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# Rethinking Decentralization in Developing Countries

JENNIE LITVACK  
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# **Rethinking Decentralization in Developing Countries**

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**JENNIE LITVACK  
JUNAID AHMAD  
RICHARD BIRD**

**THE WORLD BANK  
WASHINGTON, D.C.**

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# Foreword

Central governments around the world are decentralizing fiscal, political, and administrative responsibilities to lower-level governments and to the private sector. Political pressure probably drives most decentralization efforts. But whatever the origins, decentralization can have significant repercussions for resource mobilization and allocation and ultimately for macroeconomic stability, service delivery, and equity. For these reasons, the World Bank is actively involved in understanding the design and impact of decentralization policy in many developing countries.

Much of the literature on decentralization, normative and empirical, is based on industrial countries. Developing nations, however, have very different institutional frameworks. Given that the World Bank's work is exclusively in developing countries, it must carefully consider what unintended consequences these institutional differences might have on decentralization policies and what the implications are for project design and policy dialogue.

We do not know enough empirically to make definitive recommendations about which types of decentralization are best for which services in which institutional settings. But we do know that the best design will vary depending on circumstances and institutions and that this complexity has sometimes been overlooked in the haste to offer policy advice. If we can develop a common framework, we can begin to document cases of decentralization, so that within a few years we may

be able to identify more precisely what works and what doesn't in particular institutional settings. And by identifying what institutions are important for successful decentralization in industrial countries and how these institutions differ in developing countries, we can find ways to compensate for weak institutions in the short run and to build the basic elements of key institutions in the long run.

This paper, a product of the Public Sector Group and the Decentralization Thematic Group in the Poverty Reduction and Economic Management (PREM) Network, is intended to stimulate thinking and encourage a more nuanced approach to decentralization policy. This approach recognizes the importance of institutions and policy design in determining the impact of decentralization on efficiency, equity, and macroeconomic stability. It implies the need to address decentralization within a broader institutional assessment. The paper draws on a wide body of literature and recent experiences documented by the World Bank and proposes a framework for improving the design of decentralization by incorporating information about country-specific institutions. The paper is the product of a partnership between an academic researcher, operational staff, and network staff, an exchange that has already enriched the policy dialogue in several countries. It is expected that PREM and other networks will continue to join in the policy dialogue through similar partnerships in the future.

*Masood Ahmed*  
*Vice President*  
*Poverty Reduction and*  
*Economic Management Network*





# Abstract

This paper draws on the literature and growing experience with decentralization in developing countries to explore how a wide range of variables can affect decentralization efforts and how policies and incentives can be designed to improve outcomes. The paper highlights the fact that decentralization is neither good nor bad for efficiency, equity, or macroeconomic stability; but rather that its effects depend on institution-specific design. It discusses the building blocks of fiscal federalism (expenditure and revenue assignment, intergovernmental transfers, and subnational borrowing) and then discusses five means through which decentralization policy and institutions interact. These are the regulatory framework for subnational borrowing, the financing and delivery of services, information systems and competitive gov-

ernments, asymmetrical decentralization, and policy synchronization.

The paper's starting point is the traditional fiscal federalism approach. But the primary measures for local and central accountability assumed in most discussions of decentralization may not hold or are different in many developing countries. Drawing on the evidence from the World Bank's operational work, therefore, the paper suggests the need for a stronger focus on *institutions* in designing decentralization policies. This broader agenda suggests an enhanced focus on accountability, governance, and capacity in the context of designing policies for decentralization. This approach has strong implications for the Bank's project design and policy dialogue and calls for a reinvigorated research effort focused on developing countries.



# 1. Why Should We Worry about Decentralization?

Central governments around the world are decentralizing fiscal, political, and administrative responsibilities to lower-level governments and to the private sector. Decentralization is particularly widespread in developing countries for a variety of reasons: the advent of multiparty political systems in Africa; the deepening of democratization in Latin America; the transition from a command to a market economy in Eastern Europe and the former Soviet Union; the need to improve delivery of local services to large populations in the centralized countries of East Asia; the challenge of ethnic and geographic diversity in South Asia, as well as ethnic tensions in other countries (Bosnia and Herzegovina, Ethiopia, Russia) and the attempt to keep centrifugal forces at bay by forging asymmetrical federations; and the plain and simple reality that central governments have often failed to provide effective public services.

Political pressure probably drives most decentralization efforts. But whatever its origins, decentralization can have significant repercussions for resource mobilization and allocation, and ultimately macroeconomic stability, service delivery, and equity. Since

decentralization can greatly affect economic development and poverty reduction, it is no surprise that the World Bank is actively involved with decentralization policy in many developing countries.

The Bank is involved in decentralization issues in a variety of ways:

- Since many countries are undergoing some form of decentralization either by design or by default, a growing number of Bank-funded projects are in effect supporting sectoral decentralization strategies. Twelve percent of Bank projects completed between 1993 and 1997 involved decentralizing responsibilities to lower levels of government. A sectoral and regional breakdown is provided in Table 1.
- The Bank is also supporting decentralization through loans to subnational governments. Although these loans are (necessarily) guaranteed by the central government, they are otherwise negotiated and undertaken by independent local authorities. Such loans are used for both specific projects and state-level structural adjustment efforts (for example, in Andhra Pradesh state in India). A new

**Table 1: World Bank Projects with a Decentralization Component, by Sector and Region**

<i>Sector</i>	<i>Percentage</i>	<i>Region</i>	<i>Percentage</i>
Urban	43	Africa	19
Health	27	South Asia	14
Social funds	26	Latin America and the Caribbean	13
Environment	16	Middle East and North Africa	11
Water	13	Europe and Central Asia	6
Agriculture	11		
Transport	10		
Education	9		
Energy	3		
Finance	1		

*Note:* Given an average project cycle of five years, the database used for this analysis does not include projects that went to the Board after 1992. Thus the numbers presented here likely underreport current decentralization-related projects.

*Source:* *Portfolio Review*, PRMPS, 1998.

loan instrument was established in late 1997 to facilitate subnational adjustment lending.

- Structural adjustment loans to central governments have supported the design of intergovernmental fiscal relations and the process of decentralization (for example, in Kyrgyz Republic, Russia, and Vietnam).
- Given the importance of decentralization in many countries and its potential impact on a range of development objectives, a number of recent Bank reports have focused on decentralization and related issues in specific regions and countries (see Annex 1 for a list of economic and sector work on decentralization).<sup>1</sup>
- Finally, a growing number of the Bank's country assistance strategies are giving greater prominence to decentralization (such as those for Hungary, Russia, South Africa, Thailand, and Uganda, among others).

One reason decentralization has attracted so much attention is that it is often a cross-cutting reform that can relate to such important Bank concerns as the relation between fiscal and financial development; macroeconomic stability; poverty alleviation and the social safety net; institutional capacity, corruption, and governance; investment in infrastructure; and the provision of social services. Other international and national institutions are currently studying various aspects of these issues from their own perspectives.<sup>2</sup> Given the importance of decentralization for economic management, the Bank also needs to invest in understanding it.

Much of the literature on decentralization, normative and empirical, is based on industrial countries and assumes the existence of institutions that are usually very weak in developing countries. For example, much of the traditional public finance literature related to fiscal decentralization relies on "voice" and "exit" to ensure local accountability and achieve the allocative efficiency gains expected from decentralization. According to this view, if people are dissatisfied with decisions made by local leaders, they can vote them out of power. If they do not like the package of local taxes and public services offered, they can exit (or "vote with their feet") by moving to a jurisdiction that better matches their preferences (Tiebout, 1956).

Yet governments in many developing countries are often not responsive to their citizens, and decision-making is rarely transparent and predictable. Opportu-

nities for voice and exit are limited because of weak institutions. Democratic systems are often frail, rendering the electoral system a highly problematic method of achieving accountability. Strong, broadly based local participation can overcome weak formal election systems, but powerful elites make this difficult in many places. Mobility is often constrained by poor information, infrastructure, and legal frameworks, which result in weak markets for land, labor, and capital. Although all countries have at least some urban areas, in smaller municipalities and rural areas it is often unrealistic to expect a family to sell their land, learn of employment opportunities in other jurisdictions, physically move to the new area, and borrow money in a new locality where they are unknown. The chances of overcoming these obstacles are further reduced because low incomes and weak social safety nets often make households risk averse in developing countries.

A third channel for local accountability is through hierarchical relationships within the public sector (World Bank, 1997), including the formal rules and oversight arrangements that exist within government. This is the primary channel for accountability in many developing countries, but it is often ineffective because of poor information and monitoring systems. In short, the primary measures for local accountability assumed in most discussions of decentralization may not hold in many developing countries.

Given that the World Bank's work is exclusively in developing countries, it must carefully consider what unintended consequences these institutional weaknesses might have on decentralization policies, and their implications for project design and policy dialogue. This paper is intended to initiate this type of analysis and help those working on decentralization in developing countries develop a more institutionally sensitive perspective when analyzing decentralization in a particular country.<sup>3</sup> We draw on the literature and growing experience with decentralization in developing countries to explore how a wide range of variables can affect decentralization efforts and how policies and incentives can be designed to improve outcomes.<sup>4</sup>

We do not know enough empirically to make definitive recommendations about which types of decen-

tralization are best for which services in which institutional settings. Much of the discussion of decentralization reflects a curious combination of strong preconceived beliefs and limited empirical evidence. But we do know that the best design will vary depending on circumstances and institutions, and that this complexity has sometimes been overlooked in the haste to offer policy advice. If a common framework can be established, we can begin to assemble documented case studies of decentralization, so that within a few years we may be able to identify with more precision patterns of success and failure. Also, by identifying institutions that are important for successful decentralization in industrial countries and that may be weak in developing countries, we can also begin to identify ways to

compensate for the weak institutions in the short run, and build key elements of important institutions in the long run.

The next section describes the complexity of the decentralization process. It concludes that the debate on whether decentralization is “good” or “bad” is unproductive since decentralization is a political reality worldwide—one that varies greatly in form within and among countries. The third and fourth sections focus on the lessons learned about the design of decentralization, with an emphasis on the building blocks of fiscal federalism and on the importance of institutions in decentralization efforts. The final section draws implications from this analysis and describes the research agenda that remains to be explored.

## 2. Decentralization: A Complex Phenomenon

Decentralization—the assignment of fiscal, political, and administrative responsibilities to lower levels of government—is occurring worldwide for different reasons, at different paces, and through different means. The “why” of decentralization is as varied as the “how” (Box 1). The complexity inherent in the decentralization process is further aggravated by its cross-cutting impact. For policymakers, who often have little control over the political genesis or pace of decentralization, the challenge is to implement it in a way that ensures the stability, efficiency, and equity of the economic system.

### Why Is Decentralization Happening?

In most countries decentralization reflects a broader process of political and economic reform (World Bank, 1997). Political changes worldwide have given voice to local demands and the need to bring economic and political systems closer to local communities. In some cases the very preservation of a national political system has required the decentralization of power. In addition, technological changes and global integration of factor markets have changed the size of government needed to manage economic systems. On one hand, economic mobility has led to the creation of supranational bodies to manage the growing economic integration among nations. On the other, an increasing number of public services can be efficiently provided by decentralized (and often private) organizations (World Bank, 1995a). For example, in metropolitan Buenos Aires the entire water and sewerage system is operated, maintained, and invested in by a consortium of private companies (Triche, Mehia, and Idelovitch, 1993). Finally, the collapse of central economic systems has encouraged regional and local gov-

ernments to participate in the political and economic process.

### What Is Decentralization?

Decentralization is not easily defined. It takes many forms and has several dimensions. Indeed, a wide variety of institutional restructurings are encompassed by this label, and several variants may be operating at the same time within a country, and even within a sector. Thus care must be used in labeling, and labels—including those used in this paper—must be interpreted with care.

One widely used distinction is among deconcentration, delegation, and devolution (Rondinelli, 1981 and 1989). *Deconcentration* occurs when the central government disperses responsibilities for certain services to its regional branch offices. This does not involve any transfer of authority to lower levels of government and is unlikely to lead to the potential benefits or pitfalls of decentralization. The “decentralization” that has occurred in many unitary countries is actually deconcentration, since independent local governments (which are legally accountable to local constituents) do not exist and local field offices of the central government are simply used to improve the efficiency and effectiveness of service delivery. This is the case in many East Asian countries and, until recently, was the rule in Eastern European countries (Kornai, 1992). Deconcentration can also exist for some functions in federal countries when the central government maintains a strong interest in ensuring delivery of a particular service.

In contrast, the central issue for both delegation and devolution relates to the balancing of central and local interests. *Delegation* refers to a situation in which the

### Box 1: Rationales for Decentralization

Many rationales for decentralization may be discerned in the literature and in practice. Not all will be relevant in any one country, nor are they all necessarily consistent or equally important to all relevant parties. As noted, most are based on normative or empirical work in industrial countries.

The most common theoretical rationale for decentralization is to attain allocative efficiency in the face of different local preferences for local public goods (Musgrave, 1983; Oates, 1972; Tiebout, 1956). Problems may arise with respect to coordination—which is itself costly (Breton and Scott, 1978)—where interjurisdictional spillovers are important, including stabilization (Tanzi, 1996; Wildasin, 1997) and distribution (Tresch, 1981). Most World Bank work on decentralization has focused on this rationale (World Bank 1988, 1994, and 1997).

Related issues, on which there is neither theoretical nor empirical agreement, concern the direction and importance of the relation between decentralization and the size of the public sector (Mueller, 1996; Ehdaie, 1994) and between decentralization and the rate of economic growth (Martinez-Vazquez and McNab, 1997; Zhang and Zou, 1998).

Equity and distributional concerns about decentralization cut both ways. Some analysts argue that in some circumstances local governments achieve such goals more effectively than central governments (Pauly, 1973). Others argue that central redistribution is needed both for effectiveness (Musgrave, 1983) and to overcome biases of local elites (Wilensky, 1974; Inman and Rubinfeld, 1997). Another view is that, regardless of what local governments may attempt to do in the way of redistribution, their attempts will be frustrated by resource mobility and the openness of the local economy (Buchanan and Wagner, 1971). All these views may be found in different Bank country studies in recent years.

Decentralization's potentially destabilizing effect on the macroeconomy has caused much concern to some (Prud'homme, 1995; Tanzi, 1996; Ter-Minassian, 1997). Others suggest, however, that such effects are more likely to reflect inappropriate incentives than any problem inherent to decentralization (Spahn, 1997a and 1997b). In countries that have "decentralized" to offload fiscal imbalances from the center, it is of course not surprising to see a strong association between decentralization and fiscal imbalance at lower levels (Wallich, 1994). At least three World Bank studies—on Argentina (1996a), Brazil (Dillinger, 1997), and Colombia (1996b)—have examined this issue and suggested that destabilization effects

arose mainly from design problems, including a soft budget constraint between levels of government.

An interesting argument asserts that a primary economic rationale for decentralization is to improve the "competitiveness" of governments—that is, decentralization will make local governments try to satisfy the wishes of citizens (Breton, 1996; Salmon, 1987). Although suggestive, there has been little empirical examination of this idea (Kenyon, 1991; Mueller, 1997). Some Bank work has occasionally recognized "horizontal" competition, particularly with respect to taxation (both at the national and local levels), although it has generally been viewed as a problem rather than a potential benefit. Little attention seems to have been paid to the more troublesome question of "vertical" intergovernmental competition and the nature and enforcement of the rules that may make intergovernmental competition beneficial (Breton, 1996). However, Weingast (1995) proposes that competitive local governments act as checks on the central government to prevent it from confiscating wealth; thus federalism preserves markets.

Another political rationale for decentralization is that good governments are those closer to the people (Inman and Rubinfeld, 1997; World Bank, 1997). Since John Stuart Mill, this argument has been closely related to questions of political participation and democracy, but it is still undeveloped in theoretical (Breton, Cassone, Fracchini, 1998) or, especially, empirical terms (Martinez-Vazquez and McNab, 1997). Although there has been some indirect discussion of this proposition in relation to such governance concerns as corruption (Prud'homme, 1995), little has yet been done to link decentralization, participation, and good governance apart from an interesting general empirical paper (Huther and Shah, 1998), one examining electoral accountability and economic policy choices by U.S. governors (Besley and Case, 1995), and a revealing case study on Colombia (World Bank, 1995b).

A quite different political rationale for decentralization is to accommodate pressure for regional autonomy and, hence, perhaps increase the legitimacy and sustainability of heterogeneous national states. In a sense, there may sometimes be a tradeoff between political and economic stability (Treisman, 1998). Although touched on in a Bank study of Russia (Litvack, 1994), this idea has—perhaps understandably, given the nature of the Bank's clients—not been much developed in Bank literature. Still, the emphasis in many studies on the role of "equalization" transfers can perhaps be attributed to political stability as well as a more magnanimous desire for interjurisdictional equity (Ahmad, 1996).

central government transfers responsibility for decisionmaking and administration of public functions to local governments or semiautonomous organizations that are not wholly controlled by the central government but are ultimately accountable to it. These organizations usually have a great deal of discretion in decisionmaking. This form of decentralization can be characterized as a principal-agent relationship, with the central government as the principal and the local government as the agent. From this perspective, the main design issue is to ensure that the self-interested agent (the local government or semiautonomous organization) faces incentives that induce it to act as closely as possible in accordance with the wishes of the principal (the central government).<sup>5</sup>

Finally, *devolution*, a more extensive form of decentralization, refers to a situation in which the central government transfers authority for decisionmaking, finance, and management to quasi-autonomous units of local government. Devolution usually transfers responsibilities for services to municipalities that elect their own mayors and councils, raise their own revenues, and have independent authority to make investment decisions. In a devolved system, local governments have clear and legally recognized geographic boundaries over which they exercise authority and within which they perform public functions (Rondinelli, 1998).

The shift in responsibility between tiers of government is underpinned by several fiscal, political, and administrative instruments. These define the extent to which intergovernmental relations are deconcentrated, delegated, or devolved. *Fiscal decentralization*—who sets and collects what taxes, who undertakes which expenditures, and how any “vertical imbalance” is rectified—has been especially prominent in recent discussions in many countries, but as just indicated many of the more fundamental questions relate to political and administrative decentralization. *Political decentralization* refers at one level to the extent to which political institutions map the multiplicity of citizen interests onto policy decisions (Inman and Rubinfeld, 1997). *Administrative decentralization* is concerned with how political institutions, once determined, turn policy decisions into allocative (and distributive) outcomes through fiscal and regulatory actions. The political decision to devolve powers from

central government, for example, can only be translated into actual powers being shifted if subnational governments have the fiscal, political, and administrative capacity to manage this responsibility.

### **What Are the Implications of Decentralization?**

For policymakers and their advisers, the multidimensional aspect of decentralization—the dispersion of fiscal, political, and administrative powers—suggests three implications that heavily influence the context for thinking through decentralization. First, because decentralization can change the mobilization and allocation of public resources, it can affect a wide range of issues from service delivery to poverty reduction to macroeconomic stability. (Thus we refer to it as a “cross-cutting” issue.) Second, the management of decentralization requires intimate knowledge of local institutions and a nuanced understanding of the process of decentralization—that is, what is driving decentralization in a country (and sector) and which stakeholders are involved. Third, limited empirical evidence exists about what works and what does not. Together these three factors pose a daunting challenge for those responsible for designing and managing decentralization.

#### *Broadly based reform and cross-cutting impacts*

Decentralization is often implemented as a broadly based reform that affects various sectors and levels of government. Outcomes reflect the interaction and coordination of policies between different tiers of government. In many countries it is a considerable challenge to coordinate sectoral reforms undertaken by a ministry of the central government with decentralization of fiscal, political, and administrative responsibilities to local governments.

The cross-cutting influence of decentralization has a clear implication for the World Bank. Understanding the evolution and status of a nation’s decentralization process is essential to understand and analyze policy issues across sectors. For example, the successful delivery and financing of education or welfare systems, as in South Africa, depends on the public finances of mul-



tiered governments rather than the edicts of a central line ministry. In general, major policy reform of individual sectors—such as health, education, or infrastructure—cannot be undertaken without an assessment of a country's intergovernmental system, or vice versa. This outlook needs to be embedded in the country team framework at the Bank.

### *Country context*

Many factors affect both the ideal and the actual form of decentralization adopted in any country for any service at any time:

- The number of subnational units as well as their absolute and relative sizes and wealth.
- The distribution of functions (relative to the “span” of public goods, externalities and jurisdictional spillovers, and so on).
- The nature of the “common” institutions (with particular attention to their effects on government competition).
- The role and status of the constitution (for example, with respect to the independence of the judiciary and collective rights).
- The technical characteristics and policy objectives of specific public services.
- The current political situation.

Much of the discussion of decentralization presumes that it is a matter of choice or deliberate design, but in many countries it may equally well be either a political necessity (for example, to hold a fractious heterogeneous country together) or a default option (that is, a way to try to execute more satisfactorily some necessary functions of the state in the face of central fiscal crisis and political weakness). Indeed, all these rationales may be at play at once, possibly to varying degrees, in a single country. For these and other reasons, decentralization often encompasses an extremely nuanced set of activities that can only be understood, analyzed, and—to the extent possible—guided on the basis of thorough knowledge of local institutions.

### *Strong beliefs but limited empirical evidence*

Many people hold strong beliefs about various aspects of decentralization: its intrinsic political and economic

merits, its potential problems, and its effects on static and dynamic allocative efficiency, income distribution, macroeconomic stability, institutional demands on local capacity, potential for corruption, governance, and so on. But the actual empirical evidence on these propositions is either nonexistent or conflicting. In some respects this is not surprising. Given the complexity and multiple dimensions of the concepts involved and the context-specific nature of decentralization, it is to be expected that studies will show considerable uncertainty about the strength and even the direction of the relation between decentralization and, say, growth, governance, distribution, and stability. Conflicting evidence and interpretations may be found with respect to decentralization and local tax efforts (Bird and Fiszbein, 1998), the relationship (if any) between increased local democracy and allocative efficiency (Martinez-Vazquez and McNab, 1997), the relationship between subnational expenditures and growth (Zhang and Zou, 1998; Davoodi and Zou, 1998), and the ability to target the poor under different forms of decentralization (Ravallion, 1998; Alderman, 1998; Inman and Rubinfeld, 1997). A particular challenge in this respect is to understand how best to match fiscal, political, and administrative arrangements to achieve the potential benefits of decentralization for any given service in any given country.

### **Successful Decentralization Depends on Institution-Specific Design**

Designing decentralization policy is difficult in any country because decentralization can affect many aspects of public sector performance and generate a wide range of outcomes. But it is particularly difficult in developing countries because institutions, information, and capacity are all very weak. The cross-cutting nature of decentralization, the importance of local institutions in influencing the impact of decentralization, and the limited empirical evidence on what works and what does not make the design and implementation of decentralization a considerable challenge (for example, matching expenditures and revenues at each level of government, providing a regulatory framework that imposes a hard budget constraint on subnational

governments, and incorporating local participation and accountability in decentralization). Evidence suggests that the problems associated with decentralization in developing countries reflect flaws in design and implementation more than any inherent outcome of decentralization. The following sections illustrate this important point by discussing how design can alter the impact of decentralization on equity and macroeconomic stability.

### *Decentralization and equity*

The impact of decentralization on interregional and interpersonal equity can vary greatly depending on institutional arrangements and policy design details. If the central government makes no effort to redistribute resources to poorer areas, fiscal decentralization will result in growing disparities. Similarly, if provinces or states do not redistribute within their jurisdictions, poor people may lack access to public services. But decentralization need not produce such outcomes. Depending on the preferences of the national population, horizontal equity—that is, ensuring some level of comparability in ability to provide public services throughout the country—can be achieved through intergovernmental transfers that include equalization components. How intergovernmental transfers are designed (block or specific purpose, matching or nonmatching, flat rate matching or progressive matching) and monitored largely determines the extent to which decentralization results in greater balance or imbalance in service provision between regions, states, towns and villages, and households.

Decentralization can affect interpersonal equity through public expenditure policy, tax policy, and the design of intergovernmental transfers. If decentralization of expenditure decisions leads to a greater share of public resources being spent on services used by the nonpoor, equity will suffer. Similarly, if decentralization leads to a higher tax burden for the poor (through higher user fees and local taxes and no offsetting changes in other taxes), then this too can weaken equity. Nonetheless, if the central government is concerned about preserving equity and protecting the poor, it can do so in part—despite decentralized expenditures and taxes—through the design of intergovernmental transfers.

How decentralization affects equity also depends in part on the extent of local accountability and local political participation by the poor. Accountability can be enhanced when local leaders are elected and are concerned about providing services to their constituents. When the poor participate in the political process, they can exert influence on leaders. The mere existence of a democratic political system is insufficient unless there is meaningful political participation by all groups. For example, India has a long democratic tradition but since local participation depends on social caste, the poor often have little influence. In contrast, in Cuba and Vietnam there is considerable participation at the grassroots level (World Bank, 1996c). In Oaxaca, Mexico, the targeting of poverty expenditures depends heavily on how representative local governments are (Fox and Aranda, 1996).

Decentralization can also enhance access by the poor if it increases competition in the delivery of services (such as water and electricity) and this drives down prices. In addition, if policy reform separates efficiency and equity objectives, decentralization can enable service deliverers to charge user fees and focus on efficiency and then use the revenues to expand coverage or improve quality, which can benefit the poor. For example, the introduction of earmarked user fees for primary health care in Cameroon led to an improvement in quality and an increase in utilization—particularly for the poor, who previously lacked access to alternative providers (Litvack and Bodart, 1993).

### *Decentralization and macroeconomic stability*

The stringent conditions for successful decentralization have recently been emphasized with respect to developing countries (Prud'homme, 1995; Tanzi, 1996). In particular, it has been argued that not only can decentralization fail to improve local service delivery, it may even risk national destabilization. Argentina in the 1980s is a commonly cited example, but others are not hard to find in the transition economies of Central and Eastern Europe (Bird, Ebel, and Wallich, 1995). Similar fears appear to have played a role in China's fiscal reforms (Bahl, 1998).

Concerns about decentralization and macroeconomic instability are fueled by instances where governments

have decentralized without adequate planning to control the deficit behavior of local governments. For example, international experience suggests that if countries decentralize more expenditure responsibilities than revenue resources, service levels will fall or local governments will press—sometimes successfully—for more transfers, more loans, or both. One of the clearest and most analyzed cases of this phenomenon is the Russian Federation (Wallich, 1994). On the other hand, if more revenues than expenditures are decentralized, local revenue mobilization may decline because of tax competition, and again macroeconomic imbalances may emerge—as in Argentina, Brazil, and Colombia. This risk is greatest when revenues are decentralized without adequate steps to ensure that local revenue mobilization is maintained and that local authorities are capable of carrying out the corresponding expenditure responsibilities. Even if both sides of the budget are decentralized in a balanced fashion, local governments may not have adequate administrative or technical capacity to carry out their new functions. Such problems may give rise to particular concern in developing countries where local governments are charged with important social and economic infrastructure investments (Bird, 1994).

Regardless of their empirical validity, concerns about macroeconomic disaster ensuing from fiscal decentralization rank high in many countries. Thus care must be taken to avoid unwanted outcomes in this respect. Some analysts fear that unchecked subnational governments may increase current expenditures well above their capacity to finance them out of

current revenues and then attempt to close the gap through borrowing. Others argue that since macroeconomic stabilization is properly a national government task, it is important that the national government have full control over all the policy instruments it needs to carry out this task, including borrowing—particularly borrowing abroad. The key to addressing this problem is to ensure that decentralization is undertaken in a way that increases rather than decreases accountability. This can be done by implementing stronger rules and regulations (such as the balanced budget rules in the United States) and by changing the incentives facing various actors.

If a national government wants to avoid macroeconomic problems arising from subnational debt, it can do so by not subsidizing such borrowing and by letting subnational governments that borrow too much go bankrupt. One way to approach this is to make the rules of the game clearer and more transparent. This is exactly what was done in Morocco, where the government changed the subsidy scheme for local governments from one of budget-balancing grants, in which capital and interest payments on loans increased transfer receipts, to a formula-based equalization transfer that takes no account of borrowing (Vaillancourt, 1998). In addition, lenders were explicitly told not to count on financial bailouts. As a general rule, however, the difficulty of envisioning, let alone carrying out, bankruptcy in the public sector provides good reason to require fairly stringent conditions on subnational borrowing to ensure local government accountability.

# 3. Designing Decentralization: The Building Blocks of Fiscal Federalism

Much of the literature on decentralization, including that generated by the World Bank, reflects the “fiscal federalism” orientation of the traditional public finance approach to this issue (Walsh, 1992; Shah, 1994). The emphasis is on setting the appropriate expenditure and tax assignment for each tier of government and on designing intergovernmental transfers. The framework is driven by the Musgravian principles of efficiency, equity, and stability (Musgrave, 1983). Although this literature has considered institutional issues, particularly in recent years (Huther and Shah, 1998), the main emphasis has been on economic policies. Less attention has been paid to how these policies might be implemented in disparate institutional settings and what impact they might have on the design of institutionally sensitive policy. This section reviews the traditional issues of public finance, while the next section explores the institutional issues further.

## Assigning Expenditure Responsibilities

Both theory and experience indicate that it is important to state expenditure responsibilities as clearly as possible in order to enhance accountability and reduce unproductive overlap, duplication of authority, and legal challenges. In theory, decisionmaking should occur at the lowest level of government consistent with allocative efficiency (for example, the geographic area that internalizes the benefits and costs of decisionmaking for a particular public service). Thus the optimal size of jurisdiction for each service and service component would likely differ, although in practice economies of administration and transactions costs would presumably lead to the grouping of roughly

congruent services at the local (street lighting, refuse removal), regional (rural-urban roads, refuse disposal), and national (intercity highways, environmental policy) levels.

Decentralized decisionmaking enlarges possibilities for local participation in development. However, accountability is often best promoted by establishing a clear and close link between the costs and benefits of public services, so that the overall amount of expenditure responsibility assigned to a level of government ideally will correspond to the amount of revenues that level has at its potential command.

Some national allocative objectives can be carried out either directly by the central government or indirectly by local governments responding to incentives created by national grants and regulations (as well as interlocal or interregional agreements). Moreover, national governments have obvious roles in formulating stabilization and distribution policies, and attention must be paid to possible local conflicts with these policies. In many instances it seems appropriate for some functions to be shared in the sense that higher levels of government may exercise a regulatory or policy role, while lower levels of government are responsible for delivering services.

Sectors need to be unbundled because some aspects of service delivery are appropriately undertaken by higher levels of government while other components are best done locally. For example, there are four broad functions in water supply and sewerage (usually considered a local service), and each has several components:

- Policymaking (central and local, financial, economic, environmental, health-related, subsidies).
- Regulation (economic, environmental, water quality, service quality).
- Investments (planning, financing, execution).

- Operations (production and treatment, distribution, commercial operations and consumer relations, maintenance).

The characteristics of each function differ and thus have different implications for the role of the government and private sector, and the level of government involved (Triche, 1993).

A key to designing good policy is a clear understanding of what outcomes are important for the central government, and what outcomes can be determined by local governments. The central government should retain control (either by directly providing services or by creating incentives for local governments to act according to central preferences) over functions for which it desires certain outcomes (such as family planning), and should relinquish control on issues where local divergence in priorities is not a big issue. Local governments must be held accountable to the center for nationally mandated services, while for other devolved functions they must be held accountable to their local constituents.

Finally, experience has shown that effective decentralization requires complementary adaptations in a variety of institutional arrangements for intergovernmental coordination, planning, budgeting, financial reporting, and implementation. Such arrangements may encompass both specific rules (for example, in the design of fiscal transfers) and provisions for regular intergovernmental meetings and periodic reviews of intergovernmental arrangements. Detailed central control over local use of funds is seldom appropriate. Instead, what is needed is better monitoring and oversight of local fiscal performance.

### **Raising Revenue**

Two broad principles of tax assignment are the need for economic and administrative efficiency and the desirability (for accountability reasons) of having each government finance its own expenditures out of its own revenues. Unfortunately, these two principles generally conflict.

- Economic and administrative efficiency suggests that taxes on mobile factors (such as corporate and personal income taxes), value-added taxes, and

taxes on international trade should be assigned to the central government. Similarly, local governments should presumably tax only immobile factors (such as land and real estate) in addition to applying user charges wherever feasible.

- Because the central government has a large role to play in achieving distribution and stabilization goals, it seems logical for it to be responsible for progressive (redistributive) taxes (such as those on wealth and personal income), as well as those taxes most sensitive to economic fluctuations (such as corporate income taxes and taxes on natural resources) and any specific taxes (for example, carbon taxes) related to national objectives.<sup>6</sup> On the other hand, to ensure accountability to local residents, local governments should to the extent feasible be responsible for financing local services. When local governments are responsible for such major expenditures as education, accountability thus suggests more taxing power for local governments than efficiency—or central policy—permits in most countries.

An important national policy consideration in countries where subnational governments have independent taxing power is to ensure an adequate degree of internal tax harmonization and coordination to preserve the internal common market. This concern also argues against giving lower-tier governments the power to impose taxes on corporate income, value-added, or natural resources. For corporate taxes, such governments may engage in inefficient tax competition or in equally undesirable (for accountability reasons) interjurisdictional tax exporting. Tax exporting (from producer to consumer regions) and administrative complexity provide strong arguments against subnational value-added taxes. Tax exporting and instability both argue against assigning resource revenues to local or state governments. The same arguments can be made with respect to tax-sharing arrangements under which local governments receive a fixed percentage of certain national taxes collected in their jurisdiction. Such arrangements create undesirable incentives for tax exporting and bias national tax policy (in the direction of raising taxes that do not have to be shared). Moreover, tax rates in such systems are invariably set by the central government, and the sharing rate is often

applied uniformly throughout the country. Thus the accountability link is broken and subnational governments have no incentive to ensure that the amount and pattern of their spending is efficient.

As a rule, the allocation of revenues in most countries provides most (and often all) lower-tier governments with insufficient own-source revenues to finance the expenditures for which they are responsible. Apart from borrowing, there are two ways to bridge this financing gap, either or both of which may be applicable to varying extents in different countries.

The first is to supplement local revenues with inter-governmental fiscal transfers—without undesirably reducing local efforts to collect taxes (see below). The second is to permit subnational governments to levy their own broadly based taxes—so long as they burden local residents only. In principle two such taxes are possible: a retail sales tax and a personal income tax. Administrative difficulties rule out retail sales taxes in practice. Thus the only efficient broadly based subnational tax that seems both feasible and desirable is likely to be a flat-rate surtax (or surcharge) on a national personal income tax—provided that such a tax exists and works moderately well.<sup>7</sup>

To ensure local accountability with respect to such a surtax, a local property tax, or local taxes in general, local governments must be restricted (to the extent possible) from exporting taxes and allowed to set their own tax rates. For efficiency it may be desirable to assess the base of a tax centrally and even to have it collected by the central government. But for accountability it is critical that the local authorities be responsible (perhaps within limits) for setting the tax rate.

### **Overseeing Subnational Borrowing**

Subnational governments can be permitted to borrow, but a great deal of caution is required. Unchecked subnational governments, particularly those highly dependent on national transfers, may increase current expenditures well above their capacity to finance them out of current revenues and then close the gap through borrowing (especially if, as in Argentina, local governments control provincial banks), often pledging future revenue transfers to service the loans. More generally,

it is sometimes argued that subnational governments should be restrained from accentuating cyclical pressures by borrowing—especially borrowing abroad and thus adding to the national obligation to service foreign debt (Ter-Minassian, 1997). On the other hand, allocative efficiency and intergenerational equity often require that long-lived investment projects, especially those that will increase productive capacity, be financed by borrowing rather than relying solely on current public savings or transfers from above. The question, then, is how to distinguish good borrowing from bad borrowing.

In the past subnational borrowing was an issue of fiscal federalism because local borrowing was guaranteed by central governments or secured through central intermediaries. This has changed significantly in recent years with the rise of local and global capital markets, increasing political decentralization, and the importance of the regulatory environments in which subnational borrowing occurs. For these reasons, subnational borrowing is addressed in greater detail in section 4.

### **Designing Intergovernmental Transfers**

Since transfers are the main source of revenue for subnational governments in most countries, the design of transfers is of critical importance to the success of decentralization. Transfers can be broadly divided into nonmatching (lump sum) and matching transfers. Nonmatching transfers can in turn be divided into selective (conditional) and general (unconditional). Conditionality ensures that the recipient government spends at least the amount received on the designated functions, though the fungibility of funds means that some money that would have been spent on such functions in any case may be diverted elsewhere. Empirical studies of industrial countries suggest that as a rule even unconditional grants are fully spent by recipient governments rather than used to lower local taxes (the so-called “flypaper effect,” meaning that money sticks where it hits; Hines and Thaler, 1995). Similar results have been noted in developing countries, such as Colombia (World Bank, 1996b). Matching transfers require that the funds be spent on

specific purposes and that the recipient to some extent matches the grant out of its own funds. Such transfers may distort local priorities and be considered inequitable in that richer jurisdictions can raise matching funds more easily. But the latter problem can be offset to some extent by varying matching rates with jurisdictional wealth, and the former may be the desired outcome when the transfer is intended to, for example, internalize spillovers or achieve overriding national policy objectives.

When local governments are expected to play a major role in delivering social services, the design of intergovernmental transfers is particularly important because the central government usually retains a strong interest in at least some of the outcomes. If the central government is, in effect, using local governments as agents in executing national policies—for example, to provide primary education at a specified level throughout the country—then it is important to make the transfer conditional on the funds actually being spent on education or on the attainment of some level of educational performance (Bird, 1993).<sup>8</sup>

If key services are to be provided through decentralized governments, careful attention has to be paid to getting the prices facing service providers right (for example, through a well-designed system of matching grants), setting up an information and inspection system capable of ensuring that the desired services are delivered to the target groups, and devising some system (such as a national “fail-safe” provision) for dealing with the non-compliant without punishing the innocent.

As Bahl and Linn (1992) show, the most appropriate form of a transfer largely depends on its objective. Regardless of the particular design, however, good intergovernmental transfer programs share certain characteristics:

- Transfers are determined as objectively and openly as possible, ideally by some well-established formula. They are not subject to hidden political negotiation. The transfer system may be decided by the central government alone, by a quasi-independent expert body (such as a grants commission), or by some formal system of central-local committees.
- Transfers are relatively stable from year to year to permit rational subnational budgeting. At the same time they are sufficiently flexible to ensure that

national stabilization objectives are not thwarted by subnational finances (Box 2). One approach that appears to achieve this dual objective is to set the total level of transfers as a fixed proportion of total central revenues, subject to renegotiation periodically (say, every three to five years).

- The transfer formula (or formulas) is transparent, based on credible factors, and as simple as possible. Unduly complex formulas are unlikely to prove feasible or credible in countries where, for example, there is serious dispute about regional population sizes.

If several of the objectives discussed earlier are applicable—for example, some degree of equalization is desired while at the same time there are clear national policy objectives—it will generally assist both clarity and effectiveness if separate transfers are targeted at each objective (see World Bank 1996b).

### **Assembling the Building Blocks: A Systems Approach**

The assignment of expenditures, revenues, transfers, and subnational borrowing together compose the system of intergovernmental finance. Though there is much to know about each of these components as well as their sequencing, it is perhaps most important to know that these issues must be considered together, as part of a complete system. This system, combined with the institutional environment (see the next section), determines impacts on efficiency, equity, and macroeconomic stability. For example, an intergovernmental fiscal system might assign local governments the responsibility for financing primary school, collecting local school fees, and administering central funds to target subsidies to poor schoolchildren. This set of expenditure, revenue, and transfer policies can increase efficiency and equity. But if the three policies are not designed with a common objective, the quality of services could decline dramatically and the poor could lose access to schooling.

Although the ultimate impact of decentralizing any one fiscal instrument will depend on the design of all of them, all components should not be designed simultaneously. Expenditure functions should be assigned

**Box 2: Experience with Intergovernmental Transfers**

Any good system of intergovernmental grants must be stable. Yet it must also be flexible. How can both characteristics be achieved simultaneously? From the perspective of a central government, the best system might be one in which the total amount to be transferred (sometimes called the “distributable pool” or the “primary distribution”) is determined each year in accordance with budget priorities. But unless the amounts to be received are to some extent predetermined and predictable, recipient governments will not be able to budget properly and will not face an appropriately hard budget constraint. One way to provide some degree of stability to local governments and some degree of flexibility to the central government without biasing central tax policy is to establish a fixed percentage of all central taxes (or current revenues) to be transferred—preferably in accordance with an objective distributive formula (the “secondary distribution”) that takes into account such factors as the needs and capacity of recipient governments. If not too complex, such a system will also be transparent. Moreover, interjurisdictional equalization can be built into the formula.

Many transfer systems in developing countries possess few or none of these characteristics. In Russia and other former socialist countries transfers are negotiated every year in an obscure political process. In Bangladesh nominally predetermined transfers are not made available in a reliable fashion. And in Argentina the factors in the formula are complex, contradictory, and not optimally equalizing.

Fortunately, better examples can be found around the world. The Philippines, for example, distributes 20 percent of national internal revenues to local governments. Similarly, Colombia distributes 25 percent of (non-earmarked) national current revenues to departmental (intermediate-level) governments, in part in equal portions and in part on the basis of population. Colombia also distributes 30 percent of value-added tax revenues to municipal governments, largely on the basis of population. Although these systems have their flaws, they are objective, stable, and transparent.

Even these systems, however, make no formal provision for periodic reexamination of the total amount to be distributed or the distribution formula (although Colombia’s 1991 constitutional reform provided for a one-time reevaluation of the municipal grant system after five years). In contrast, formally federal countries such as India and Pakistan have established fiscal commissions to carry out such evaluations and to recommend changes every five years. India, for example, has had 10 such reports over the years and has made numerous changes in the distribution amount and formula as a result. South Africa’s Financial and Fiscal Commission may play a similar role.

A number of developing countries distribute transfers using a formula intended both to equalize public expenditures in localities with different needs and capacities and to stimulate local fiscal efforts, although severe data problems often constrain the parameters used in such formulas. Brazil and India, for example, allocate some transfers in accordance with per capita incomes in the different states, but few other developing countries do so owing to data difficulties. In the absence of such data, simpler approaches—like those used in Colombia and Morocco—based on, for example, population and a simple categorization of localities (by size, type, and perhaps region) are more likely to prove useful in measuring general expenditure needs. Few developing countries include explicit capacity measures in their formulas. India and Nigeria include a measure of tax effort in the basic distributional formula to states, and Colombia has such an element in one of its transfer programs. Chile goes further and actually “taxes” richer localities to some extent by reducing their transfers and raising those granted to poorer localities. Of course, this approach makes sense only if local governments have the ability to vary local tax rates. The absence of much local autonomy with respect to local taxes, combined with data difficulties, probably explains the few examples of transfer programs incorporating explicit capacity measures in developing countries.

In principle, a system requiring local governments to cover some portion of service costs out of their own funds is desirable for accountability and efficiency reasons. In addition, given that different localities have quite different capacities to finance services, it may be appropriate to require different degrees of local finance (matching ratios). An example of such a system is in Zambia, where local governments receive a transfer that equals the difference between the estimated cost of providing a specified level of local services and the expected revenues to be raised locally by applying a standard set of local tax rates. The basic problem with this approach is that it is quite demanding in terms of information.

The design of intergovernmental transfers is particularly important for the social sectors, where central governments maintain a strong interest in certain expenditures and outcomes (as in public health and primary education). Rules and incentives set by the center through intergovernmental transfers are the key to ensuring that central mandates are realized. In Vietnam, despite central efforts to target more funds for primary education and basic health care to poorer provinces, the funds do not necessarily reach the poorer districts and communes or even the intended subsectors, since provinces are not provided with specific instructions on how to allocate the funds.



first. Assignment of expenditure functions can broadly follow the subsidiarity principal, which addresses interjurisdictional spillovers; however, fine-tuning of functional assignments within countries will lead to different outcomes. Once expenditure functions are determined, revenues should be assigned to different levels of government to ensure that services can be financed and there are no unfunded mandates. Local revenues will come from a combination of intergov-

ernmental transfers and local taxes. The transfers should address both vertical imbalances and horizontal inequities, but assigning at least minimal tax instruments to local levels is an important part of accountability. The combination of transfers and taxes should cover local recurrent expenditures. Subnational borrowing (under the conditions described in the following section) should serve as the last source of finance for the capital budget.

## 4. Designing Decentralization: Incorporating Institutions

The impact of the intergovernmental fiscal system on economic or service delivery outcomes depends on how that system is designed and on the institutional setting in which it is implemented. Institutions can be defined as the rules of the game in society (or the incentives and constraints that influence human behavior) and the organizations and other means to enforce them. Both the rules and the enforcement mechanisms influence the design of decentralization.

Institutions have had an increasingly important influence on decentralization in recent years because of technological change, political demands for greater participation, and the emergence of global and local capital markets, among other factors (Box 3). This section identifies five institutional factors that shape the design of decentralization and influence its economic impact: the regulatory framework, the organization of service delivery, information systems and competition, the potential for asymmetric decentralization, and the need for policy synchronization. Taken together with the traditional public finance perspective, these factors reflect an approach to decentralization that is based on the design of institutional incentives and rules of governance as instruments for better economic management.

### Adjusting the Regulatory Framework and Decentralizing Borrowing

There are many sound justifications for allowing subnational governments to finance their own investments (for example, the intertemporal nature of large capital investments). But experience has shown that maintaining a hard budget constraint for subnational governments is both essential and extremely difficult. Several approaches are possible:

- One common strategy is to restrain provincial and local borrowing by, for instance, limiting such borrowing to financing for capital expenditures, limiting debt service to a maximum percentage of current revenues, or requiring prior approval of central government for borrowing.
- A more fundamental approach is to remove the institutional problems that give rise to unsustainable subnational borrowing. This focus might include reassigning revenues and expenditures to provide local governments with some own sources of revenue with which to finance local expenditures, revising the transfer system, introducing transparent, timely, and reliable reporting systems, and establishing a stable, accepted periodic review process. These measures are related to the fiscal system that binds different tiers of government. Equally important would be to ensure transparent reporting by and regulation of the financial sector—particularly as it relates to borrowing by subnational governments.

International experience suggests an important objective in the design of an intergovernmental fiscal system: keeping the fiscal and financial systems separate (Box 4). Indeed, the lack of separation between fiscal and financial systems—rather than the decentralization process itself—may have led to macroeconomic instability in some countries, as the web of implicit obligations suddenly appeared as explicit budget commitments. In addition, government involvement in the financial sector may dampen the economic role of capital markets in allocating credit and signaling creditworthiness. Thus it could limit the financial sector's ability to promote economic efficiency and local accountability.

In Argentina, for example, provincial government deficits have been financed in part by provincial banks, many of which have gone bankrupt. As Wildasin

### Box 3: Decentralization in South Africa: Redesigning Intergovernmental Fiscal Relations and Creating Institutional Incentives

South Africa has embarked on a comprehensive decentralization of political, fiscal, and financial responsibilities to provinces and local governments. At the political level, the apartheid system was formally ended with the elimination of racial jurisdictions, the holding of elections on a nonracial basis for all tiers of governments, and the writing of a new constitution. Legislation is being enacted to implement a new fiscal system for subnational governments, to provide a framework for subnational borrowing, and to provide institutional incentives for efficient service delivery. In addition, the central government has initiated a multipronged strategy for capacity building to enable successful decentralization. The overall framework does not, however, take a uniform view of decentralization. Guided by the demographic and economic concentration of the urban sector (which accounts for 60 percent of the population and 80 percent of GDP)—and perhaps by its political clout—decentralization is being implemented rapidly for local governments in urban areas, particularly in metropolitan centers, but with greater caution in the provinces.

A major objective of the fiscal system in the post-apartheid era is to improve the distribution of income imposed by apartheid. The policies implied by this objective involve the efficient assignment of expenditures, central financing of redistributive measures, and the development of a stable and predictable intergovernmental grant system. Given their redistributive and spillover impact, education and health have been designated as provincial responsibilities but are financed from the center. The central government uses its “divisible pool” of national revenues to support transfers to poorer jurisdictions through two channels: one for provinces and one for local governments. Both systems are formula driven. For local governments the formula is based on household per capita income and for provinces on household per capita income augmented by a measure of the rural economy in a region. As a result the transfers have shifted resources into poorer jurisdictions. The system has also eliminated the ad hoc and inequitable fiscal transfers of the apartheid era, which shifted resources from central to subnational tiers for the purpose of balancing end-of-the-year local deficits.

To complement the transfers, all local authorities have been given access to user charges, property taxes, and some business taxes, and can set rates for user charges and property taxes. But provinces do not have their own tax instruments, creating potential problems of accountabili-

ty and governance. In addition, the central government is reforming budget systems. A uniform accounting system is being established for municipalities in hopes of setting up clear budget rules to link all tiers of government to an integrated budget system.

On the financial side, a regulatory framework is being developed to enable local governments to access local capital markets directly. The framework will have clear rules for public sector bankruptcy. This policy measure complements the political and fiscal decentralization by decentralizing borrowing powers. Borrowing for long-term infrastructure development will be more appropriate in large metropolitan areas, while smaller urban governments and local rural governments will still require intergovernmental transfers to finance capital investment. A capital grants program from the center to the local level has been established to accommodate this need. But in the case of the provinces, access to capital markets has been prohibited. This policy is consistent with the policy of not granting provinces any significant own-taxes because it avoids creating implicit liabilities for the central government from provincial access to capital markets. To facilitate capital investment at the provincial level, a program of capital grants is expected to be implemented.

In addition, legislation is enabling local governments to restructure the institutional organization of municipal delivery systems. In particular, municipalities are legally able to experiment with partnerships with the private sector (such as concessions) and nongovernmental organizations (such as community delivery systems). Thus the decentralization framework not only assigns responsibilities to local authorities but also extends it to the private sector and community groups. The institutional focus also covers metropolitan areas, where a policy debate is under way about the appropriate structure of metropolitan governments. Similarly, a debate is under way about the appropriate structure of welfare and health systems, currently the responsibility of provinces, and its implication for provincial governance.

The central government has focused on capacity-building measures to support the overall framework of decentralization. For example, rather than impose top-down, supply-driven systems of capacity measures, the central government provides grants to municipalities to buy capacity for projects involving the private sector in the delivery and financing of municipal services. Similarly, the central government (in partnership with

donors and the private sector) has launched management training programs aimed at municipal authorities. A similar program for provincial treasuries is being formulated.

Finally, the central government is investigating institutional settings for coordinating economic policies in a decentralized system. Currently, national policies (such as those for standards and personnel) are set by central line ministries, but financing and implementation are in the hands of subnational governments. This divergence is very acute in the social sectors (such as education and health) and, therefore, in the relationship between the center and the provinces. How to coordinate national policies with an emerging multitiered system of govern-

ment is an important design issue in the formulation and implementation of intergovernmental systems.

Decentralization is far from complete, and it is far too early to judge the outcome of the measures taken. But what is striking is the comprehensive vision of South African policymakers in the design of the decentralization framework. Political, fiscal, financial, and institutional changes are being managed simultaneously and in different ways for different jurisdictions. Few countries have taken such a fundamental approach to reforming their intergovernmental systems. Given its potential to offer other countries a host of lessons in the reform of intergovernmental systems, South Africa will be watched very closely by researchers and policymakers for years to come.

(1997) points out, the central bank's policy of managing these banks and absorbing their losses provided provincial governments with a circuitous mechanism of inflationary finance. It also weakened incentives for fiscal discipline at the provincial level. In Brazil too,

evidence suggests that the de facto structure of intergovernmental fiscal relations includes the use of state banks, and their relationship to the central bank through the financial regulatory system shifted implicit liabilities for state deficits to the central bank. In

#### **Box 4: Separating Fiscal and Financial Systems and the Evolution of Capital Markets**

Separating fiscal and financial systems helps the growth of implicit liabilities for the central government and so reduces the possible macroeconomic consequences of decentralizing borrowing powers. It also raises several issues on the nexus between the sequencing of policies for separating fiscal and financial systems and the institutional development of capital markets.

In countries without a domestic capital market, it may be preferable to have central fiscal transfers (from a central government borrowing from international sources) provide additional resources to subnational governments, while focusing central government policy efforts on developing a private commercial banking system. This approach avoids the creation of development finance institutions, keeps fiscal and financial systems separate, and potentially offers a better starting point for a municipal finance system. The reform of the financial sector in Eastern Europe is a case in point. As the private banking system emerges and establishes itself, long-term finance can be provided through discount facilities funded by central governments. Discount facilities take only the maturity risk by stretching the term of commercial bank lending to municipalities. Commercial banks, however, retain the credit risk for their retail lending, thus preserving the separation of risks between the public and private sectors.

As capital markets emerge with financial instruments offering long-term finance, the need for discount facilities will disappear. And as long as the fiscal system is well designed, subnational governments will be able to access longer maturities. For fiscally weaker municipalities (such as rural local governments), however, transfers would remain an important vehicle for access to funds.

Finally, institutional changes in the organization of delivery systems provide mechanisms for accessing capital markets to expand the delivery of services (such as water and electricity) while offering mechanisms to separate fiscal and financial systems. For example, even where capital markets are weak, the creation of privately managed delivery systems (such as concessions for water and electricity) may provide access to equity and debt from private international markets. Similarly, smaller municipalities may pool their service delivery systems by contracting out to a regional utility and take advantage of economies of scale on the production side. This option may alleviate the need for the public sector to catalyze or manage a financial pooling instrument to lower the cost of funds for smaller local government units (for example, the Michigan Bond Bank used such a financial pooling mechanism). What remains important, however, is to develop a regulatory framework that ensures these delivery systems are not inherited by the public sector in the case of bankruptcy.

commenting on the Brazilian story, Dillinger (1997) points out that the hard budget constraint imposed on the fiscal side was circumvented because states have—wittingly or not—used the financial system to obtain federal resources. Similarly, in China the weak revenue base of the center has created political pressures on the People's Bank of China to offer credit to lower-level governments. As Lall and Hofman (1995) suggest, such policy lending can have a negative impact on macroeconomic price stability and, presumably, fiscal discipline at the subnational level.

These examples suggest various mechanisms for separating fiscal and financial systems. An important issue is, where possible, getting the public sector out of the financial system. This includes privatizing the banking system. But by itself privatization is not sufficient to enforce the separation. As the U.S. savings and loan crisis and elements of the recent Asian financial crisis suggest, private banks must be supervised with a clear prudential, regulatory framework that monitors the level and nature of their aggregate liabilities.

The central government also must clarify the fiscal rules of the game and follow them. For example, it should first clearly assign expenditure responsibilities to each level of government. After these responsibilities have been assigned, tax instruments should be assigned to subnational governments to increase their access to own-revenues, and arrangements should be fixed for three to five years to improve predictability. Similarly, ensuring the stability and predictability of the fiscal transfer system and implementing the legal framework for pledging revenues as debt payments are also essential. Transfers and own-revenues provide the “collateral” necessary for access to capital markets. In fact, the lack of access to financial markets by subnational governments often results in central government intervention in financial markets when the real issue is designing and implementing an appropriate fiscal framework.

On the other hand, if financial intermediation is undertaken by the public sector, as in the case of development finance institutions or municipal development funds, the separation of fiscal and financial mechanisms may need to be enforced in other ways. For example, it would be important to ensure that the capital borrowing of public entities responsible for onlending to subnational governments is an explicit line item on the cen-

tral government's budget and a formal part of the central government's liabilities. This measure will eliminate a possible source of implicit liabilities and may provide a check through the budget system on the spending behavior of development finance institutions and municipal development funds.<sup>9</sup> The credit allocation mechanism must be made transparent and binding to reduce ad hoc and politically influenced allocation of finance. In addition, the municipal development fund must not provide subsidized funding since this will hinder the development of local capital markets—which ultimately will be the sustainable, sound source of local investment finance (Peterson, 1997). Finally, a credible exit strategy for the institution would be needed, especially as local capital markets develop.

Macroeconomic crises linked to subnational finance have been caused more by a lack of institutional separation between fiscal and financial systems than by decentralization per se. In fact, decentralization may even provide incentives for a central government to institutionalize the separation of these systems. When subnational governments have direct access to capital markets, the risk of inheriting liabilities may provide an impetus for the central government to monitor borrowing, making the interaction between subnational governments and capital markets—whether through public or private intermediation—more transparent.

In addition, it may be useful to develop a mechanism by which any emergency central support required to work out such debt problems will carry with it the obligation to introduce and make effective all these reforms under the supervision of a central review board (World Bank, 1996a). To avoid any moral hazard behavior from this implicit insurance scheme, however, it would be necessary to specify through legislation the bankruptcy procedures.

Still, at least two basic guidelines for subnational borrowing seem to be needed. The first is a limit on borrowing solely for investment (which may, of course, be difficult to enforce in the absence of strictly segregated capital budgets). The second is a requirement for explicit national approval for foreign borrowing. At a deeper level, given the heavy dependence on central transfers of subnational governments in most developing and transition economies, stronger restrictions on borrowing may be warranted—particularly if some

subnational units are large enough to affect national macroeconomic variables (Wildasin, 1997). Unless subnational governments are able to save themselves from fiscal crises by drawing on their taxing powers, their only options are bankruptcy or bailouts. In some cases the only way to reduce the moral hazard implicit in this situation may be by imposing stricter limits on subnational borrowing than would be needed if capital markets functioned well and the central government's nonguarantee of local debt was credible.

Finally, it should be noted that there is almost no case for central government lending for local investment in infrastructure—other than the possible argument that such lending may help develop a private capital market to finance such investment. Central finance may be appropriate if the central government has an interest in local infrastructure, but it should be provided through, for example, competitive grants from a social investment fund (Glaessner and others, 1994) rather than through subsidized credit. As experience with municipal development funds has shown, subsidized financing agencies almost inevitably become contaminated by political concerns and end up blocking rather than aiding the development of private capital markets. Thus they weaken rather than strengthen the potential regulatory role of such markets with respect to subnational borrowing.

### **Organizing Service Delivery**

The broader institutional approach to decentralization has several important implications. For example, to the extent that decentralization is intended to improve the delivery of services, it is essential to consider in detail not only the nature of each service but also the structure of delivery. Not only does infrastructure investment raise quite different questions than do social services, there are also important differences within each category. As the *World Bank's World Development Report 1994* shows, for example, roads, power, telecommunications, and water and sewerage each have specific requirements with respect to the most appropriate institutional structure for efficient and equitable service delivery (see also Kessides, 1993). Similarly, education, health, and social assistance—or, more broadly, the “social safety net”—may be very different with

respect to such critical matters as the justification for, and appropriate level of, public subsidy and the role of different tiers of the public sector in financing, delivering, or regulating a service. Economic support services such as those involved in rural development may raise still other problems.

In this connection, it is useful to distinguish between public delivery of services (production) and public financing of services (provision). It is also important to distinguish between production efficiency (that is, the cost of delivering a given quantity and quality of service) and allocative efficiency (that is, the extent to which public expenditures reflect local demand). In principle, there is a wide—almost unbounded—variety of forms in which particular public services may be produced and provided, and there is no necessary link between the two (Box 5).

Schools, for example, may be run by a local education authority, a local government, a nonprofit body, or a private company. This is the production side, to which issues of production efficiency (such as economies of scale and scope) relate. In some instances—such as schools—a case can be made that public production is a more efficient way of obtaining a desired output (say, uniform primary education) than is regulation and monitoring of contracted production. In other cases public production may be warranted to achieve economies of scale—as in the technical design of super-highways in countries that do not afford sufficient scope for the development of competitive private producers (and that do not want foreigners to enter the market). It is important not to confuse the question of who should deliver a service with the question of how much should be provided and who should pay for it. The more fundamental question from an allocative point of view is who pays, not who delivers. And, as noted, the two can be quite different. It is also important to determine who decides who delivers services. It is still an open question whether local governments should be allowed to choose to deliver services or contract out. Where procedures are transparent and basic rules of procurement are in place, this may be a good idea. But without these preconditions, it may not.

In one sense privatization is the ultimate form of decentralization. In recent years a wide variety of countries have seen the private sector play an increasingly

**Box 5: Alternative Ways to Produce or Provide Local Public Services**

Services can be produced (delivered) or provided (financed) by many different public institutional structures, including:

- Central government (department, decentralized agency, or enterprise)
- Regional government (department, decentralized agency, or enterprise)
- Local government (department, decentralized agency, or enterprise)
- Central-regional arrangement
- Central-local arrangement
- Central-regional-local arrangement
- Regional-local arrangement
- Association of local governments
- Special-purpose local authority (encompassing more than one local government, coterminous with a local government, or covering less area than a local government)

In each of these cases the service may be produced by one structure (such as a regional enterprise) and provided by another (such as a specific local government department).

Services can also be provided in whole or part by the public sector but produced by the private sector. Again, there are many possible forms:

- Build-operate-transfer (BOT) or build-own-operate (BOO) arrangements
- Other forms of public-private partnerships
- Development charges, exactions, and similar schemes
- Franchise arrangements
- Service contracts

Finally, public services can also be both produced and provided by private agents, sometimes in response to coercive legal requirements and sometimes even voluntarily:

- Compulsory provision by developers
- Compulsory provision by individuals (through vouchers or self-financed)
- Voluntary provision (through formal or informal arrangements)
- Provision by nongovernmental organizations (churches, enterprises)

Even this extensive list is incomplete. Many of the arrangements listed have a number of possible variants, and there are ways to combine all these organizational structures. Moreover, different structures might apply for policymaking, regulation, financing, production, and so on. Finally, different structures may apply for different services and for local governments with different characteristics (size, financial capacity, and so on).

Source: Bird, 1995.

large role in the delivery and to some extent the financing of many public services, depending on the extent of externalities involved. New forms of service delivery incorporating private, public-private, and horizontal and vertical combinations of public and private actors already exist, and more are being created all the time. Private delivery of services is important in developing countries because it loosens the traditional monopoly of public service providers, which often provide inefficient, poor-quality services.

Market solutions to service delivery offer many advantages in terms of efficiency and may even be equitable (for example, by enabling public subsidies to be targeted to the poor, or by reducing the travel costs for the poor to obtain quality services). Most public services, however, embody some degree of "publicness," some relevant externalities, some broader political or social purpose (often redistribution), or some combination of these features. Such services cannot be fully pri-

vated or fully funded through user charges without breaching either efficiency or equity concerns. Although regulation of private services can help deal with some issues—for example, content of educational curriculums—it cannot deal with others—for example, equal access for the poor—without continuing an explicit or implicit subsidy. Consequently, although privatization may often be one way to deal with many problems of public service delivery, in other ways it may make the task of the institutional policy designer even more complex, since the number of agents has expanded and the degree of control over agents has diminished.

### **Establishing Information Systems and Competitive Governments**

One of the theoretical arguments supporting decentralization is that local governments have better

information about local preferences; thus decentralization should enhance allocative efficiency. Information asymmetries make it difficult for central governments to monitor local government agents. The decentralization literature developing this argument has implications for the design of intergovernmental grants and the earmarking of transfers and revenues (Cremer, Estache, and Seabright, 1995; Boadway, Marceau, and Sato, 1997). But no serious research has been done in developing or transition economies to test such basic propositions as the presumed greater knowledge of local preferences by local rather than central governments. There is, however, anecdotal evidence that decentralization increases the availability of local information (Crook and Manor, 1994). Recent work on Colombia is particularly interesting in this respect (World Bank, 1995b). Nonetheless, it is important to keep informational constraints in mind when analyzing and prescribing decentralization strategies.

However the decentralization literature is interpreted, it seems clear that the efficiency of any competition engendered by decentralization will largely depend on the rules of the game that are set and enforced by the central government or perhaps by an independent judiciary. As Inman and Rubinfeld (1996) show, electoral competition alone is unlikely to produce efficiency—although as Breton (1996) shows, government competition can take many other relevant forms in addition to counting votes. Very little research has been done—even in industrial countries—on the effect alternative institutional forms have on outcomes. This issue is particularly important in developing countries, where institutional settings vary dramatically and can strongly influence the outcomes of decentralization. Thus developing a better understanding of this issue should be a top priority for the World Bank.<sup>10</sup>

One conclusion that can be emphasized, however, is that the key to usefully competitive governments is to make relevant decisionmakers accountable for their decisions, and that the key to effective accountability is to make relevant comparative information publicly available.<sup>11</sup> Accountability and public information are easier to achieve in industrial countries than in developing countries. At its base, the ultimate mechanism

for competition is, on one hand, the ability of citizens to compare governments in terms of the services they provide and the taxes they levy (“exit”) and, on the other, the ability of citizens to affect and alter the decisions of government (“voice”). It is important to ask how relevant this mechanism is for developing countries, where poor information, weak democracies and traditions of participatory decisionmaking, and often weak rural labor markets constrain both popular participation and interjurisdictional mobility (voice and exit). Moreover, poor information and weak capacity make hierarchical accountability particularly difficult in developing countries.

One key lesson relevant everywhere is thus that the more that is known, and the more publicly it is known, the better the outcome of decentralization efforts is likely to be, whatever their rationale and whatever the circumstances in which they occur.<sup>12</sup> Because the feasible and desirable implementation of this generalization may vary widely from place to place and for different services, World Bank contributions to supplying and supporting information relevant to understanding and evaluating the impacts of decentralization can play a crucial role in improving outcomes. As with the information-theoretic approach to decentralization, the competitive approach signals both the importance of improving knowledge—and public awareness of knowledge—in order to improve outputs and the importance of considering in detail the institutional structure of particular decentralization arrangements. It is not enough to discuss, for example, tax assignment or the case for or against equalization transfers. Close attention must also be paid to the details of how such fiscal institutions actually work in the context of particular countries in order to understand and analyze the incentives facing various decisionmakers. Indeed, assigning revenue sources to localities that lack channels for public participation may be counterproductive.

An unfortunate side effect of decentralization in some countries has been the virtual disappearance from the central government’s cognitive horizon of reliable information on the provision of such services. The role of the central government in ensuring and monitoring effective and efficient decentralization is especially critical when the main goal is to enhance service



delivery, particularly for services (such as health and education) that are important not only for national development but also for poverty alleviation and general welfare. Decentralization does not mean that the central government no longer has any responsibility in these areas. What it means is that the nature of this responsibility has changed from delivering services directly to regulating and monitoring the efficiency and equity of services delivered by others—usually local governments. The essential tool for this task is an accurate information system—generated, for example, by requiring local governments to file uniform and informative budgets and financial reports. Uniform information is important so that comparisons can be made across communities and yardstick competition used. Fiscal transparency is fundamental to sound decentralization policy and, indeed, public policy in general. All government accounts should be comprehensive, comprehensible, and widely available. Budgets should be drawn up to display the real status of public finances, ideally including the long-run implications for taxation of current spending decisions. This acute need for reliable information has been neglected in most decentralizing countries (Box 6).

Some of the needed incentive for compliance with information demands can be created for local governments by making timely submission of such reports a condition of receiving fiscal transfers. This requirement may imply significant setup costs for system design, training, and implementation. To spend money wisely in a decentralized system may thus require some initial investment. While such concerns are less important when full responsibility for the efficiency and equity of services are devolved (as in a formal federal structure) rather than simply delegated to subnational governments, the need for an adequate information system remains critical to macroeconomic management even in this instance, given the importance of such services as education and health in total public expenditure. Regardless of the form of decentralization, an important institutional problem is thus how to ensure that the relevant central agencies have adequate incentives to monitor subnational activity. And, as noted earlier, such information is even more necessary when democratic institutions are important.

### Adopting Asymmetric Decentralization

Economic, demographic, and social diversity is often reflected in a multitude of government and delivery structures even within a single country. For example, South Africa has provincial and regional governments, rural districts, one and two-tiered metropolitan governments and smaller urban municipalities, and special service delivery units such as water boards and health districts. Given such diversity, both in the nature of political jurisdiction and the characteristics of households, “one size fits all” is definitely not true for decentralization. Different instruments may have very different effects in different circumstances, and very different approaches may be needed to achieve similar (or acceptable) results. For example, privatizing water services may achieve efficiency and equity objectives in a dense, urban setting, but it may fail to reach similar goals in a sparsely populated rural region. Private sector delivery and financing of water services may then have to be complemented with public sector and community delivery systems for specific areas. To accommodate the need for such diverse approaches, asymmetrical central policies—treating different units differently—may be required to achieve similar outcomes.

An important element of such an approach is the principle of asymmetrical decentralization. For example, in many countries it may be feasible to decentralize political, economic, and administrative responsibilities to large urban areas. Similarly, at the regional level, fiscal and administrative capacity may make it easier to decentralize responsibilities only to some provinces or states. In other cases it may be feasible to decentralize responsibilities directly from central government to the private sector rather than to local governments.

But asymmetrical decentralization may raise a fundamental political problem: the perceived need to have a law that treats all units similarly, in the face of the reality that there are wide and relevant differences between them. In South Africa, for example, there is growing political debate about the capacity of many newly formed provinces—especially those that have inherited significant administrative problems from the apartheid system—to manage the delivery of social

**Box 6: Why Do We Know So Little about Local Government Finance?**

Good data on local finance are hard to find in developing countries. In some countries careful examination of national data sources may disclose some relevant information, but data are often old, incomplete, budgeted rather than actual, aggregated (say, by region), or in some other way not easily usable for analytical purposes. Moreover, information is often hard to interpret. Few developing countries compile local fiscal data in a way that is comparable over time, let alone across countries. What information exists is often the result of special and occasional studies; the main international example is the massive work of Bahl and Linn (1992). A common reaction to this work by those with little experience in the field is, "Why do so many of the numbers refer to the early 1980s or even the 1970s?" But those who have carried out such work can only applaud the massive data collection effort reported in this volume. No similar effort seems to have been carried out anywhere since then.

Local finance data are poor for a number of reasons. First, few countries attach much importance to its systematic collection. Second, collecting such data is difficult in countries with low administrative capacity and poor communications systems. Third, local government structures are often complex and differentiated, which makes it difficult to design adequate data collection procedures and to ensure that the data gathered is reliable. Fourth, local government finance is complicated: tracing fiscal flows among and within the array of local governance bodies found in most countries is not easy. Fifth, even if information is obtained, how should it be interpreted?

*Source:* Bird, 1995.

Incidence and other problems of economic analysis are critical in this connection, but surprisingly little empirical progress has been made toward resolving such problems even in the most developed, and statistically sophisticated, countries. Finally, and in the end perhaps most important, local finance data are poor because no one is really asking for improvement: other things seem much more important, and resources are scarce, so this omission may seem understandable.

Such neglect is often a mistake, however. Local governments are among the most important service deliverers in most countries; unless they do better, the public sector is not likely to do much better, and how can their performance be assessed in the absence of information? Moreover, governments everywhere are decentralizing; again, how can decentralization policies be properly designed, or adequately implemented, in the absence of the information needed to assess them? Finally, in the absence of good information, policies and assessments are too often based on what central officials or visiting experts happen to know, or think they know, about what is going on in local governments. Given the variability of local reality in most countries, such biased judgments may be very misleading. It is difficult to read accounts of local finance in China, for example, without being reminded of the tale of the seven blind men describing an elephant, each inappropriately generalizing from the bit they happen to know. All in all, paying more attention to getting the facts straight about local (or, more broadly, subnational) finance would seem to be a worthwhile investment in most countries.

services such as health and education. An option may be to decentralize responsibilities only to those provinces that show the capacity to manage such services. But this option may be politically difficult to implement because it will require some elected representatives to agree to receive less autonomy than their counterparts in other provinces. In such cases, and depending on the country, solutions may be sought through such means as making the application of a particular decentralization provision conditional on the satisfaction of a number of preconditions, on the voluntary assumption of certain financing or other obligations, or on the signing of a contract that permits individuation of both the timing and extent of decentralization. Such legislation assures the ultimate

decentralization of political and economic powers and does not leave it to the discretion of the center but, rather, to the actions of elected representatives of subnational governments.

**Synchronizing Policy**

As noted earlier, a difficult but important design issue is how to match fiscal, political, and administrative arrangements to achieve the potential benefits of decentralization. Most countries do not get the mix right—they devolve decisionmaking to local levels without providing budgets to make meaningful decisions, or they decentralize finance without ensuring adequate

local accountability through political decentralization. Even within the fiscal realm, coordination is extremely difficult. Countries sometimes decentralize expenditure responsibility without providing adequate revenues (as in Russia and other countries of the former Soviet Union), or decentralize revenue but mandate virtually all expenditures (as in Ecuador). Or the central government devolves a service fiscally and politically, yet determines all wage and employment policies, or issues the locality with a long list of service delivery mandates that provides very little flexibility in local decisionmaking. Decentralization has been likened to a soufflé where all ingredients must be present in the right amounts and prepared in the right way to achieve success (Parker, 1995). Moreover, like a soufflé, the best method of preparation will depend on the environment and the best mix of ingredients is a matter of taste.

Policy synchronization is difficult not only because of the many fiscal, political, and administrative issues that require careful consideration, but also because each service and even each function within a service will differ with regard to the appropriate form of decentralization. Depending on the nature of the service (externalities and interjurisdictional spillovers), the political landscape, and possibly the administrative capacity, the amount of autonomy given to a local government will differ (Bossert, forthcoming).<sup>13</sup> For example, certain public health programs (family planning, immunizations) are of national concern, and thus local governments may be given some autonomy for implementa-

tion but must be responsible to the central government for achieving nationally specified outcomes. The wholesale decentralization of the health sector led to the failure of one state to undertake a family planning program deemed important by the central government in the Philippines, and to a drop in vaccination coverage in Papua New Guinea (Kolehmainen-Aitken and Newbrander, 1997).

The issue of providing flexibility to local levels in determining wages and job requirements—decentralizing the design of labor market conditions in the public sector—provides an important example of the need for policy synchronization in the design of decentralization. In the Philippines, for example, decentralization of the health system resulted in health care workers doing the same job being paid at three different rates based on their previous employment (central, provincial, or local). This gave rise to morale and budgetary problems. Inadequate attention to the financing of pension obligations when transferring employees from one level of government to another has complicated decentralization efforts in Colombia and many other countries. The failure to give local governments any leeway in staff complements or salaries largely vitiated initial decentralization efforts in a number of Eastern European countries (such as Romania). Such issues are especially important with respect to large, labor-intensive activities such as health and education, where matters are further complicated by externalities (for example, with respect to public health) and basic welfare (accessibility) concerns.

## 5. Rethinking Decentralization in Developing Countries

To debate whether decentralization is good or bad is unproductive and misleading since the impact of decentralization depends on design. Yet it is essential to consider the wide range of issues that influence decentralization. The traditional fiscal federalism approach is a starting point, but the need for a stronger focus on institutions—both the rules that influence the behavior of actors at different levels of government, in the private sector and in civil society, and the organizations that implement those rules—is increasingly evident in the World Bank's operational work. This broader agenda has led to an enhanced focus on accountability and capacity, has strong implications for the Bank's project design and policy dialogue, and calls for a reinvigorated research effort focused on developing countries.

### Incentives for Accountability

Decentralization is dispersing fiscal, political, and administrative responsibilities across different tiers of government and between the public and private sectors. Responsibility for delivering services, for example, may lie with all or some tiers of government, with community groups, or with the private sector. The challenge is to design decentralization so that it creates incentives that hold each entity accountable for its responsibilities and makes explicit the institutional relations between each entity.

How can decentralization provide such incentives?

First, in democratic settings political decentralization and elections provide direct political accountability. More broadly, as Breton (1996) demonstrates, in all functioning political structures there are a variety of means by which indirect political accountability is

attained. Many developing countries, though, have weak representative decisionmaking processes and local elites are often deeply entrenched. Local elites often take leadership roles, and although not necessarily bad, this can result in the hijacking of resources unless transparency and accountability are somehow enforced (Narayan, 1998). One way to improve local participation and accountability is through transparent budgeting processes and public procurement procedures. Experience in Brazil and Mexico has shown that participatory budgeting (that is, where all citizens are invited to a public meeting to discuss budgetary priorities) can provide a critical link between communities and government.<sup>14</sup> Governments should actively seek community participation and use performance-based budgeting so that their constituents know not only what inputs were used but what outcomes were achieved. Similarly, publicizing procurement bids, proposals, and selection enhances community awareness and ultimately accountability. Stressing the importance of community participation in local decisionmaking should be an important component of the dialogue on decentralization.

Second, by diffusing responsibilities across different entities, decentralization provides a basis for comparison and competition (even if indirect). In developing countries, where interjurisdictional mobility may be constrained, competition among service providers of goods that can be privately consumed within a jurisdiction increases options for residents.<sup>15</sup> (Decentralization and private sector development have an interdependent relationship whereby the former enables the latter, and the latter strengthens the former.<sup>16</sup>)

Third, in distributing fiscal instruments to all levels of government, with the right to set rates, decentralization creates incentives for fiscal accountability. Being forced

to tax one's constituency—either to deliver additional services or to pay for policy mistakes—is an important restraint on political decisionmaking. But in developing countries, where it may not be easy for people to move to the jurisdiction where the tax and service bundle matches their preferences or to vote the incumbent decisionmaker out of power, maximizing accountability means selecting tax instruments that closely match taxes and services. In this respect, user charges are particularly important for accountability because they create a close link between the delivery agent and the client.<sup>17</sup>

Finally, access to well-functioning markets by governments and households may provide additional check on politicians and administrators. For example, decentralizing borrowing powers offers a mechanism for using capital markets to provide accountability by sending market signals on the performance of governments and private firms. Well-functioning land markets make “voting with one's feet” a credible threat because policy decisions get capitalized in land values. In both cases information helps ensure that markets function efficiently. Strengthening the regulatory framework to improve the functioning of markets is essential for establishing the self-correcting methods of accountability that will lead to successful and sustainable decentralized decisionmaking.

Properly designed and sequenced decentralization may deliver each of these forms of accountability. The framework of incentives and accountability is especially important given the uncertainty that generally pervades the decentralization process. We may not be able to say exactly what the “correct” form of decentralization is for a particular country, but we do know that correct institutional incentives are essential both to reveal mistakes and to provide a self-regulatory mechanism.

### **The Role of Capacity**

Increasing fiscal, political, and administrative responsibilities and setting clear rules holding each tier of government accountable for those responsibilities lead to an important set of questions: Does the public sector—that is, central and local governments—have the capacity to support and manage decentralized responsibilities? Does it have the political capacity to identify

and respond to individual preferences? Does the central government have the administrative capacity to provide technical and financial support where appropriate? Do local governments have the capacity to deliver promised services at low cost? Political capacity has to do with the channels for local participation and administrative capacity with the processes required of central and local administrators and with their training. The evidence on these issues is sparse.

Local administrative capacity is sometimes considered inadequate because bureaucratic requirements imposed by the center are inappropriate for local decisionmakers. In reality, if the appropriate requirements were assigned to each level of government according to the information required for them to perform their functions, local capacity would probably not be as problematic. In other cases local administrative capacity is identified as a problem by the central government when in fact the central government may also lack the capacity to manage local affairs. In yet other cases the design of intergovernmental fiscal relations does not provide guidelines, resources, and incentives that would lead to strong local capacity. All these factors may be in play at the same time. For example, in South Africa limited administrative capacity at the provincial level has constrained the decentralization of education and welfare payments. There has been less debate on whether the central government has the capacity to manage the delivery process or whether the failure is driven by the design of the intergovernmental system (Ahmad, 1995). Local capacity is a complicated issue, and the appropriate way to improve it may not simply be through increased training of local officials.

Colombia provides an example of how local governments have relied on demand-driven processes for both infrastructure investment and capacity building. This approach has increased allocative efficiency (matching investments to local preferences) and directed resources to the poor (Box 7; World Bank, 1996b).

The experience with developing capacity for local decisionmaking and administration is encouraging for believers in the potential allocative and democratic virtues of decentralization. As in such well-known Asian cases as the Orangi project in Karachi, Pakistan (Bird, 1995), local participation appears both to reveal preferences and to keep costs down. Depending on the

**Box 7: Developing Capacity in Colombia**

Under Colombia's "coparticipation" system, local communities provide labor and local materials for new projects, and municipal governments contribute a portion of the cost. This approach not only fosters community involvement in identifying needs and choosing projects, it also promotes community participation in the execution, operation, and maintenance of the works. Municipalities have to prepare projects that are then appraised using technical and environmental criteria. Project beneficiaries should be low-income rural families, and projects can be carried out by any contractor (private contractors, nongovernmental organizations, state agencies, universities) that competes to supply the works and services.

Preliminary evidence is surprisingly encouraging on local capacity to carry out such functions. A recent study of 16 municipalities found that decentralization has enhanced local capacity in terms of labor, capital, and technology (World Bank, 1995b). Colombian municipalities are, for example, increasing the skills of local bureaucracies through such means as competitive hiring, sharing the services of professionals among municipalities, training municipal employees, and rotating personnel across different departments in the same municipality. Capital spending capacity has also increased. One municipality

has totally privatized road maintenance; another has put private developers in charge of constructing urban roads. In other localities computers have been introduced to monitor water and sanitation services. In addition, municipalities have started to share equipment and they have improved their technological capability for internal organization, planning, and monitoring to ensure better project management.

Underlying these improvements is a more basic change: Colombian municipalities have been moving from a supply-driven (top down) to a demand-driven (bottom up) approach to public services. Increasingly, reflecting the new liveliness of local politics and (with substantial variations from area to area) more extensive community participation, people are getting what they want rather than what someone in the capital thinks they should want. Emphasis has been put on roads, education, and water works; those are the needs that people perceive, and those are the needs that newly empowered and responsive local governments are attempting to satisfy. Opinion surveys suggest that the resulting sectoral allocation of resources is consistent with community preferences, with most respondents indicating that they trust the local government more than the national government to deliver goods and services.

*Source:* World Bank, 1995b.

nature of the project, community involvement may also enhance targeting of the poor, since participants who self-select communal work projects are willing to volunteer their labor without remuneration.

In assessing the link between decentralization and capacity, therefore, several issues and competing hypotheses need to be raised. The initial impression that capacity constraints may inhibit decentralization seems to be an offshoot of a paradigm that looks at capacity building in a top-down, supply-driven framework. The policy implication of this view is that capacity building should precede decentralization. A competing hypothesis suggests a more dynamic and demand-driven relationship between decentralization and capacity building: shifting responsibilities to lower-tier governments may provide the incentive for public officials to invest in capacity building or seek creative ways to tap into existing sources of capacity. The latter could include not only outsourcing to the

private sector and nongovernmental organizations but intergovernmental contracts and agreements as well.

In addition, the discussion of capacity constraints may incorrectly assume that all subnational governments are similar. In reality, urban governments (particularly in large cities) have more capacity to manage and finance service delivery than do rural governments. Similarly, different regional governments—provinces and states—have different fiscal and management capacity. In this context the principle of asymmetric decentralization offers an approach to decentralizing responsibilities where feasible rather than relying on an all or nothing approach.

**Policy Dialogue and Project Design**

The institutional perspective makes clear the importance of understanding the concrete and specific cir-

cumstances of the country concerned. What can be done in terms of decentralization largely depends on where, when, and how it is done. Initial conditions determine the level of trust, the reputation of the various actors, the existence (and rigidity) of constraints to institutional change, and so on. The interests of the main stakeholders in the existing system must be understood to ascertain the existing or potential political support for change and the resources available, and to determine the best strategy (objectives) and tactics (timing, sequence, duration) for change. Decentralization is political, and adequate political and institutional analysis is needed to undertake it successfully and appraise its success—or to assist or intervene in the process effectively.

As noted, decentralization has strong implications for resource mobilization and use. Because these issues affect all of the World Bank's main policy concerns—growth, macroeconomic stability, service delivery, and, most important, poverty reduction—the Bank must engage countries in a dialogue on the design of decentralization. The potential benefits of decentralization can only be achieved—and the potential pitfalls can only be avoided—if policy design focuses on creating the appropriate institutional arrangements in which decentralization can occur.

Even if decentralization efforts are far from optimally designed, the Bank may still be able to improve their allocative and distributive outcomes—for example, by enhancing local capacity and working directly with local officials (as in Colombia) or by using adjustment lending to support a productive decentralization agenda (as in the Kyrgyz Republic). Useful dialogues on decentralization have been held in countries as diverse as Vietnam—where focusing on rural service delivery rather than central-provincial relations proved helpful—and South Africa—where a low-key but potentially high payoff dialogue on decentralization has been sustained through a pivotal period in the country's history.

Tools of public policy exist in all countries to bring about some desired consequences of decentralization. Yet institutions differ dramatically between industrial countries and developing countries, and these differences have implications for the extent and type of decentralization that may be appropriate. In developing countries weak democracies, factor markets, and regulatory frameworks affect the accountability

imposed on local decisionmakers by citizens (“voice”), by competition (“exit”), and by the public sector (“hierarchy”; World Bank, 1997). Governments are generally not as responsive, transparent, or predictable as they are in industrial countries. Thus the same policies implemented in an industrial country may have very different consequences in a developing country (and this outcome will vary between developing countries depending on their institutions).

Since the outcome of decentralization depends heavily on the institutional arrangements with which decentralization policy interacts, successful decentralization (that is, a process that achieves efficiency objectives without jeopardizing equity or macroeconomic stability) requires a careful examination of each country's institutions. A framework for assessing institutional weaknesses and factoring them into the design of decentralization policy is shown in Table 2. This list is meant only as a starting point. We must identify which institutional structures are most important to achieve the benefits of decentralization and avoid the pitfalls, encourage their development, and compensate for institutional weaknesses (at least in the short run) when advising decentralizing governments on policy design. In the longer run, institutional strengthening is essential. But given that decentralization is happening now, and institution building takes time, our advice should take these institutional weaknesses into account.

In countries that seem to lack most forms of accountability, aspirations for decentralization should be modest. In these cases decentralization can do more harm than good, and the best technical advice the Bank can provide is how to go forward with some benign forms of decentralization (such as local trash collection) while encouraging the institutional development necessary for further advances.

### **More Case Studies, Data, and Research**

Because decentralization is an inherently country-specific (and sometimes activity-specific) process, considerable contextual information is required to analyze and assess, let alone assist. Detailed, information-intensive case studies are the essential building blocks to knowledge in this field.

**Table 2: Moving toward Better Design of Decentralization in Developing Countries**

<i>Institutional Weakness</i>	<i>Impact</i>	<i>Design Feature to Compensate</i>
Weak democratic institutions and processes	<ul style="list-style-type: none"> <li>• Less local accountability through “voice” mechanisms</li> <li>• Greater chance of local elites capturing benefits</li> <li>• Decisionmaking less transparent, predictable, responsive</li> </ul>	<ul style="list-style-type: none"> <li>• Create channels for community participation</li> <li>• Initiate process of participatory budgeting</li> <li>• Legislate open, public procurement procedures</li> </ul>
Weak legal and regulatory systems	<ul style="list-style-type: none"> <li>• Less interjurisdictional mobility and less accountability through “exit” mechanisms</li> </ul>	<ul style="list-style-type: none"> <li>• Diversify local service providers to give more choice (provide technical assistance to facilitate public-private partnerships)</li> </ul>
Weak markets for land, labor, and capital	<ul style="list-style-type: none"> <li>• Decisionmaking less transparent, predictable, responsive</li> </ul>	<ul style="list-style-type: none"> <li>• Consider earmarking user fees to improve accountability</li> </ul>
Weak information systems	<ul style="list-style-type: none"> <li>• Less “hierarchical” accountability</li> </ul>	<ul style="list-style-type: none"> <li>• Create more local incentives for compliance with central objectives</li> </ul>
Weak regulatory systems	<ul style="list-style-type: none"> <li>• Decisionmaking less transparent, predictable, responsive</li> </ul>	<ul style="list-style-type: none"> <li>• Improve information systems</li> <li>• Prioritize key regulations</li> </ul>
Weak information systems	<ul style="list-style-type: none"> <li>• Moral hazard</li> </ul>	<ul style="list-style-type: none"> <li>• Establish transparent and internally consistent multitiered budgeting systems</li> </ul>
Weak regulatory systems	<ul style="list-style-type: none"> <li>• Soft budget constraint between levels of government</li> </ul>	<ul style="list-style-type: none"> <li>• Establish subnational debt reporting, monitoring, and rules for central government intervention</li> </ul>
Weak financial systems	<ul style="list-style-type: none"> <li>• Potential central government bailout</li> </ul>	<ul style="list-style-type: none"> <li>• Legislate independence of central bank</li> </ul>
Nontransparent fiscal systems		
All of the above	<ul style="list-style-type: none"> <li>• All of the above</li> </ul>	<ul style="list-style-type: none"> <li>• Encourage only modest decentralization of certain local services</li> </ul>

Detailed data should be collected from country case studies and a cross-country dataset developed to provide a context against which to assess country experiences. Only those who have tried to do cross-country comparisons of decentralization can appreciate how bad, inadequate, and incomparable is the existing database on almost anything one might wish to examine. It is not much of an exaggeration to say that one can prove, or disprove, almost any proposition about decentralization by throwing together some set of cases or data. More comparable and meaningful cross-country data are needed on various measures of decentralization (Huther and Shah, 1998), effects of alternative transfer designs (Ahmad, 1996), and so on. Though in recent years much work has been done on this issue by academics and international agencies, much more remains to be done. The World Bank's Decentralization Thematic Group has undertaken a project to merge several cross-country data collection efforts from different parts of the Bank and from several external partners in order to form a comprehensive database that includes fiscal and institutional country variables. An effort will be made to regularize the collection of subnational data in all client countries.

Given the importance of accurate, timely, and reliable information with respect to what is going on and its effects on various policy outputs, the Bank should consider fostering and supporting not only the development of information systems but also, and perhaps more important, the creation of governmental and especially nongovernmental forums and centers of expertise (such as the Center for Local Government in Hungary or the official but still independent Financial and Fiscal Commission in South Africa). Unless and until the citizens of decentralizing countries have better access to information and analysis, they, the governments involved, and outside agencies (such as the Bank) will continue to stumble along with respect to many of the issues that are most critical to designing and assessing decentralization policies.

More generally, decentralization is an issue about which it may truly be said that “the devil is in the details.” Much research needs to be done—primarily in case studies—on a variety of important issues, particularly with respect to the outcome of alternative institutional changes. These include but are by no means limited to the effect of intergovernmental transfers on local tax efforts and service expenditures, the



effect of fiscal decentralization on macroeconomic indicators and capital market development, alternative forms and methods of strengthening local institutional and service delivery capacity, assessments of the

extent to which different decentralization initiatives improve (or worsen) governance, and potential uses and limitations of user charges as a means of financing decentralized services.

# Annex. World Bank Economic and Sector Work on Decentralization, 1988–Present

<i>Report Number</i>	<i>Report Type</i>	<i>Date</i>	<i>Country</i>	<i>Title</i>
<i>General</i>				
13399	ER	10/26/94	—	Stability in a decentralized economy
11620	SR	10/1/94	—	Health priorities and options in the World Bank's Pacific member countries
8634	ER	5/1/90	—	Public sector decentralization: economic policy reform and sector investment programs
<i>Sub-Saharan Africa</i>				
16593	ER	11/26/97	Ethiopia	Public expenditure review
13011	SR	11/30/94	Madagascar	Decentralization and local government reform
12930	SR	11/10/94	Eritrea	Options and strategies for growth
9643	SR	3/1/93	Malawi	Public sector management review: selected issues
8997	SR	4/23/92	Kenya	Local government finance study
9101	ER	6/1/91	Madagascar	Beyond stabilization to sustainable growth
8995	SR	6/1/91	Zaire	A review of government expenditure
8974	SR	2/1/91	Nigeria	Urban transport in crisis
7844	SR	1/1/91	Nigeria	Road sector strategy paper
8221	SR	12/1/89	Ghana	Fiscal decentralization
7963	SR	10/1/89	Mozambique	Food security study
7495	SR	10/1/89	Tanzania	Population, health and nutrition sector review
6930	SR	8/1/89	Zaire	Urban sector development in Zaire: a new approach to poverty alleviation
<i>East Asia and the Pacific</i>				
16737	SR	6/1/97	Papua New Guinea	Accelerating agricultural growth: an action plan
16047	SR	2/25/97	Lao PDR	Priorities for rural infrastructure development
15745	ER	10/31/96	Vietnam	Fiscal decentralization and the delivery of rural services: an economic report
15573	SR	6/27/96	China	Higher education reform
15898	SR	6/11/96	Philippines	Education financing and social equity: a reform agenda
14933	SR	11/13/95	Philippines	A strategy to fight poverty
14540	ER	10/18/95	China	Public investment and finance
14680	SR	9/5/95	Philippines	Public expenditure management for sustained and equitable growth
13847	SR	4/3/95	Korea, Rep. of	Transport sector: resource mobilization challenges and opportunities
13313	SR	11/30/94	Philippines	Power sector study: structural framework for the power sector
13143	ER	9/26/94	Vietnam	Public sector management and private sector incentives
12929	SR	9/15/94	China	Power sector reform: toward competition and improved performance
12343	SR	5/23/94	Philippines	Devolution and health services: managing risks and opportunities
11764	ER	11/1/93	Malaysia	Managing costs of urban pollution: country economic report
12407	ER	10/1/93	Indonesia	Fiscal decentralization: towards a new partnership for progress
11094	SR	7/28/93	China	Budgetary policy and intergovernmental fiscal relations
10716	SR	1/1/93	Philippines	Fiscal decentralization study
10050	ER	11/27/91	China	Reforming intergovernmental fiscal relations
9354	ER	6/1/91	China	Economic development in Jiangsu Province
8532	ER	8/1/90	Lao PDR	Issues in public economics
8074	ER	6/1/90	China	Reforming social security in a socialist economy
7927	SR	12/1/89	Indonesia	Power sector institutional development review

Report Number	Report Type	Date	Country	Title
7605	SR	6/1/89	China	Revenue mobilization and tax policy
7483	ER	6/1/89	China	Macroeconomic stability and industrial growth under decentralized socialism
7098	SR	3/31/88	Philippines	Transport sector review
7007	ER	3/1/88	Indonesia	Selected issues of public resource management
<i>Europe and Central Asia</i>				
16420	ER	7/3/97	Estonia	Public expenditure review update
16112	SR	6/25/97	Ukraine	Public expenditure review: restructuring government expenditures
15601	ER	2/24/97	Azerbaijan	Poverty assessment
15353	ER	7/15/96	Kazakhstan	Transition of the state
14546	SR	6/28/96	Bulgaria	Private sector assessment
14925	SR	12/19/95	Estonia	Financing local governments
14862	SR	11/29/95	Russian Federation	Fiscal management in the Russian Federation
14929	SR	8/1/95	Russian Federation	Housing reform and privatization: strategy and transition issues
14470	ER	7/20/95	Latvia	Local government expenditures and resource transfers
14110	SR	6/13/95	Russian Federation	Poverty in Russia: an assessment
13187	SR	12/12/94	Russian Federation	Restructuring the coal industry: putting people first
13039	ER	9/28/94	Poland	Growth with equity: policies for the 1990s
12273	ER	2/23/94	Bulgaria	Public finance reforms in the transition
11302	ER	12/1/92	Russian Federation	Intergovernmental fiscal relations in the Russian Federation
11190	SR	9/1/92	Romania	Decentralization and local government reform
10446	ER	7/1/92	Poland	Decentralization and reform of the state
10061	ER	5/1/92	Hungary	Reform and decentralization of the public sector
<i>Latin America and the Caribbean</i>				
15543	SR	5/30/96	Belize	Environmental report
15298	ER	4/29/96	Colombia	Reforming the decentralization law: incentives for an effective delivery of services
15044	ER	4/26/96	Paraguay	The role of the state
15272	ER	2/22/96	Bolivia	Poverty, equity and income: selected policies for expanding earning opportunities for the poor
14085	SR	7/7/95	Colombia	Local government capacity: beyond technical assistance
13304	SR	1/20/95	Guatemala	Basic education strategy: equity and efficiency in education
12673	SR	8/8/94	Colombia	Poverty assessment report
12293	SR	6/29/94	Paraguay	Poverty and the social sectors in Paraguay: a poverty assessment
11933	SR	3/2/94	Colombia	Toward increased efficiency and equity in the health sector: can decentralization help?
11130	SR	12/23/93	Venezuela	Venezuela 2000: education for growth and social equity
11160	ER	12/23/92	Venezuela	Decentralization and fiscal issues
8972	ER	1/21/92	Venezuela	Public administration study
8924	SR	7/1/91	Mexico	Decentralization and urban management: urban sector study
8918	ER	1/1/91	Ecuador	Public sector finances: reforms for growth in the era of declining oil output
9093	SR	11/1/90	Honduras	Social sector programs
8994	SR	8/1/90	Colombia	Decentralization reform: a review of political and administrative aspects
7870	SR	10/1/89	Colombia	Decentralizing revenues and the provision of services: a review of recent experience
<i>Middle East and North Africa</i>				
16522	SR	5/8/97	Tunisia	Higher education: challenges and opportunities
13233	SR	7/26/96	Iran	Education, training and the labor markets
14043	SR	5/1/95	Islamic Rep. of Jordan	Intergovernmental fiscal relations and municipal finance management sector study
10157	SR	6/1/92	Morocco	Issues and prospects in the public sector
8782	ER	8/1/90	Morocco	Decentralization in local government expenditures and management
7150	SR	3/1/88	Tunisia	Municipal finance and management
7115	SR	2/1/88	Morocco	Municipal finance sector report

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<i>Report Number</i>	<i>Report Type</i>	<i>Date</i>	<i>Country</i>	<i>Title</i>
<i>South Asia</i>				
15677	SR	7/31/97	India	The Indian oilseed complex: capturing market opportunities
16506	ER	5/30/97	India	1997 economic update: sustaining rapid growth
16558	SR	5/1/97	Bangladesh	Municipal finance management sector study
16113	ER	12/20/96	Bhutan	Country economic memorandum
15905	ER	7/31/96	Bangladesh	Public expenditure review
14960	SR	6/6/96	Pakistan	Improving basic education: community participation, system accountability, and efficiency
15092	SR	11/20/95	Pakistan	Supporting fiscal decentralization in Pakistan
9518	SR	12/20/91	India	Irrigation sector review
7946	ER	1/1/90	Bangladesh	Poverty and public expenditures: an evaluation of the impact of selected government programs

*Note:* ER is Economic Report; SR is Sector Report.

# Notes

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1. It is interesting to note that Africa, the region with the highest proportion of decentralization projects, has completed the least formal economic and sector work on the broader topic of decentralization or intergovernmental fiscal relations. By contrast, Europe and Central Asia, the region that has focused its analytical work most on intergovernmental fiscal relations, has the lowest proportion of decentralization projects. The experience from these regions suggests that there may be inadequate connection between sectoral and project issues on one hand and the macroeconomic and broader policy dialogue on the other.

2. See, for example, recent studies by the International Monetary Fund (Ter-Minassian, 1997), Inter-American Development Bank (1994, 1997; Lopez-Murphy, 1996), and CEPAL/GTZ (Aghon and Krause-Junk, 1996), as well as the recent conferences sponsored by the U.S. Agency for International Development (Washington D.C., October 1997) and the Food and Agriculture Organization (Rome, December 1997).

3. The traditional methods used by the Bank to promote transparency and accountability—procurement rules and financial audits—are inadequate for improving the quality of government at the local level because of the lack of basic institutions to ensure political and economic accountability.

4. Dillinger explored the importance of institutional issues for Bank work in urban areas in his discussion of urban finance in 1994. This paper furthers that analysis.

5. Alternatively, as in the traditional economic theory of “fiscal federalism” (Oates, 1972), both levels of government may be seen as agents of different groups of citizens, with the central government encompassing the subsets included within the purview of the different local governments. So long as local governments are hierarchically subordinated to the central government, both approaches lead to the same conclusion: the central government’s preferences—whether seen as representative of all

citizens or simply as the superior jurisdiction—should dominate, and the design problem is as just stated (Seabright, 1996).

6. The tax and expenditure decisions made by local governments can also have a major impact on redistribution.

7. Bird and Gendron (1998) suggest that surcharges on a value-added tax may also be feasible in some circumstances, provided administrative capabilities are high enough.

8. An alternative view is the “federalist approach,” where the primary objective is to ensure that all regions of the country are able to provide such services at acceptable minimum standards and have adequate resources to do so. In this case simple lump-sum transfers, with no conditionality other than the usual requirements for financial auditing, are called for (Shah, 1994). In this approach it is essentially assumed that the fact that the funds flow to locally responsible political bodies will ensure sufficient accountability and that it is neither necessary nor desirable for the central government to attempt to interfere with, or influence, local expenditure choices.

9. The success of this option would depend, of course, on the rules that guide the budget process.

10. For example, recent World Bank research on decentralization of education has indicated that the most important element in improving outcomes (as part of education reform) is parent involvement in teacher supervision (King and Ozler, 1998). Knowing which aspects of decentralization are most important can help in creating the appropriate institutional structures to benefit from decentralization.

11. Democracy without good information is not enough; nor, of course, is information without democracy. Nonetheless, even in countries without truly democratic institutions in which decentralization is simply another instrument of the central government, good information is essential to improving service outcomes.

12. Toward this end, the Economic Development Institute is working in Africa (Zimbabwe) and Latin America (Venezuela) to develop pilot experiences with municipalities to increase

transparency through participatory budgeting and public information campaigns.

13. Since some functions are of national importance, the principal-agent framework (whereby the center provides mandates and incentives so that local governments will achieve desired results) is appropriate. Yet decentralization provides myriad opportunities for independent local decisionmaking that affects efficiency, equity, and quality of services. How much local discretion (or “decision space”) is provided to local governments will differ depending on the sector and the particular function. (For more discussion, see Bossert, forthcoming.)

14. Porto Allegro, Brazil, offers a fascinating case of transparent budgeting and community participation in local government fiscal decisionmaking. Indeed, Porto Allegro and a dozen municipalities in Brazil publish their budget on the Internet (see <http://www.prefpoa.com.br/opart/default.htm>). Regrettably, most participatory budgeting in Latin America has focused only on capital works, not on recurrent revenue and expenditures (see also Paul, 1995, on India).

15. Pure public goods will be underprovided and underconsumed if left to the market and thus must still be provided by government. Thus accountability for local public goods must still rely on electoral processes or interjurisdictional mobility.

16. Technical assistance can be provided to local governments to facilitate public-private partnerships. For example, risk management templates for solid waste have been designed and used in the Philippines to help local governments analyze the structure of financing and the risks faced for different aspects of service delivery under different contractual agreements.

17. If indeed mobility is constrained, then general local taxes—such as a sales tax or a piggybacked income tax—are appealing from an efficiency standpoint. (The problem of interjurisdictional tax competition would not exist.) Yet in most developing countries the administrative capacity is weak for such tax collections. If local democracy is also weak, then it may be more likely that funds raised through earmarked user fees will be spent more efficiently to better reflect local preferences.

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