice of different levels at appropriate prices, and allowing individual consumers to decide the quantity of a given service based on their own tastes and preferences.

3.12 Piped water, bus transit, and toll roads for example, are all services for which user charges are appropriate. Fees for refuse collection and sewerage are also appropriate.<sup>2</sup> Urban governments in developing countries in fact already impose such charges, but the level of charges is far below the financial costs of providing the service. (As a result, in the Federal District of Mexico,

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2. Strictly speaking, fees for solid waste and sewerage should not be treated as user charges. There are public health externalities associated with these services; therefore, it is not desirable to allow individual consumers to choose the level of these services they wish to consume, based on their individual evaluation of benefits. Because such fees can be clearly associated with the services they are financing, however, they have some of the benefit-equity attributes of user charges.

for example, subsidies to the municipal bus line consume about 22 percent of the District's recurrent budget.) The constraint on the present use of user charges is partly regulatory. Central governments restrict the level of user charges, ostensibly on distributional grounds. This justification does not hold up to scrutiny. Subsidies for water supply or bus transit are a particularly ineffective means of pursuing poverty-reduction goals because they inadvertently subsidize nonpoor consumers and are inefficient because they reward over-consumption. Analysts of both water utilities and bus companies also note the adverse management implications of such subsidies. As governments rarely provide compensation to the providers for the full costs of these subsidies, their costs take the form of deferred maintenance and reluctance to extend service into low-income areas.

3.13 Governments can therefore encourage user charges through deregulation. But the evidence from developing countries suggests that municipal governments will not exploit this revenue source, even where they have the legal authority to do so—as long as less politically sensitive revenue sources are available. As discussed below, user charge reform must therefore be synchronized with reform in the other sources of municipal revenue.

### *Benefit taxes*

3.14 Local taxes are in principle an appropriate means of financing services whose benefits are localized but cannot be confined to individual consumers, but nevertheless do not extend beyond the municipal boundaries. In a sense, local taxes are the collective analogue of user charges. Where user charges are the means by which individuals can express their demand for services whose benefits are largely private, local taxes are the means by which taxpayers within a community can express their demand for services that are consumed collectively. Benefit taxes also provide a degree of geographical equity to the financing of municipal services, imposing the costs of municipal services on the people who benefit from them.

3.15 Virtually all countries already assign some form of local tax to their local governments (as shown earlier in Table 4). Reform therefore consists in part of overcoming the regulatory and administrative constraints on the use of these taxes. As noted earlier, local taxation is often highly regulated, with central government controlling rates, exemption policies, and any other factors that affect the level of tax liabilities. Like the controls on user charges, this degree of regulation does not appear to be justified (at least on distributional or fiscal grounds). Although governments are justified in restricting the kind of taxes municipal government may impose (to prevent local governments from exporting their tax burdens onto neighboring jurisdictions)<sup>3</sup>, there does not appear to be a justification for a central government preventing a municipal jurisdiction from imposing a price on itself.

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3. Thus there is a case for maintaining constraints on the use of certain taxes that are assigned to local government. In many LDCs, the highest yielding local taxes are those imposed on business activity. The specific form of such taxes varies: some are imposed on single sector (such as the service tax in Brazil) or types of transactions (such as the octroi in Pakistan); others extend more broadly to all industrial and commercial activity. In socialist economies, broad taxes (or profits) from public enterprises are the principle source of municipal revenue. Shanghai's profits tax and industrial and commercial taxes are, for example, largely imposed on firms owned by various levels of the public sector. Some business taxes have rudimentary assessment methods, taking the form of flat fees, to be paid by each business according to its particular sector; others employ more sophisticated methods of assessment, reflecting gross turnover or profits. Business taxes are high yielding because they are indirect—their incidence can be hidden in the form of higher prices (or lower wages and returns to capital). But because they are indirect, they function poorly as benefit taxes: in shifting the burden forward onto consumers or backward onto labor, they also shift the burden across jurisdictional boundaries. Governments should therefore discourage the use of these taxes. Such taxes need not be abolished entirely however, provided some limitation is placed on their use. In Chile, the maximum level of the business tax on any individual firm is limited to 100,000 pesos. In France, local governments are permitted to impose a business tax, but the rate is limited to a percentage of the property tax rate they are willing to impose.

3.16 Local tax deregulation can involve the removal of explicit controls on tax rates. It can also include the removal of more subtle restrictions on tax yields. In countries with high levels of inflation, one of the major constraints on the yields of the property tax is the stipulation that properties may not be revalued without a physical inspection. Indexation is the solution to this problem. (Some states in Mexico, for example, now permit automatic adjustments in property valuations based on a cost of living index.)

3.17 Reform may also require a change in the mix of benefit taxes that local governments are permitted to impose, to encourage the use of more easily administered, less politically sensitive taxes. As described in Box 2, there are no perfect local taxes. The factors that make for a good benefit tax—a broad base with direct incidence—also make for difficult administration. Countries exacerbate the administrative problem by assigning too many benefit taxes to their local governments (each with its own separate administrative overhead). The number should be reduced. As a country's economy modernizes, with an increasing proportion of income earned through formal sector employment, there may also be a case for increasing reliance on personal income taxes (following the model of the northern European countries and Japan.) But (as noted in Box 2), until those preconditions are met, municipal governments in developing countries are left with a choice of unattractive alternatives.

### *Transfer reform*

3.18 Any attempt to reform the structure of urban service delivery must address the largest source of local revenue: intergovernmental transfers. Transfers can serve several important positive roles in the financing of municipal services. First, they permit central governments to influence the sectoral pattern of local expenditure; to use the power of the purse to induce local governments to undertake expenditures that are of national, rather than local interest, compensating local government for the costs of services that the central government is expecting them to provide. Left to their own devices, local governments would be expected to base their budget decisions only on the benefits captured by their constituents; transfers can induce local government to take wider, national benefits into account.

3.19 Second, transfers permit central governments to use local governments as agents of national income redistribution policies. Local governments themselves are badly positioned to pursue distributional objectives from their own tax bases. Poverty is not uniformly distributed in geographic terms: mayors in poor jurisdictions cannot redistribute income from high-income populations elsewhere. Central governments, with their ability to raise taxes from the high-income populations regardless of residence, can use intergovernmental transfers as a tool of national income distribution policy.<sup>4</sup>

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4. Transfers can provide local government access to central government taxes with lower administrative costs. Because central governments are unconstrained by the need to tie the geographical incidence of their taxes to the location of their expenditures, they can—and do—rely to a great extent on indirect taxes; these are more cost effective than the taxes typically assigned to local government. It is not clear, however, that on the margin, the administrative costs of local benefit taxes are higher than those of central taxes.

### Box 3. Choosing among local benefit taxes

**Property taxes.** The property tax is the most universally assigned local tax, but rarely stands alone. Among the eight major LDC cities listed in Table 3, for example, the property tax is assigned to six, but is the principal revenue source in only two. As a local incidence tax, the property tax performs well: the incidence of the tax (at least its residential component) is geographically confined and its coverage is broad enough to reach the majority of beneficiaries. The property tax is, however, difficult to administer successfully. In part, the reasons are technical: the number of tax paying units is large. Assessments are inherently controversial because values must be imputed, rather than observed from actual transactions, and the base must be revalued annually to maintain its buoyancy. (Conditions in LDCs make the property tax particularly difficult to administer—the basic market data on which the property assessments are based is inaccessible or unreliable.) There are, however, particular political costs associated with the property tax: as a direct tax, its burden is particularly visible; and as a tax on wealth, its burden falls disproportionately on groups with great political influence.

**Income and payroll taxes.** Local income and payroll taxes are not uncommon in developing countries. (Of the eight cities in Table 3, two—Budapest and Mexico—derive income from this source.) Various forms of local income taxes are also imposed in countries as disparate as Kenya and Sweden. Personal income taxes have the geographically defined incidence sought in a benefit tax, and where imposed in conjunction with a national income tax (as in Budapest) are cheap to administer. The constraint on income taxes functioning as prices is their narrow coverage. In low income countries, income taxes that are confined to formal sector employment fall on too small a proportion of the population to serve effectively as benefit taxes: they impose costs on too small a proportion of beneficiaries. In Kenya, for example, the local payroll tax is, in effect, a tax on public school teachers salaries, except in Nairobi. Less developed countries employ more rudimentary forms of income taxation, including flat "poll" taxes and taxes based on imputed income. But income taxes that attempt to reach incomes in the informal sector are often not cost effective to administer. (In Onitsha, Nigeria, the costs of administering the poll tax exceed the entire revenues of the tax.) Income and payroll taxes are therefore more suited to higher income countries where coverage is broader.

**Utility taxes.** Taxes imposed in connection with utility bills—particularly with electricity bills—are also not uncommon in developing countries. Shanghai derives a significant share of its tax revenue from a surcharge on electricity bills. In Jordan, a flat fee (earmarked for garbage collection) is imposed as part of the residential electricity bill. In principle, such taxes have localized incidence and—given the ubiquity of electric service even in illegal settlements—reasonably broad coverage. Costs of administration are low, as the tax can be imposed jointly with electricity bills. The extent to which an electricity surcharge can be relied on exclusively is limited, however, by the basis of assessment: if the tax is imposed ad valorem (as in Shanghai), it distorts the price of power. If it is imposed as a flat fee (as in Jordan) it fails to capture variations in ability to pay (and is therefore limited by the tax paying ability of the poorest electricity consumers).

**Taxes on automobiles.** Local automobile taxes—both recurrent taxes on automobile ownership, and one-time taxes on purchase—are also significant auxiliary sources of revenue. Automobile taxes are the primary tax source in Jakarta, where two separate taxes—one on purchase, the other on sales—contribute 22 percent and 14 percent of municipal tax revenues respectively. Except in multi-jurisdictional metropolitan areas, the incidence of such taxes is easy to confine; such taxes are relatively easy to administer, and enforce.

3.20 Intergovernmental transfers are therefore appropriate wherever the central government expects local governments to perform an expenditure on its behalf, on either sectoral or distributional grounds (where the local government lacks the leverage to mandate the expenditure through regulation). But transfer reform is required both to increase their effectiveness in achieving their sectoral and distributional objectives and to reduce the adverse side effects of badly targeted or badly administered transfers.

3.21 Perhaps the most important measure developing countries can take is to reduce the

unnecessary adverse side effects of existing transfer programs—to reduce the uncertainty and bargaining that now accompanies intergovernmental financial flows and remove incentives for strategic behavior. Ecuador, for example, has recently replaced its system of *ad hoc* annual grants with a formula-based transfer system. Countries can also revise transfer formulas to remove more subtle unintentional inducements to perverse behavior: Morocco, for example, is in the process of replacing its deficit-filling grant distribution formula with one based largely on population. Countries can also revise transfer formulas to reduce the extent of the arbitrary interjurisdictional transfers that are imbedded in some transfer formulas. Brazil, for example, has recently moved to reduce the mandated “origin” content in its value-added transfer formula, allowing states to increase the weight attached to factors such as population.

3.22 But countries also need to expand transfer programs to adequately finance the expenditures they have assigned to local government. Large, recurrent transfer systems are likely to be appropriate wherever services with major distributional or benefit spillovers are assigned to local government. Primary education, for example, is an appropriate object of intergovernmental finance. The case for education transfers is most easily made on distributional grounds: primary education is arguably the largest transfer in kind to low-income populations that the public sector makes, and it is reasonably cost-effective, as wealthy people do not send their children to public schools (Haddad and others 1990). There is a similar case for transfer financing certain aspects of health care. Although there are few benefit spillovers from curative health care, there are clearly positive benefit spillovers in preventive health—the control of communicable diseases (health inspection, vector abatement, vaccinations for communicable diseases) whose impacts spill across jurisdictional boundaries (Over 1991). And (as with education) there are distributional arguments for transfer financing both preventive and curative health care, on the grounds that publicly provided health care constitutes a reasonably cost-effective transfer-in-kind to low-income populations. In most of the G-5 countries, local government expenditures on primary education and primary health care are largely financed through intergovernmental transfers (originating at the national level in France and the U.K., and at the state/prefecture level in Japan and Germany).<sup>5</sup> There is also clearly a case for intergovernmental transfers to finance direct payments by local governments to the indigent. (Practices vary in the G5 countries, with central governments making direct payments to indigent households in some cases and using local governments as agents in others. Both approaches are used in the U.S.)

3.23 The effectiveness of transfers in achieving these objectives can in principle be increased through changes in design: in changing the method used to determine the amount to be transferred, the criteria used to distribute the distributable pool, and the conditions attached to the use of the transfer. Where the intent of a transfer is to encourage increased expenditure on education, for example, there is a case for earmarking the transfer for this function (and for imposing a matching condition, to ensure that recipient local governments do not reduce the expenditure that they would otherwise have made on this function, substituting the transfer). Similarly, where the intent is to provide direct aid to low-income households, there is cause for greater use of earmarking and matching.

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5. While the U.S. lags in this respect, the costs of primary education are increasingly being financed through state government transfers to local school districts.

3.24 Earmarking and matching are used in the G5 countries, although more widely in the United States than in Europe or Japan. (Although transfer formulas in the U.K. and Japan are based on complex calculations of expenditure needs—local school enrollments and numbers of indigent households—no explicit conditionality is imposed requiring transferred funds to be spent accordingly.) The ability of LDC governments to use similar techniques to improve the targeting of transfers depends on whether they also possess a similar quality of information on local revenue and expenditure and a similar capacity to monitor transfer use. To ensure that money is spent on functions of national interest, a government must have the capacity to ascertain and monitor local expenditures. To determine the level of subsidy required to achieve a desired level of expenditure, it must have data on relative strengths of local tax bases. G-5 countries possess this information. Central governments in developing countries do not. (In Nigeria, for example, even data on the population of individual local governments were not available for many years; and few local governments can present an accurate statement of income and expenditure.) In consequence, countries may have to consider whether the direct provision of education or health services through central government ministries would be more cost effective than attempts to manipulate the desired level of expenditure on these functions by local officials.

### *Access to capital*

3.25 Reform is also needed in the arrangements by which municipal governments obtain access to financing for capital investment, to reduce arbitrariness in capital allocation, improve targeting, and (in South Asia) to address the problems arising from the organizational separation of capital expenditure responsibility from operations and maintenance responsibility.

3.26 To an extent, improvements in allocation can be achieved by improving the targeting of grant programs. Grant reform is particularly appropriate in places where the preconditions for allocation by lending do not exist—where the local revenue base is too precarious, where the local political time horizon is too short, or where the object of the capital work is one that reflects national, rather than local, interest. Thus there is a case for concentrating on grant reform in Mozambique or Nepal (both countries without a history of viable local government); a case (historically) in Mexico, where the combination of the short tenure of mayors (mayors are restricted to a single, three-year term) and the high staff turnover that typically accompanies changes in administration, limits the time horizon of political leaders. There is also a case for concentrating on grant reform where the works to be financed are of national interest, such as schools or health posts, where local government is, in effect, acting as an agent of national sector or distributional policy.

3.27 Where the benefits of a capital work are largely local, a principal focus of reform has been on reforming the allocation process by changing the terms on which funding is provided; replacing grant financing with loan financing. In principle, loan financing has several desirable attributes. Providing funds on a loan basis rather than a grant basis would be a means of improving targeting and depoliticizing the allocating process. By allocating funds on the basis of beneficiaries' willingness to incur debt, lending would force potential beneficiaries to reveal their degree of commitment to specific projects. Lending would presumably help depoliticize the allocation process by placing a price on finance, rather than requiring the government to attempt to ration a free good.

3.28 While governments already administer such loan programs, their effectiveness in doing so has been questioned. The experience of government-administered municipal infrastructure lending programs has been mixed. With the taxpayers ultimately bearing the financial risks of bad loans, the

pressure on governments to use access to credit for political purposes—to allocate resources to politically favored jurisdictions and to ease up on debt service enforcement in favored jurisdictions—is difficult to resist.

**3.29** As a result, there is increasing interest—particularly among donors—in privatizing this role—in turning responsibility for the mobilization and allocation of long-term savings over to the private capital market. Such an arrangement would, in effect, force municipal governments to seek funding on the same footing as any private-sector borrower. The private-sector model has much to recommend it. With their own capital at risk, private lenders would be less likely to make unsound loans and more likely to insist on repayment. But in most developing countries, the private market has been given the opportunity to lend to local government and has declined. Long histories of macroeconomic instability have caused private savers to view long-term financial commitments of any kind as extremely risky, and government controls on the returns to savings have ensured that the risk is not compensated by the prospect of commensurate reward (Levy 1991). As political entities lacking readily marketable collateral, local governments are viewed as particularly unattractive to private capital. Thus, even in countries where local governments have the legal authority to borrow, the market has cleared at zero.

**3.30** With the private capital market unwilling to lend, and governments unwilling to insist on repayment, the focus of reform has turned to organizational hybrids—attempts to combine the commercial incentives of private lenders with the financial backing of central governments. Under the general rubric of MCIs, these organizations represent an attempt to put an arm's length between the government and the lending process, thus isolating lending and loan administration in an entity that enjoys some legal and bureaucratic separation from the government budgeting process and establishing clearer allocation and recovery rules to defend the organization from political interference—while still ultimately carrying the financial backing of the government.

**3.31** MCIs also have a mixed track record, as shown in Table 5. And while various administrative and managerial measures can increase the likelihood of their success (as described in Box 4), two overall conclusions emerge from the experience of MCIs in developing countries. First, although organizing a lending program as an MCI may provide some protection against government political interference, it cannot prevent it. A determined government can interfere in the lending decisions of any bank that it owns, regardless of the bank's legal structure. Thus, what matters most is not the organizational form, but rather the government's commitment to the financial integrity of the MCI's operations. Second, the viability of any lending program depends on the health of its borrowers. MCIs are unlikely to thrive where local governments are not creditworthy, or where economic conditions are unstable. Government attempts to establish MCIs must therefore be accompanied by measures to support the financial health of municipal governments and the stability of the economy as a whole.

**3.32** Ultimately, the existence of creditworthy local governments and a stable economic environment should provide the conditions for private lenders to enter this market, obviating the need for a government-backed municipal credit institution. MCIs should therefore be seen as an interim solution, a way station on the road to more direct relationships between municipal governments and private capital markets.



**Table 5. Municipal lending organizations**

	Organization Form	Source of Funds	Portfolio Results	Collateral	Share of Total Capital Transfer
Brazil PRAM	managed by unit of state planning secretariat; state bank acts as financial agent	IBRD, and state; capitalized to revolve	good	withholding from transfers	large only in small towns
Colombia FINDETER	loans originated by pvt banks; rediscounted by funds administered by Board	compulsory bonds sold to S&L	good	borrow pledges transfers, specific source	small
Morocco FEC	department in CDG-government bank (now being converted to independent board, chaired by the PM who will appoint MOI)	bonds floated by CDG, donors, government capital	good	indirectly financed through government transfers	small
Indonesia RDA	bonds floated by CDG, donors, government capital	Govt loans	poor	none	small
Jordan CVDB	legally independent board, chaired by Minister	compulsory LA deposits, central bank loans, donors	poor	withholding from transfers	large, but LGs have few functions
Kenya LGLA	legally independent board, chaired by Minister	donor on-lending	poor	none	large in small LGs

Sources: Project PCRs, interviews with project officers

### Balancing Regulation with Political Accountability

3.33 How much a system of municipal service delivery should rely on accountability upward to central government—through regulation—or downward to constituents—through political participation—is not an issue that lends itself to universal prescription. Whether central government bureaucrats or local politicians are better stewards of public interest is not an issue that this paper will resolve. Neither extreme appears to be desirable.

#### **Box 4. Improving the performance of MCIs**

MCIs have a long and successful record in Europe, both as funds (the British Public Works Loans Board, for example), or as banks (Credit Local de France). But their record in developing countries is uneven. As shown in Table 5, the repayment record of municipal borrowers into MCIs is generally poor except where the institution is permitted to deduct debt service from intergovernmental recurrent transfers. Even where MCI portfolios are performing reasonably well, their long term financial prospects are questionable: none charge the level of interest rates that would enable them to mobilize funds from private long term capital markets without heavy government subsidies.

Despite this experience, MCIs have to be considered reasonable interim alternatives. Abandoning an MCI approach could mean, on the one hand, relying entirely on central government budget allocations to finance municipal projects, an approach that provides no institutional safeguards against inappropriate political influence. At the opposite extreme, it could mean forcing municipal governments to rely entirely on private capital markets—a solution that, under current conditions, is equivalent to cutting off all access to long term credit.

Experience suggests several organizational characteristics that increase the likelihood of an MCI's viability. First, the enabling legislation of an MCI should leave the MCI free to make lending decisions solely on financial criteria, clearly segregating the government's sectoral or developmental interests in project selection from the financial role that the institution is intended to perform. Funding for the MCI should be provided en bloc, rather than on an individual project basis, with governments holding MCIs accountable for their overall financial performance, monitoring the performance of their portfolios, and conditioning further financial backing on satisfactory financial returns, but refraining from interfering with individual project decisions. (Government's sectoral interests can, nevertheless, be imposed at a prior stage in project evaluation. In Jordan, for example, project proposals must be approved by the Ministry of Local Government before the Jordanian MCI ever sees them.)

Second, government's commitment to the financial integrity of the MCI should be reflected in the composition of its board. The representation of the Ministry of Finance, for example, is a useful counterbalance to the influence of a Minister of Local Government.

Third, in order to reduce political pressure on technical staff, appraisal regulations should clearly define the terms and conditions under which loans will be approved; employing readily verifiable criteria (such as debt service coverage ratios) to assess the credit-worthiness of potential borrowers; and explicitly forbidding new loan commitments to jurisdictions that are currently in default.

Governments must also manipulate the environment in which the MCI is operating. MCIs are often instigated at the behest of donors. With few exceptions, the terms and conditions imposed by donors have not been carried over into other channels of funding for municipal capital investment. Through a variety of grants and competing donor programs, governments undermine the market for MCI lending. MCIs then either fail to disburse or become financial enclaves, with no impact on the system of municipal infrastructure as a whole. Governments should refrain from this practice. They should coordinate the terms on which funding is provided, and reduce grant or soft loan programs that directly compete with the markets the MCI is designed to serve.

Finally, governments should take the steps necessary to permit local governments to become good credit risks—assigning revenue sources appropriate to local functional responsibilities, allowing greater autonomy over tax rates and expenditure decisions. As noted in the text, the existence of credit-worthy local governments, combined with an economic environment that fosters the development of a private capital market, can, in the long run, obviate the need for an MCI, and allow the private capital market to assume this role.

### ***Central regulation***

3.34 Some degree of accountability to central government through a national regulatory framework appears to be appropriate to any structure of municipal service delivery. In no country are local governments entirely sovereign. In all the G5 countries, as well as in developing countries, local governments function within a legal framework established in national (or in the U.S. and Germany,

state) law. There is, nevertheless, a case for restraining the scope of central regulation in developing countries, to issues where the behavior of local government has adverse consequences outside its jurisdiction and where the central government has the administrative capacity to regulate effectively.

3.35 Central regulation is clearly appropriate where local government behavior can affect national monetary, trade, or fiscal policy. Thus local governments should not have the authority to print money (a principle that was, in effect, violated by the provincial governments of Argentina under the previous regime) (World Bank 1990). Central regulation on external borrowing by local government is also appropriate, to permit central control over the balance of payments. Central regulation over the aggregate level of domestic borrowing may also be justified. In the UK, for example, where local governments account for nearly half of public-sector investment, the central government has historically attempted to control the aggregate level of local borrowing as an instrument of fiscal policy.

3.36 Central regulation is also clearly appropriate where local governments are carrying out functions on behalf of central government. As Winkler has pointed out in the case of education, even in the highly decentralized systems in some of the G5 countries, central (or state) governments maintain control over certain policy decisions—the ages of mandatory attendance, the core curriculum—while relinquishing responsibility for day to day management to local government (Winkler 1991). As noted earlier, earmarking on intergovernmental transfers—a form of expenditure regulation—is clearly appropriate where the central government is using local government as an agent, to ensure that funds are spent for the purpose they were intended.

3.37 But where impact of local government behavior is largely localized, and regulation requires detailed knowledge of local conditions and priorities, the case for central regulation is more difficult to justify. In such cases, it is not clear that the regulations posed by central government are a useful restraint, or an inhibition to the responsiveness of local government.

### ***Political accountability***

3.38 The obvious counterpart to central regulation is local political accountability—the reliance on voters to regulate the behavior of their political leaders. The view that local elections perform impeccably in this role does not stand up well to scrutiny.<sup>6</sup> The validity of elections after long periods of authoritarian rule appears particularly questionable. O'Donnell and Schmitter note that under these conditions, “voters will have relatively little experience in choosing among

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6. As O'Donnell and Schmitter note succinctly “the theory of liberal democracy was based on the presumption that active citizens would elect and hold accountable individual representatives who would, in turn, produce substantively superior decisions. Contemporary theories of democracy place the burden of consent on party elites and professional politicians (sporadically subject to electoral approval) who agree among themselves that they will compete among themselves in such a way that those who win greater electoral support will exercise their temporary political superiority in such a way as not to impede those who may win greater support in the future from taking office, and those who lose in the present agree to respect the contingent authority of the winners to make binding decisions, in exchange for being allowed to take office and make decisions in the future. (O'Donnell and Schmitter, “Convoking Elections” in *Transitions from Authoritarian Rule*, 1986).

candidates; party identification will be weak... One can therefore expect a good deal of tactical voting—[which may] be quite disconnected from longer term class, sectoral, ethnic or other interests” (O’Donnell, Schmitter, and Whitehead 1986). Campbell, moreover, notes that “in most [Latin American] countries, minimum conditions for electoral choice making—civil liberties and at least quasicompetitive parties do not apply to the selection of local candidates. The long dominance of central government and parastatals in service supply has weakened voter identification with local government as an instrument for the expression of demand. In this environment, even where there are local multi-party elections, they tend to become miniaturized battlegrounds for expressing preferences regarding national scale political issues or political ideology” (Campbell 1992).

3.39 The advent of local democracy, while increasingly common,<sup>7</sup> is therefore no panacea. There is, nevertheless some evidence that specific changes in election rules can influence the degree to which local elections function as referenda on local government performance. Venezuela has increased the local focus of elections by changing the basis on which candidacies are identified. Until 1988, Venezuela’s municipal elections were contested on the basis of national party slates, rather than as individual candidacies; the winning party was permitted to designate its candidate for mayoral positions after the elections. Candidates now run as individuals, a reform that has reportedly shifted the focus of the campaign to more localized issues.

3.40 There are alternative and supplementary means of holding local municipal leaders accountable. In Korea, for example, mayors have traditionally been appointed by the government, but their career trajectories (determined by the Ministry of Home Affairs) were clearly based on their success in responding to local constituents. To this end, the city of Seoul operates “citizen complaint reporting centers” and the mayor and top administrative staff make themselves available every Saturday for a “day of dialogue with the citizen.” (As noted earlier, Korea has nevertheless introduced direct elections in all municipalities except Seoul.)

3.41 The geographical deconcentration of specific municipal services to submunicipal branch offices also appears to be a means of strengthening municipality accountability, by bringing providers into closer geographical proximity to clients. Such an arrangement is fairly common in large metropolitan areas. The Bombay Municipal Corporation is subdivided into four zones and 23 wards, headed by Deputy Municipal Commissioners and ward councilors, respectively, with responsibility for solid waste removal, road maintenance, and water and sewerage services. Budapest is made up of 22 districts. Each district is headed by an elected mayor and has specifically assigned service responsibilities, and independent revenue sources. Seoul, similarly, is divided into 22 Gu, each responsible for solid waste collection and street maintenance within its jurisdiction and authorized to charge a corresponding service fee.

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7. Among the countries that have recently authorized local elections for municipal offices are Colombia (1988), Nigeria (1989), Chile (1990), and Korea (except Seoul) (1991).

## **Synchronizing the Elements of Reform**

**3.42** There is clearly no one way to organize the delivery of urban services. The extent to which a system of accountability should rely on local politics or central regulation—whether primary education should be delivered by local government and financed through earmarked grants, or simply delivered directly by the field administration of central government ministries—are issues for which there are no universal answers. What does appear evident is that the various pieces of the intergovernmental relationship have to fit together. Little is gained by granting local political autonomy if elected officials have no discretion over expenditure or revenue levels. There is little benefit in establishing a credit-based system for infrastructure financing if local governments do not have the means to be creditworthy.

**3.43** The importance of synchronizing the various parts of the intergovernmental relationship becomes increasingly evident in countries that are undergoing political decentralization. The political impetus behind decentralization has prompted central governments to make political concessions hastily. But granting local elections is a step that can be taken quickly. What is slow and difficult is the working through of new regulatory relationships between central government and local government, the transfer of central government assets (and staff); the conversion of what had been annual budgetary transfers within a central government into intergovernmental transfers that are transparent and predictable. Such data as exist suggest that problems of synchronization are widespread in countries undergoing decentralization. In Eastern Europe, expenditure responsibilities have been transferred to local governments before a workable structure of revenue assignments was in place. In Latin America, revenues have been decentralized ahead of functional responsibilities. In Africa, political autonomy was granted before either expenditure or revenues were decentralized.

**3.44** In a sense the most daunting task for reform lies not in envisioning an ideal future, but in helping governments through the transition process. The fundamental political forces that appear to motivate political decentralization suggest that changes in the political relationships between central and local government are inevitable. Reform efforts should concentrate neither on resisting or promoting decentralization, but rather on attempting to influence the process of change so as to reduce the costs of transition, and increase the likelihood of an eventual system of urban service delivery that is efficient and responsive to its constituents.

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