Decentralization Briefing Notes

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Foreword

Decentralization, a set of policies that encompasses fiscal, political, and administrative changes, can impact virtually all aspects of development. The structure of intergovernmental relations affects everything from the efficiency and equity of service delivery, the social safety net, and poverty alleviation programs to the development of the financial sector and macroeconomic stability. The division of power and responsibility between levels of government also raises issues of institutional capacity, as well as corruption and governance. Unfortunately, the far-reaching implications of decentralization are often overlooked, as the literature and specialists tend to focus on specific dimensions. Top policymakers in decentralizing countries are often the only ones who address the full range of issues.

The notes in this volume are designed to highlight the broad range of issues that need to be considered with regard to decentralization. They are intended to provide brief overviews of the many different aspects of decentralization and summarize key issues that need to be considered by practitioners. The notes were prepared originally for a World Bank internal web site to help Bank staff understand the multidimensional aspects of decentralization. Each note is not meant to address its topic in great depth, but rather to help readers consider which questions to ask in their countries. Most importantly, by bringing these individual notes together in this volume, readers are encouraged to consider the cross-cutting nature of decentralization and the importance of a comprehensive approach.

A key lesson emerging from this approach is that the impact of decentralization will depend greatly on the many factors related to design. Simply put, with decentralization, as with many complicated policy issues, the "devil is in the details." The outcome will depend on myriad individual political, fiscal, and administrative policies and institutions as well as their interaction within a given country.[1]

The volume is divided into four chapters. The first chapter, *What and Why,* provides an overview and explains the multidimensional nature as well as the rationale for decentralization. It also sets the stage for understanding that the impact of decentralization will depend greatly on many specific policy and institutional issues described in the second chapter, *Project Design: Political, Fiscal, and Administrative Decentralization.* This chapter addresses key political factors (the constitutional, legal, and regulatory framework and local participation), fiscal dimensions (expenditure assignment, tax assignment, intergovernmental transfers, and subnational borrowing), and administrative considerations (civil service reform, information and monitoring, and local technical and managerial capacity. The third chapter,

1. For a comprehensive discussion of these issues and their impact in developing countries, see Jennie Litvack, Junaid Ahmad, and Richard Bird, "Rethinking Decentralization in Developing Countries," Sector Studies Series, PREM, World Bank, 1998.

Service Delivery, focuses on issues pertaining to decentralization of specific sectors and the delivery of different services (education, health care, safety nets, infrastructure, water, natural resources management). Finally, the fourth chapter, *Potential Impacts of Decentralization*, discusses potential impacts on equity objectives, macroeconomic stability, growth, and accountability and corruption.

Acknowledgments

This volume is a collective effort of the World Bank's Decentralization Thematic Group. The notes that make up the volume were drafted, reviewed, and edited by many insightful, experienced people.

We appreciate the contributions of Richard Bird and Keith McLean, who reviewed and contributed to the editing of several of the notes. In addition, the following individuals reviewed at least one of the notes: Harold Alderman, William Ascher, Nazneen Barma, Joel Brakan, Greg Browder, Robert Ebel, Peter Fallon, Ariel Fiszbein, Sandra Giltner, Graham Kerr, Christine Kressides, Deepa Narayanan, Barbara Nunberg, Jesse Ribot, Dennis Rondinelli, Eluned Schweitzer, David Sewell, Dominique van de Walle, and Debbie Wetzel.

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What and Why

This chapter contains two notes that describe the different forms of decentralization and the rationale for decentralization. They provide a broad overview to the several types of decentralization that can occur across countries, and even within the same country and sector. Distinguishing among different types of decentralization facilitates the discussion of policy design, and particularly of impact. For example, whether a country chooses to "deconcentrate," "delegate," or "devolve" certain functions—and the impact of those decisions—will depend on the policymakers' objectives, as well as on many factors related to the political, administrative, and fiscal structure of that country. It is important to introduce consistency in any discussion of decentralization to avoid comparing apples and oranges and to ensure that lessons can be elicited where appropriate.

What Is Decentralization?

Decentralization—the transfer of authority and responsibility for public functions from the central government to subordinate or quasi-independent government organizations or the private sector—covers a broad range of concepts. Each type of decentralization—political, administrative, fiscal, and market—has different characteristics, policy implications, and conditions for success. All these factors need to be carefully considered before deciding whether projects or programs should support reorganization of financial, administrative, or service delivery systems.

While distinguishing among the different types of decentralization is useful for highlighting its many dimensions and the need for coordination, these concepts overlap considerably. Political, administrative, fiscal, and market decentralization can appear in different forms and combinations across countries, within countries, and even within sectors. Precise definitions are less important than ensuring a comprehensive approach.

Political Decentralization

Political decentralization aims to give citizens and their elected representatives more power in public decisionmaking. It is often associated with pluralistic politics and representative government, but it can also support democratization by giving citizens or their representatives more influence in formulating and implementing policies. Advocates of political decentralization assume that decisions made with greater participation will be better informed and more relevant to diverse interests in society than those made only by national political authorities. The concept implies that the selection of representatives from local electoral jurisdictions allows citizens to better know their political representatives and allows elected officials to better know the needs and desires of their constituents.

Political decentralization often requires constitutional or statutory reforms, development of pluralistic political parties, strengthening of legislatures, creation of local political units, and encouragement of effective public interest groups.

Administrative Decentralization

Administrative decentralization seeks to redistribute authority, responsibility, and financial resources for providing public services among different levels of government. It is the transfer of responsibility for planning, financing, and managing certain public functions from the central government and its agencies to field units of government agencies, subordinate units or levels of government, semi-autonomous public authorities or corporations, or areawide, regional, or functional authorities.

Administrative decentralization has three major forms—deconcentration, delegation, and devolution—each with different characteristics.

DECONCENTRATION. Deconcentration, the redistribution of decisionmaking authority and financial and management responsibilities among different levels of the central government, is often considered the weakest form of decentralization and is used most frequently in unitary states. Within this category, however, policies and opportunities for local input vary: deconcentration can merely shift responsibilities from central government officials in the capital city to those working in regions, provinces, or districts, or it can create strong field administration or local administrative capacity under the supervision of central government ministries.

DELEGATION. Delegation is a more extensive form of decentralization. Through delegation central governments transfer responsibility for decisionmaking and administration of public functions to semi-autonomous organizations not wholly controlled by the central government, but ultimately accountable to it. Governments delegate responsibilities when they create public enterprises or corporations, housing authorities, transportation authorities, special service districts, semi-autonomous school districts, regional development corporations, or special project implementation units. Usually these organizations have a great deal of discretion in decisionmaking. They may be exempt from constraints on regular civil service personnel and may be able to charge users directly for services.

DEVOLUTION. Devolution is the transfer of authority for decisionmaking, finance, and management to quasi-autonomous units of local government with corporate status. 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 geographical boundaries over which they exercise authority and within which they perform public functions. It is this type of administrative decentralization that underlies most political decentralization.

Fiscal Decentralization

Financial responsibility is a core component of decentralization. If local governments and private organizations are to carry out decentralized functions effectively, they must have adequate revenues—raised locally or transferred from the central government—as well as the authority to make expenditure decisions. Fiscal decentralization can take many forms, including:

- Self-financing or cost recovery through user charges
- Cofinancing or coproduction, in which users participate in providing services and infrastructure through monetary or labor contributions
- Expansion of local revenues through property or sales taxes or indirect charges
- Intergovernmental transfers of general revenues from taxes collected by the central government to local governments for general or specific uses
- Authorization of municipal borrowing and mobilization of national or local government resources through loan guarantees.

In many developing countries local governments or administrative units possess the legal authority to impose taxes, but the tax base is so weak and the dependence on central government subsidies so ingrained that no attempt is made to exercise that authority.

Economic or Market Decentralization

The most complete forms of decentralization from a government's perspective are privatization and deregulation; they shift responsibility for functions from the public to the private sector. They allow functions that had been primarily or exclusively the responsibility of government to be carried out by businesses, community groups, cooperatives, private voluntary associations, and other nongovernmental organizations. Privatization and deregulation are usually accompanied by economic liberalization and market development policies.

- **Privatization—**Privatization can range in scope from the provision of goods and services based entirely on the free operation of the market to public-private partnerships in which government and the private sector cooperate to provide services or infrastructure. Privatization can mean allowing private enterprises to perform functions that had previously been monopolized by government. It can also mean contracting out the provision or management of public services or facilities to commercial enterprises. There is a wide range of public-private institutional forms and of ways in which such functions can be organized, particularly in infrastructure. Privatization can also include financing public sector programs through the capital market, with adequate regulation or measures to ensure that the central government does not bear the risk for this borrowing, and allowing private organizations to participate. And finally, it can mean transferring responsibility for providing services from the public to the private sector through the divestiture of state-owned enterprises.
- **Deregulation—**Deregulation reduces the legal constraints on private participation in service provision or allows competition among private suppliers for services previously provided by the government or by regulated monopolies. In recent years privatization and deregulation have become more attractive alternatives to government provision in developing countries. Local governments are also privatizing by contracting out service provision or administration.

Choosing the Most Appropriate Form of Decentralization

Under appropriate conditions all of these forms of decentralization can help broaden participation in political, economic, and social activities in developing countries. Where it works effectively, decentralization helps alleviate the decisionmaking bottlenecks that are caused by central government planning and control of important economic and social activities. Decentralization can help to simplify complex bureaucratic procedures, and it can increase government officials' sensitivity to local conditions and needs. Moreover, decentralization can help national government ministries reach larger numbers of local areas with services; allow greater political representation for diverse political, ethnic, religious, and cultural groups in decisionmaking; and relieve top managers in central ministries of routine tasks, allowing them to concentrate on policy. In some countries decentralization may create a geographical focus at the local level, coordinating national, state, provincial, district, and local programs more effectively, and can provide better opportunities for local residents to participate in decisionmaking. Decentralization may lead to more creative, innovative, and responsive programs by allowing local experimentation. It can also increase political stability and national unity by allowing citizens to better control public programs at the local level.

But decentralization is not a panacea, and it does have potential disadvantages. Decentralization may not always be efficient, especially for standardized, routine, network-based services. It can result in the loss of economies of scale and of control over scarce financial resources by the central government. Weak administrative or technical capacity at local levels may result in services being delivered less efficiently and effectively in some areas of the country. Administrative responsibilities may be transferred to local levels without adequate financial resources, making equitable distribution or provision of services more difficult. Decentralization can sometimes make coordination of national policies more complex and may allow functions to be captured by local elites. Also, distrust between public and private sectors may undermine cooperation at the local level.

Project and program planners must be able to assess the strengths and weaknesses of public and private sector organizations in performing different types of functions. Before developing elaborate plans for decentralization, they must assess the lowest organizational level of government that performs functions efficiently and effectively and, for functions that do not have to be provided by government, the most appropriate forms of privatization. Even program planners who do not see decentralization as their primary motive must carefully analyze the types of decentralization already present in a country in order to tailor policy plans to existing structures. The success of decentralization also frequently depends on proper training for both national and local officials in decentralized administration. Technical assistance is often required for local governments, private enterprises, and local nongovernmental groups in the planning, financing, and management of decentralized functions.

Centralization and decentralization are not either-or conditions. In most countries an appropriate balance of centralization and decentralization is essential to the effective and efficient functioning of government. Not all functions can or should be financed and managed in a decentralized fashion. And even when national governments decentralize responsibilities, they often retain important policy and supervisory roles. They must create or maintain the enabling conditions that allow local units of administration or nongovernmental organizations to take on more responsibilities. Central ministries often have crucial roles in promoting and sustaining decentralization by developing appropriate and effective national policies and regulations for decentralization and strengthening local institutional capacity to assume responsibility for new functions.

Rationale for Decentralization

Much of the decentralization that has taken place in the past decade has been motivated by political concerns. For example, in Latin America decentralization has been an essential part of the democratization process as discredited autocratic central regimes are replaced by elected governments operating under new constitutions. In Africa, the spread of multiparty political systems is creating demand for more local voice in decisionmaking. In some countries, such as Ethiopia, decentralization has come in response to pressures from regional or ethnic groups for more control or participation in the political process. In the extreme, decentralization represents a desperate attempt to keep the country together in the face of these pressures by granting more autonomy to all localities or by forging "asymmetrical federations." A variation on this theme has been decentralization as an outcome of long civil wars, as in Mozambique or Uganda, where opening political opportunities at the local level has allowed for greater participation by all former warring factions in the governance of the country. The transition economies of the former socialist states have also massively decentralized as the old central apparatus crumbled. In many countries decentralization has simply happened in the absence of any meaningful alternative governance structure to provide local government services. In some cases (particularly in East Asia) decentralization appears to be motivated by the need to improve service delivery to large populations and the recognition of the limitations of central administration.

Although in many cases decentralization seems to be happening without much planning or design, there are a multitude of design issues that affect the impact of decentralization on efficiency, equity, and macrostability. The success of decentralization is closely related to adherence to several of these design principles: finance following on the clear assignment of functions, informed decisionmaking, adherence to local priorities, and accountability. Because country circumstances differ, often in subtle and complex ways, the policy and institutional instruments that establish decentralization have to be shaped to specific circumstances.

Economic Arguments for Decentralization

A growing body of literature is examining the economic rationale for decentralization. Economists justify decentralization on the grounds of allocative efficiency. Their rationale is that decisions about public expenditure that are made by a level of government that is closer and more responsive to a local constituency are more likely to reflect the demand for local services than decisions made by a remote central government. A second economic rationale for decentralization is to improve the "competitiveness" of governments and enhance innovation—and hence the likelihood that governments will act to satisfy the wishes of citizens. Another potential benefit for decentralization is that people are more willing to pay for services that respond to their priorities, especially if they have been involved in the decisionmaking process for the delivery of these services.

A number of theoretical and practical issues complicate the view of whether decentralization is a good or undesirable economic strategy. At the macroeconomic level, an important concern has been that decentralization may make stabilization policies more difficult to implement and may even lead to destabilizing levels and composition of overall public expenditures and public debt. However, decentralized systems can be designed to avoid destabilizing effects and to ensure correct incentives. Some of the decentralization of the 1980s, for example, was actually an offloading of fiscal imbalances by central governments to subnational governments. Under these circumstances, it is not surprising to see a strong association between decentralization and fiscal imbalances at lower levels. Another macro level controversy for which evidence is inconclusive is whether decentralization retards economic growth.

Concerns about equity—interjurisdictional and interpersonal—have been central to the discussion of decentralization. Some jurisdictions are better endowed with resources than others, perhaps because of size or location. In addition, historical circumstances (such as apartheid) may have created local disparities. Thus an intergovernmental fiscal program may be designed to shift resources to disadvantaged areas to ensure that all citizens enjoy a minimum level of service, regardless of location, or receive enhanced assistance to accelerate amelioration of deficits, because of location. The allocation of poverty program grants to subnational levels should be analyzed carefully within a particular country context since lack of transparency, or inadequate specificity in transfer design, sometimes results in wealthier areas receiving more resources than poorer areas.

It is usually argued that central governments are ultimately responsible for ensuring interpersonal equity. Where local economies are intrinsically open and many resources, especially key human resources, are mobile, only limited success should be expected from jurisdictionally focused distributional programs. Still, local governments can and do play very important roles in implementing central distributional programs and in determining a host of tax, expenditure, and intralocality transfer schemes.

The specific services to be decentralized and the type of decentralization will depend on economies of scale affecting technical efficiency and the degree of spillover effects beyond jurisdictional boundaries. These issues need to be taken into account in the design of a decentralized system. In practice, all services do not need to be decentralized in the same way or to the same degree.

In an important economic sense, the market is the ultimate form of decentralization in that consumers can acquire a tailored product from a choice of suppliers. The nature of most local public services limits the full play of this option and establishes a government role in ensuring the provision of these services, but it does not automatically require the public sector to be responsible for the delivery of all services. Where it is possible to structure competition either in the delivery of a service or for the right to deliver the service, the evidence indicates that the service will be delivered more efficiently. Although uncommon in practice, local governments have successfully competed for the right to provide certain local services. In an array of local public services in any particular country, a mix of solutions from deconcentration to managed competition or privatization is likely to coexist.

Conditions for Successful Decentralization

Although politics is the driving force behind decentralization in most countries, decentralization may be one of those happy instances in which good politics and good economics serve the same end. The political objectives of increased political responsiveness and participation at the local level can coincide with the economic objectives of better decisions about the use of public resources and increased willingness to pay for local services. At least five conditions are important for successful decentralization:

- The decentralization framework must link, at the margin, local financing and fiscal authority to the service provision responsibilities and functions of the local government, so that local politicians can deliver on their promises and bear the costs of their decisions.
- Local communities must be informed about the costs of services and delivery options and the resource envelope and its sources, so that the decisions they make are meaningful. Participatory budgeting, as used in Porto Alegre, Brazil, is one way to create this condition.
- Communities need a mechanism for expressing their preferences in a way that is binding on politicians, so that there is a credible incentive for people to participate.
- There must be a system of accountability based on public and transparent information that enables communities to monitor the performance of the local government effectively and to react appropriately to that performance, so that politicians and local officials have an incentive to be responsive.
- The instruments of decentralization—the legal and institutional framework, the structure of service delivery responsibilities, and the intergovernmental fiscal system—must be designed to support the political objectives.

Meeting these conditions, or at least having local governments improve on the central government's record, is a tall order, but achievable.

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Project Design: Political, Fiscal, and Administrative Decentralization

This chapter contains nine notes that address different aspects of political, fiscal, and administrative decentralization. Although these issues are often not considered together, they are all important components of successful decentralization. For example, the "right" fiscal arrangements absent the appropriate regulatory structure or information and monitoring can lead to very different outcomes. All the issues presented in the notes of this chapter interact and thus all must be considered when designing decentralization.

The first two notes in this chapter pertain to political decentralization. The first note focuses on the constitutional, legal, and regulatory framework for decentralization and the second on the participation of society in decentralization.

The parameters within which decentralization can be designed depend on the constitutional structure of the country, in particular whether it is a federal or unitary government. In practice, the extent of autonomy provided to subnational levels varies greatly; some federal countries resemble unitary countries (for example, Mexico), and other unitary countries, de facto, operate as federal countries (China). Nevertheless, the legal opportunities and constraints for decentralization must be kept in mind. These issues are explored in this note and are relevant to all the notes in this volume.

The extent to which decentralization is able to achieve benefits of allocative efficiency depends in large part on the nature of local participation. Local leaders can only reflect local needs and desires if channels for such input exist and if leaders are accountable to their people. This note looks at the important relationship between participation and decentralization.

The next four notes address important areas of fiscal federalism: expenditure assignment, revenue assignment, intergovernmental transfer design, and subnational borrowing. These four components make up the system of intergovernmental finances. The impact of intergovernmental finances on the main economic objectives of government—equity, efficiency, and macroeconomic stability—depend on the system rather than any one component. For example, significant decentralization of expenditures and revenues can lead to greater efficiency and accountability in the wealthier parts of a country, but can lead to declines in equity in the poorer parts unless intergovernmental transfers are used to compensate the poorer areas. Similarly, expenditures and revenues need to be matched when planning decentralization. If the center decentralizes more revenues than expenditures, it can be starved of resources necessary to meet its national obligations; conversely, over decentralization of expenditures without adequate revenues can lead to starving subnational levels of resources. The pressure for unsustainable methods of finance increases in both these situations and can lead to macroeconomic instability. Thus, component parts of fiscal federalism must be examined together as a system.

The final three notes in this chapter address administrative decentralization: civil service, information and monitoring, and technical and managerial capacity. In any decentralized systems, both local and higher-level authorities will play complementary roles to enable local leaders to respond to the needs of their populations and ensure national interests. The benefits of decentralization (that is, greater allocative efficiency) can only be realized if local leaders have flexibility to respond to the local needs and desires of their constituents; if they have the financial and human resources capacity to respond effectively; if they are accountable to their populations as well as to the central government (for services delegated to local governments); and if local and central governments can obtain information and monitor services for which they are ultimately responsible.

Civil service issues are particularly important for decentralized social services because they represent the highest share of recurrent costs. Depending on wage and employment policy and sectoral administrative norms, they can impact greatly the degree of flexibility provided to local levels. Although the literature on civil service reform is well developed, little has been written on civil service reform and decentralization. The World Bank is beginning the process of developing its knowledge in this area. We are particularly interested in collecting more country experiences (successes and failures) with decentralization and civil service issues.

Constitutional, Legal, and Regulatory Framework for Decentralization

Constitutions, laws, and regulations codify the formal parameters in which decentralized systems are supposed to function. Structurally, the desirable architecture of these rules is straightforward:

- The constitutions should be used to enshrine the broad principles on which decentralization is to operate, including the rights and responsibilities of all levels of government, the description and role of key institutions at central and local levels, and the basis on which detailed rules may be established or changed.
- One or more laws should define the specific parameters of the intergovernmental fiscal system and the institutional details of the local government structure, including key structures, procedures (including elections), accountabilities, and remedies.
- A series of regulations associated with each law should interpret and detail the practices and measures by which the related law will operate. Laws that deal with tasks that are shared between national and subnational governments should include sections on intergovernmental relations.

Substantially greater detail and specificity accompany the move down this three-platform architecture from constitution to regulations, whereas greater difficulty and a higher degree of authority (minister, parliament, and constitutional assembly) are required to move up from regulations to the constitution. The levels of difficulty and the locus of authority in effecting changes are important factors in determining where in the architecture particular aspects of the decentralization system are defined, as well as the relative specificity of the definitions. The rigidities and flexibility established in this structure have important implications for the management of a decentralized system.

The placement of an item within this architecture may be the result of consensus, but it is often the outcome of sometimes difficult negotiations between competing interests. Those concerned with macroeconomic stability, for example, may want intergovernmental fiscal rules to be a matter for regulation under the Minister of Finance, to give that ministry maximum flexibility in public expenditure management. Local government advocates, by contrast, may argue (as they did successfully in Brazil) for these fiscal distributional rules to be enshrined in the constitution. In Uganda, the purposes and mechanisms for transfers are specified in the constitution along with a formula for determining the minimum size of the pool from which block grants are to be distributed; details of the distributional formulas are the subject of regulations.

Because decentralization is a complex social experiment, a good case may be made for allowing more flexibility to change the specificity of implementation instruments, while enshrining the political and philosophical principles in the constitution and the operating structures in the laws.

Interactions between Legal and Regulatory Framework and Decentralization

In addition to substantive law, a country's procedural laws can have profound effects on the success of decentralization efforts. For example, when local expenditures must be pre-audited by a central authority, rigidities are introduced that make the benefits of decentralization more difficult to achieve. When reviewing the legal framework for decentralization, it is not sufficient to examine laws specifically dealing with decentralization. Other laws that mandate aspects of service delivery, civil service, budgeting, and so on must also be considered to ensure a consistent approach.

Treatment of key issues in the legal and regulatory framework will be shaped by the government's structure as a unitary or a federal system. In some federal systems (for example, Canada and India) local governments are completely under the authority of state or provincial governments. The federal government is thereby limited in the relationships it may establish with the local level and must seek to affect local behavior and outcomes through the states or provinces. A decentralization policy such as India is trying to establish is significantly complicated by this factor.

Some unitary systems may exercise extremely centralized control over local governments. In Indonesia, the Ministry of Home Affairs has had the authority to appoint (and remove) mayors and even village heads. The structural impediments in designing a decentralized system in this context are few, but that does not mean that the process of instituting such a system is without critical hurdles. Indonesia has had decentralization legislation on its books since 1974; the process there remains far from completion.

As with other key aspects of decentralization, the legal and regulatory framework will be tailored to country circumstances. Nevertheless, there are issues this framework may be expected to address. Those issues of potential interest to the work of the World Bank include the following:

- Classification of local governments within the tiers established under the constitution
- Broad organizational structures and their roles and responsibilities
- Terms of office, operating powers, procedures, and limitations of the political leadership, as distinct from the civil service
- The degree of autonomy of personnel policies and administration of local governments
- The taxing and fiscal administration authority of local governments
- The borrowing authority and capacities of local governments
- The distribution of budgeting, expenditure management, accounting, auditing, and reporting requirements
- Service provision and delivery authority
- The mechanisms for citizen participation and voice.

The legal and regulatory framework also should be designed to recognize differences in management capacity. The assignment of functional responsibilities—

for example, provincial capital or designated growth center—often implicitly recognizes the varying capabilities of municipalities, but a more dynamic framework that recognizes capacity based on performance over time would be more desirable in the long run. Matching degree of autonomy and privileges to a set of performance indicators, which might include total expenditure, degree of revenue self-sufficiency, budget management performance (absence of deficits), and service delivery performance (client surveys), would allow the legal and regulatory framework to adjust for changes in local capacity. The appropriate time period for reassessments and indicators would need to be linked to country circumstances as well as to the specific details of the decentralization framework.

Warning Flags

Five warning flags, selected from a potentially long list of downside risks, may deserve special attention. First, local governments at the same nominal level may vary considerably in their capacities. West Bank and Gaza, for example, have municipalities that vary in population size from about 10,000 people to over 1 million, with management capacities to match. Differences in fiscal capacity may be recognized in the equity component of the intergovernmental fiscal system, but the fact that management and administrative capacities also may vary substantially is rarely accounted for. It is useful to have the legal and regulatory system recognize significant differences in management capacities through a classification of local government within levels. Policies and strategies to address these differences may then be coherently considered.

Second, local governments should have the ability to borrow when they have the capacity to repay. However, for moral hazard reasons (discussed in greater detail in the section on borrowing) every effort must be made to promote the perspective that local government loans are internal obligations of local governments and not of higher levels of government unless explicitly stated otherwise. The importance as well as the difficulties of doing this is illustrated by the circumstances of subnational debt in Brazil. The legal and regulatory framework can support this message by specifying the conditions under which local governments may borrow, the limits of those borrowings, the reporting requirements for debt and debt service, and the penalties for violating the rules.

Third, local government laws have not always anticipated the options, including private participation and managed competition, that may be pursued in the delivery of local public services. As a consequence, legal barriers may inappropriately restrain the ability of local authorities to select the most desirable options for the delivery of decentralized services. China's cities have been imaginative in innovating and delivering some services not anticipated in the legal and regulatory framework within which they operate; nevertheless, even under these circumstances rationalization is desirable. Inappropriate barriers and constraints should be avoided or corrected in the design and detailing of the legal and regulatory framework for decentralization.

Fourth, a voting democracy is often believed to satisfy the conditions for citizen participation and voice in the design of decentralized systems, but in practice this may not be sufficient. Meaningful participation requires that citizens be informed and that their voices have impact where consequences are immediate. At a minimum, the legal and regulatory system needs to provide for full, timely, and easily accessible public disclosure of resource allocation decisions—in budgets, procurement, and expenditure programs. An output and outcome orientation to expenditure management would be even more desirable. Uganda is designing readily accessible budgets for all levels of government as part of an expenditure management reform program that emphasizes an output and outcome orientation. In addition, citizens must have reliable, secure access to the means to enforce appropriate penalties for violations of rules.

Fifth, the terms of office for local political leaders are closely related to issues of authority and accountability. Mayors need incentives to focus beyond the short term to at least the medium term. This requires a long enough tenure or potential tenure to be able to be seen to be accomplishing meaningful objectives. Mexico's three-year, nonrenewable mayoral terms, for example, have been associated with a very short-term focus in local officials' governance strategies. Where multiple terms are allowed, three- to four-year terms are desirable. Where only single terms are permitted, then five to six years would be appropriate. The detailed design of authority, powers, accountability systems, and procedures must be related to local circumstances, including issues that may range from cultural traditions to the state of accounting and auditing systems. Considerations also include the balance to be struck between leaving room for aggressive leadership and protecting the community against excesses, a choice that is a matter of political taste and is often a consequence of historical experience.

The discrepancy between formal rules and actual practice regularly observed in many countries is itself a commentary on the importance of certain characteristics of the design and implementation of legal and regulatory systems. Ambiguity and complexity create openings for conflicting interpretation and confusion. A single agreed interpretation is essential. Particular efforts to prepare and disseminate popularized versions of the legal and regulatory system, as Uganda has done, must be a key part of the decentralization strategy. Complexity is often unavoidable, especially at the level of instruments for implementation. It helps, however, if one instrument is not asked to do too much. This facilitates communication and implementation of the policy that the instrument is intended to support, better monitoring of the effectiveness of the instrument in that role, and adjustment to the instrument or the policy.

Participation, Civil Society, and Decentralization

Participation and decentralization have a symbiotic relationship. On the one hand, successful decentralization requires some degree of local participation. Subnational governments' proximity to their constituents will enable them to respond better to local needs and efficiently match public spending to private needs only if information flows between citizens and local governments. On the other hand, the process of decentralization can itself enhance the opportunities for participation by placing more power and resources at a closer, more familiar, more easily influenced level of government. In environments with poor traditions of citizen participation, decentralization can be an important first step in creating regular, predictable opportunities for citizen-state interaction.

This symbiotic relationship between decentralization and participation can lead to somewhat contradictory policy guidelines. Mechanisms for citizen participation could be considered a helpful precondition when evaluating the prospects for successful decentralization. Accordingly, the design of decentralization should take into account the opportunities and limitations imposed by existing channels of local participation. Lack of participatory mechanisms, however, could be considered a motivation for decentralization and can help create local demand for more participatory channels to voice preferences.

The following paragraphs discuss each of these dimensions: participation as a means to successful decentralization and as a goal of decentralization. First, the broad mechanisms for citizen input that are best seen as parameters of decentralization policy are considered. These types of institutional structures, embedded in the national political environment and developed over a long period of time, cannot be altered quickly by a simple regulation. Then the smaller, more specific avenues for citizen participation that can be created in the process of decentralization are reviewed. Through such incremental changes, broader opportunities for citizen participation and democratic governance may eventually evolve.

Participation as a Precondition: Broad Decisionmaking Influence

The existing institutionalized channels for participation and the ability of people to use them should be taken into account in the design of decentralization programs in developing countries. Fair and regular local elections and high levels of social capital (community cohesion and history of working together) enable citizens to signal their preferences efficiently and enforce leaders' compliance with their wishes.

Studies have shown that broad, ongoing citizen control over leaders can improve the quality of government action. The continuous struggle to stay in office might lead to broad efforts to satisfy consumers on all fronts. Results from studies on Colombia, for example, show that public officials who fear for their jobs are more likely to pick better staff to carry out the day-to-day work of government.[1] Research on regional government in Italy found that governments that were more

1. Ariel Fiszbein, "Emergence of Local Capacity: Lessons from Colombia," *World Development* 25:7(1997):1029–43.

open to constituent pressure were more successful at managing resources and creating innovative programs to distribute services effectively.[2] A recent study of villages in Tanzania shows a positive association between the quality of local schooling and the level of social capital and between economic well-being and high levels of social capital.[3] Another study of local governments in Mexico suggests that Oaxaca province's long history of participatory mechanisms may help it provide services more effectively than socioeconomically similar, but less participatory Chiapas.[4] Several studies of decentralization and government size have posited that more participatory local governments tend to be larger because their constituents trust them with more resources.[5]

In some cases, however, broad participation can be disruptive. Local electoral cycles can lead to periodic fiscal indiscipline as local leaders try to attract more votes. Evidence on institutions and fiscal responsibility in Latin America shows that two-party governments with hierarchical budget processes tend to spend less than multiparty coalition governments with more collegial, participatory budgeting processes.[6]

Assessing how much citizen input affects local government's actions provides a starting point for designing decentralization policies. Such initial conditions help determine the extent to which decentralization will increase the overall responsiveness of government to citizens and provide a guideline for the inclusion of participation-enhancing measures in decentralization policy.

Regular elections, local referendums, permanent public-private councils, and other institutional structures are other easily identifiable conditions that may improve the ability of local governments to identify and act on citizen preferences. Levels of social capital, which determine how well citizens are able to take advantage of the institutional arrangements for participation, are slower to develop and harder to determine. The presence and activities of nongovernmental organizations (NGOs) and other citizen groups can be a revealing indicator, but it is also important to determine whom these organizations really represent. Disparities between those who are represented by an NGO and those who remain outside the system can lead to the capture of local government by one group and preclude efficient matching of public spending to constituent needs.

2. Robert Putnam, *Making Democracy Work: Civic Traditions in Modern Italy* (Princeton, New Jersey: Princeton University Press, 1993).

3. Deepa Narayan and Lant Pritchett, "Cents and Sociability: Household Income and Social Capital in Rural Tanzania," Policy Research Working Paper no. 1796 (Washington, D.C.: World Bank, 1997).

4. J. Fox and J. Aranda, *Decentralization and Rural Development in Mexico: Community Participation in Oaxaca's Municipal Funds Program*, Monograph Series 42 (San Diego, California: Center for U.S.-Mexican Studies, University of California, 1996).

5. W. Oates, "Searching for Leviathan: An Empirical Study," *American Economic Review* 75:748–57.

6. E. Stein, E. Talvi, and A. Grisanti, "Institutional Arrangements and Fiscal Performance: The Latin American Experience," Working Paper no. 6358 (Cambridge, Massachusetts: National Bureau for Economic Research, 1998).

Participation as a Goal: The More Attainable Beginning Reforms

Decentralization relies on participation to improve the allocation of services, but it does not require the kinds of broad citizen input mentioned earlier. In cases where local governments are not elected, where the electoral process favors a small group of elites, or where low levels of social capital impede active citizen-state interchange, the process of decentralization can be designed to build up more limited types of participation. Issue- and project-specific mechanisms for enhancing the flow of information between government and citizens can often be implemented more quickly and easily at the local level than in central governments. Demand-driven projects are one of the key tools (often supported by the World Bank and other donors) to deepen the decentralization process.

Local governments use a wide variety of techniques to gather information from their constituents. Surveys are a useful tool for refining service delivery and deciding on appropriate user fees. A survey of water supply users in Baku, Azerbaijan, for example, revealed that users were willing to pay more for better quality of service and pinpointed the most important problems to address.[7] Bangalore and several other Indian districts use report cards to evaluate service delivery, Uganda requires beneficiary feedback on some government services, and Nicaragua used a series of surveys to reform the bus system and adjust fares. Issue-specific ad hoc councils can also be a quick, easy way to determine citizen preferences and draw on private sector expertise. Colombia's municipalities, for example, have supplemented the public sector's weak technical capacity by involving more private experts on a short-term basis. Inviting citizen participation in implementing decentralized programs can also be cost-effective. World Bank-funded projects have shown that, although initial training costs can be high, the long-run savings are substantial and projects tend to be better maintained. Nicaragua's municipal development program, for example, which used beneficiary participation in barrio upgrading projects, completed projects 20 percent faster than predicted and had a 50 percent higher rate of return than expected.

In the short run, these mechanisms can help decentralization achieve improvements in allocative efficiency if local leaders base their decisions on information provided through these participatory channels. In the long run, these limited mechanisms for participation can evolve into closer and more meaningful interaction between citizens and their local governments only if leaders are democratically elected and accountable to their constituents.

Importance of Information Flows

Citizen participation in some form is an essential part of successful decentralization. It is becoming a more common element in developing country political environments—13,000 units of local government in Latin America are now elected, up

7. World Bank, "Azerbaijan: Baku Water Supply Rehabilitation Project," Environment Department Papers Series, Assessment Series Paper 17 (Washington, D.C., 1995).

from 3,000 in 1973—but the flow of information is by no means undistorted. Decentralization policies should take informational imperfections into account and attempt to improve the depth and degree of citizen participation in local government action. Local government responsiveness, one of the main rationales for decentralizing, cannot be improved when there are no mechanisms for transferring information between the local government and its constituents.

Expenditure Assignment

Fiscal decentralization involves shifting some responsibilities for expenditures and revenues to lower levels of government. The degree of autonomy of subnational entities in the allocation of their expenditures is one important factor in determining the type of fiscal decentralization. (The other, their ability to raise revenue, is addressed later.) This section outlines principles and best practice and highlights how country circumstances are ultimately the best determinant of expenditure assignments.[8]

It is important to distinguish whether local governments determine the allocation of expenditures themselves or whether the center mandates expenditures and local levels simply execute those expenditures. Statistics on subnational finance (most notably those in the IMF's *Government Finance Statistics*) usually aggregate these two types of expenditures and present them in one figure as the "percentage of subnational expenditures." Thus, analysts must be very careful when using statistics on subnational finance as an indicator of local autonomy. Autonomy will not be enhanced by fiscal decentralization if funds are tied by the center. (Of course, some countries do derive the benefits of local expenditure autonomy, because local governments find ways to access the funds and circumvent the central mandates!)

Unitary and federal governments provide different opportunities for fiscal decentralization. In systems of government, unitary subnational governments are not constitutionally empowered to make decisions over a specified range of government functions and services; rather, there are multiple subordinate levels of the same government (central, provincial, district). Federal governments, on the other hand, have constitutionally protected subnational levels of government. Thus the possibilities for independent decisionmaking are clearly stronger under federal systems. While subnational governments (provinces or states) always enjoy constitutional protection under federal systems, however, local governments (county, municipal, township) may not. In practice, the extent and nature of decisionmaking power exercised by lower tiers vary widely from country to country in both federal and unitary countries and may change from time to time. At the extremes, some nominally federal countries (for example, Venezuela) may be considerably less decentralized than nominally unitary countries (for example, Colombia).

Despite such complexities, both theory and experience strongly suggest that expenditure responsibilities need to be stated as clearly as possible to enhance accountability and reduce unproductive duplication of authority and legal challenges. Many would argue that decisionmaking should follow the principle of subsidiarity—that is, it should take place at the lowest level of government consistent with allocative efficiency, the geographic area that internalizes the benefits and costs of

8. For further elaboration on the theory of expenditure assignments, see, for example, Robin Boadway, *The Constitutional Division of Powers: An Economic Perspective* (Ottawa: Economic Council of Canada, 1992); Wallace Oates, *Fiscal Federalism* (New York: Harcourt, Brace, Jovanovich, 1972); Anwar Shah, *The Reform of Intergovernmental Fiscal Relations in Developing and Emerging Market Economies* (Washington, D.C.: World Bank, 1994).

decisionmaking for a particular public service. The optimal size of jurisdiction for each service could differ theoretically, but in practice economies of administration and transactions costs lead to the grouping of roughly congruent services at each level—local (street lighting, refuse removal), regional (rural-urban roads, refuse disposal), and national (intercity highways, environmental policy). Decentralized decisionmaking enlarges possibilities for local participation in development. In addition, national allocative objectives may be carried out by local governments responding to incentives created by national grants and regulations as well as through interlocal or interregional agreements. National governments have obvious roles with respect to stabilization and distribution, and due attention must be paid to possible local conflicts with these policies.

In most cases, it is desirable that the national government assume responsibility for national public services, international affairs, monetary policy, regulation, transfers to persons and businesses, fiscal policy coordination, regional equity, redistribution (in which all levels of government may play a role), and preservation of an internal common market. Some central functions, such as regulation of the financial sector or the environment, may be effectively shared with subnational governments. State governments may have significant responsibility for education, health, social insurance, intermunicipal issues, and oversight of local governments. (Particularly for the social sectors, however, the central government continues to play a critical role by ensuring a minimum level of some services for reasons of externalities or equity.) All local services should be assigned to local governments. In areas of shared responsibilities, the roles should be clarified. Generally, the central government should be involved with overall policy, setting standards, and auditing; state governments should have an oversight function; and local governments should be involved in the provision of infrastructure and services.

Assignment of public services to local or regional governments can be based on considerations such as economies of scale, economies of scope (appropriate bundling of public services to improve efficiency through information and coordination economies and enhanced accountability through voter participation and cost recovery), cost-benefit spillovers, proximity to beneficiaries, consumer preferences, and flexibility in budgetary choices on composition of public spending. Assignment of responsibilities to various local governments could be asymmetric, based on population size, rural-urban classification, and fiscal capacity. Thus large cities may have responsibilities for some services that are provided directly by the center in other areas.

An illustrative representative assignment of expenditure responsibilities is depicted in table 2.1, which takes into account the desirability in some instances of decentralization beyond formal government to civil society. An additional important consideration is that accountability is often best promoted by establishing clear and close linkages between the costs and benefits of public services, so that the amount of expenditure responsibility assigned to a particular level of government corresponds to the amount of revenues that level has at its potential command.

Table 2.1 provides guidelines on expenditure assignments based on the subsidiarity principle. In practice, it is unlikely that any country would or should precisely follow the divisions set out in the table. In many instances some functions

Table 2.1. A Representative Assignment of Expenditure Responsibilities

Function	*Policy and standards oversight*	*Provision/ administration*	*Production/ distribution*	*Comments*
Interregional and international conflict resolution	U	U	N,P	Benefits and costs international in scope
External trade	U	U,N,S	P	Benefits and costs international in scope
Telecommunications	U, N	P	P	National regulation not feasible
Financial transactions	U,N	P	P	National regulation not feasible
Environment	U,N,S,L	U,N,S,L	N,S,L,P	Externalities of global, national, state and local scope
Foreign direct investment	N,L	L	P	Local infrastructure is critical
Defense	N	N	N,P	Benefits and costs national in scope
Foreign affairs	N	N	N	Benefits and costs national in scope
Monetary policy, currency, banking	U, ICB	ICB	ICB, P	Independence from all levels essential, some international role for common discipline
Interstate commerce	Constitution, N	N	P	Constitutional safeguards important for factors and goods mobility
Immigration	U,N	N	N	U due to forced exit
Transfer payments	N	N	N	Redistribution
Criminal and civil law	N	N	N	Rule of law, a national concern
Industrial policy	N	N	P	To avoid beggar-thy-neighbor policies
Regulation	N	N,S,L	N,S,L,P	Internal common market
Fiscal policy	N	N,S,L	N,S,L,P	Coordination is possible
Natural resources	N	N,S,L	N,S,L,P	Promotes regional equity and internal common market
Education, health and social welfare	N,S,L	S,L	S,L,P	Transfers in kind
Highways	N,S,L	N,S,L	S,L,P	Benefits and costs of various roads vary in scope
Parks and recreation	N,S,L	N,S,L	N,S,L,P	Benefits and costs of various roads vary in scope
Police	S, L	S,L	S,L	Primarily local benefits
Water, sewer, refuse, fire protection	L	L	L,P	Primarily local benefits

U Supranational responsibility.
ICB Independent central bank.
N National government.
S State/provincial government.
L Local government.
P Nongovernmental sectors/civil society.

Source: Anwar Shah, *The Reform of Intergovernmental Fiscal Relations in Developing and Emerging Market Economies* (Washington, D.C.: World Bank, 1994), Table 2.

should be shared between levels of government; higher levels of government might exercise a regulatory or policy role, while lower levels of government are responsible for service delivery. Even in service delivery there are aspects best shared between different levels of government. For example, the technical specifications for bridge construction might come from a higher level of government, while construction and maintenance are handled at the local level. In health care, the center may continue to provide technical training for staff, to procure pharmaceuticals to benefit from economies of scale and ensure quality, and to fund public health services. Intermediate levels might supervise local-level personnel, provide refresher training courses, and together with the local level, decide the appropriate mix of curative services to offer and ensure adequate maintenance of facilities and satisfaction with the personnel.

Assigning responsibility for the provision of service to a specific level does not imply that the same level of government should be directly engaged in its production. Collection, transport, and treatment services in solid waste management, for example, can be assigned to different public and private entities depending on economies of scale, commercial viability, and externalities. Many other services can also be unbundled. Production decisions should result from an evaluation of alternatives using efficiency and equity criteria.

Experience has clearly shown that effective decentralization requires complementary adaptations in 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 transparency and accountability to local constituencies supported by strengthened higher level monitoring and reporting of local fiscal performance (see section on accountability, transparency, and corruption).

Issues in Tax Assignment

Governments rely on a wide variety of direct, indirect, general, specific, business, and individual taxes to meet their revenue needs. The question addressed here is which types of tax instruments are most suitable for use by each level of government.

Principles of Tax Assignment

The assignment of taxes by jurisdiction depends partly on the mix of taxes used in the country overall. Public finance theory has not yet fully resolved the issue of the ideal tax mix, even in the unitary state. Governments almost universally employ balanced tax systems, meaning that different taxes apply to basically the same bases. For example, general sales taxes, payroll taxes, and income taxes have broadly overlapping bases. On efficiency and equity grounds, a single general tax base should suffice. Yet no government behaves that way, in large part, to minimize tax evasion.

The usual explanation is that administrative considerations play an important role. A mix of taxes keeps the rate on any individual tax low, thereby reducing the incentive to evade or avoid the tax. Furthermore, a mix of taxes means that taxpayers who would otherwise be able to avoid taxation of one type are caught in the net of another, making the tax system fairer. The importance of the various taxes in the overall mix remains, however, a matter of judgment rather than something that can be deduced from principles.

These same general considerations apply to assigning taxes in a federal system of government. Efficiency and equity arguments have to be tempered by administrative considerations, and the exact assignment depends on informed judgment. We can, however, outline the economic principles that come into play in deciding which taxes to assign to lower levels of government.

Efficiency of the Internal Common Market

The internal common market is functioning efficiently if all resources (labor, capital, goods, and services) are free to move from one region to another without impediments or distortions imposed by policy. Decentralized tax systems can interfere with the efficiency of the economic union in two ways. First, the uncoordinated setting of taxes is likely to lead to distortions in markets for resources that are mobile across states or provinces, especially capital and tradable goods. State governments that recognize this mobility may shape their tax policies in order to attract resources to their own states. If all jurisdictions engage in such socially wasteful beggar-thy-neighbor policies, the end result will simply be inefficiently low taxes (or high subsidies) on mobile factors.

National Equity

The tax transfer system is one of the main instruments of achieving redistributive equity. The argument for making equity a federal objective is simply that all people in the country ought to enter into society's "social welfare function" on an equal basis, and the federal government is presumably the only level that can ensure that residents in different regions are treated equitably. This view may be tempered if states have different tastes for redistribution, or if centralized decisionmaking is not guided by normative criteria. To the extent that equity is viewed as a federal policy objective, decentralized taxes can interfere with the achievement of that objective. As in the efficiency case, uncoordinated subnational tax policies may unwittingly induce arbitrary differences in redistributive consequences for residents of different jurisdictions. States may use both taxes and transfers to attract people with high incomes and to repel those with low incomes. Such policies are likely to be offsetting with respect to resource allocation, but they will result in less redistribution than in their absence. (Of course, those who are opposed to redistribution through government will prefer decentralized policies for precisely that reason.) This is obviously likely to be more of a problem for taxes that are redistributive in nature, as well as for transfers.

Administrative Costs

The decentralization of tax administration can also increase the cost of collection and compliance for both public and private sectors. There are fixed costs associated with collecting any tax that have to be borne for each type of tax used by the states. Taxpayers also incur compliance costs for all taxes levied. For some types of taxes, in particular where the tax base is mobile or straddles more than one jurisdiction, the possibilities for evasion and avoidance increase with decentralization. In the case of multidistrict tax bases, rules are needed to allocate tax revenues among jurisdictions, for in their absence, some tax bases may face either double taxation or no taxation at all. Auditing procedures may also be more difficult for tax bases that involve transactions across state boundaries.

Fiscal Need

To ensure accountability, revenue means should be matched as closely as possible at the margin to revenue needs (that is, expenditure responsibility). Thus tax instruments intended to further specific policy objectives should be assigned to the level of government with responsibility for the related service. Progressive redistributive taxes, stabilization instruments, and resource rent taxes would be suitable for assignment to the national government, while tolls on intermunicipal roads are suitably assigned to subnational governments. In countries with a federal value added tax (VAT), subnational sales taxes may be too cumbersome. In such circumstances, the fiscal need criterion would suggest allowing subnational governments access to taxes that are traditionally regarded as more suitable for national administration, such as personal income taxes.

Reconciling the Difference: Making Subnational Governments Accountable while Avoiding National Distortions

The main problem with the tax assignment that emerges from the preceding prescriptions, as illustrated in table 2.1, is that it generally does not provide sufficient revenues for lower-tier governments. In part for this reason, local and especially intermediate-level governments in many countries levy a variety of specific (excise) taxes on gambling, motor vehicles, and so on. Again, however, such levies seldom produce the revenue needed to finance a significant part of such major expenditures as education and health that are often assigned to subnational governments.

There are two main options for resolving the problem:

- The first way is to supplement subnational revenues with intergovernmental fiscal transfers, but policies must be designed to avoid creating incentives for local governments to reduce their own tax-collection efforts (see the intergovernmental transfers section).
- The second option is to permit subnational governments to levy their own broadbased taxes for local goods, as long as they burden local beneficiaries only. In principle, a retail sales tax or a tax on personal income would be possible. In practice, however, an efficient, desirable broadbased subnational tax that seems feasible is a flat-rate surtax (often called "piggybacking") on a national personal income tax. Retail sales taxes are seldom feasible in developing or transitional countries.

Whether with respect to such a surtax, a local property tax, or local taxes in general, the critical elements required to ensure local accountability without efficiency costs are restricting local governments as much as possible from exporting taxes and permitting them 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 subnational authorities be responsible (within limits) for setting the tax rate.

The Transition Economies: Redefining Local Powers

A special situation exists in a few transition economies, including those in Eastern Europe, Central Asia and China, and Vietnam, where subnational governments have traditionally had a larger role in collecting national taxes. In these countries the central government may not have full control over its tax bases because of such local administration. For example, in China and Russia, revenues were collected at the subnational level (through a tax contracting system in China) and shared upward. This structure created incentives at the subnational level to put more collection effort into taxes fully retained at that level and less effort into taxes that were largely transferred upward. Subnational governments preferred to receive transfers in kind or contributions from their own enterprises rather than collect corporate taxes that had to be shared with higher levels. Revenue sharing on a tax-by-tax basis led to highly varied levels of efficiency in tax administration because of the disconnect between tax administration and the user of the proceeds.

Further, in countries with conflict between levels of government, subnational administration of national taxes is not advisable, because an unhappy subnational entity can refuse to submit national taxes (for example, Tatarstan in Russia). China recently strengthened its central tax administration to collect revenues from central and shared taxes. Problems are also caused by overlapping, uncoordinated administration, especially for sales and excise taxes.

The Balance between Enough and Too Much

Decentralization can reduce accountability by breaking the links between the levels of taxation and expenditure, because decentralized expenditures may well exceed local revenues (notwithstanding user fee revenues). Major expenditure responsibilities are being transferred to subnational governments in an effort to improve service delivery, but there are few high-revenue taxes that can be assigned to subnational governments without creating national economic distortions. Efficiency in tax administration suggests that subnational governments should levy taxes on immobile factors (for example, property taxes) and fiscal need criteria suggest that they should also levy cost-recovery user charges such as frontage taxes (tax per linear front foot of property), tolls on local roads, and poll taxes. These tax revenues are unlikely to be sufficient in many localities, and intergovernmental transfers are required to mitigate this imbalance. While taxation increases can create constituent pressure for good local performance, some grant designs can create central government pressure for local performance.

Intergovernmental Transfers and Grants

Intergovernmental transfers are the dominant source of revenues for subnational governments in most developing countries.[9] The design of these transfers affects the efficiency and equity of local service provision and the fiscal health of subnational governments.

Taxonomy of Grants

For the purpose of economic analysis, grants can be broadly classified as nonmatching and matching.

Nonmatching transfers may be either conditional (selective) or unconditional (general). Conditional nonmatching transfers offer a set amount of funds without local fund matching, provided the funds are spent for an established purpose. Such transfers ensure that the recipient government's spending on the specified category will be at least equal to the amount of the grant monies. If the recipient is already spending an amount equal to the grant funds, some or all of the grant funds may be diverted to other uses. In theory, because of the fungibility of funds, increases in expenditures on the specified category would only be the marginal difference between the grant and the prior local expenditures. In practice, because of the lumpiness of investments in areas such as infrastructure as well as other factors, expenditures often do exceed the amount of grants.

General or unconditional nonmatching grants attach no constraints on how the grants are spent and, unlike the case with conditional grants, no minimum expenditure in any area is expected. Because the grant can be spent on any combination of public goods or services or to provide tax relief to residents, general nonmatching assistance does not modify relative prices and is the least stimulative of local spending.

Some empirical studies have observed that the increase in local expenditure due to grant transfers is larger than would have resulted from a similar increase in the population's income. This is referred to as the flypaper effect: grant money tends to stick where it first lands.[10] The implication is that for political, technical, and bureaucratic reasons, grants to local governments tend to result in more local spending than if the same transfers were made directly to local residents.

Matching grants or cost-sharing programs are conditional transfers that require funds be spent for specific purposes and that the recipient match the funds to some degree. Such transfers have two effects: an income effect, as the subsidy gives the community more resources, some of which may go to acquire more of the assisted service, and a price or substitution effect, as the subsidy reduces the relative price of the assisted service, allowing the community to acquire more for a given budget. Both effects stimulate expenditures on the assisted category. Such transfers can be open-ended (no limit on

9. For a broad set of essays on transfers, see Ahmad Ehtisham, ed., *Financing Decentralized Expenditures: An International Comparison of Grants*, *Studies in Fiscal Federalism and State-Local Finance* (Cheltenham, U.K., and Lyme, New Hampshire: Elgar, 1997).

10. J. Hines and R. Thaler discuss possible reasons for this observable but largely unexplained phenomenon in "The Flypaper Effect," *Journal of Economic Perspectives* 9:4(1995).

matching funds) or closed-ended. Matching transfers may distort local priorities and be considered inequitable in that richer jurisdictions can raise matching funds more easily. But the second effect can be offset, if desired, by adjusting matching rates to jurisdictional wealth. The first effect—distorting local priorities—may be the desired outcome when the transfer is intended to internalize spillovers or achieve overriding national policy objectives (for example, family planning programs).

Economic Rationale for Transfers and Implications for Grant Design

There are five broad economic arguments for central-state transfers, each based on efficiency or equity, and each applying in varying degrees in different countries.

THE FISCAL GAP. An imbalance between the revenue-raising ability of subnational governments and their expenditure responsibilities (the "vertical imbalance") might arise for two reasons. First, there may be an (often inappropriate) assignment of taxing and spending responsibilities that puts the expenditure needs of subnational governments above their revenue means. Second, many taxes are more efficiently collected at the central level, to avoid tax competition and interstate tax distortions, so transfers are necessary to enable local levels to carry out their expenditure responsibilities.

FISCAL INEQUITY. A country that values horizontal equity (the equal treatment of all citizens nationwide) will need to correct the fiscal inequity that naturally arises in a decentralized system. Subnational governments with their own expenditure and taxation responsibilities will be able to provide different levels of services to their residents for the same fiscal effort owing to their differing fiscal capacities. If desired, these differences may be reduced or eliminated by tying the transfers to each jurisdiction to relative tax capacity and to the relative need for and cost of providing public services.

FISCAL INEFFICIENCY. The argument for such transfers is reinforced by the fact that the same differentials that give rise to fiscal inequity also cause fiscal inefficiency. The regional differences in levels of service received for a given fiscal effort can influence business and investment decisions, possibly leading to a less inefficient allocation of resources.

INTERSTATE SPILLOVERS. Normally, subnational governments will not have the proper incentive to provide the correct levels of services that yield spillovers across jurisdictions. In theory, a system of matching grants based on expenditures that give rise to spillovers will provide the incentive to increase expenditures. In practice, the extent of the spillover will be difficult to measure, so the matching rate selected will be somewhat arbitrary.

FISCAL HARMONIZATION. To the extent that redistribution is a goal of the central government, there is a national interest in the redistribution that occurs as a result of the provision of public services by subnational governments. Expenditure harmonization can be accomplished by the use of (nonmatching) conditional grants, provided that the conditions reflect national efficiency and equity concerns and that a financial penalty is associated with failure to comply. In choosing such policies there will always be a tradeoff between uniformity, which may encourage the free flow of goods and factors, and decentralization, which may encourage innovation, efficiency, and accountability.

The most appropriate form of a transfer depends in large part on its objective (box 2.1). Regardless of the design, however, experience demonstrates that good intergovernmental transfer programs have certain characteristics in common:

- 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 (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, but at the same time they are sufficiently flexible to ensure that national stabilization objectives are not thwarted by subnational finances. One system 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 periodic renegotiation (say, every three to five years).
- The formulas are transparent, are based on credible factors, and are as simple as possible. Complex formulas are unlikely to prove feasible or credible in developing countries because there are often serious disputes on fundamental issues such as regional population size.
- If several objectives are applicable—for example, if some degree of equalization is desired and if there are also clear national policy objectives, on the provision of minimal standards of education, but perhaps variable degrees of national support for certain local infrastructure activities—having separate transfers targeted to each objective will generally assist with both clarity and effectiveness.

Revenue Sharing

Many countries attempt to achieve the objectives of transfers through "tax sharing" or "revenue sharing" systems. While there are many such systems, most of them—perhaps most markedly in the transition economies—suffer from several common problems. First, if they apply only to a subset of national taxes, they may bias national tax policy. Second, if, as is often the case, the systems share revenues from origin-based (production) taxes to the jurisdictions from which the revenues are collected, they break the desirable link between benefits and costs at the local level and hence reduce accountability and the efficiency of decentralization. Third, because tax rates in such systems are invariably set by the central government, and because the sharing rate is often applied uniformly throughout the country, the accountability link is broken and subnational governments have no incentive to ensure that the amount and pattern of their spending are efficient. In addition, if, as

Box 2.1. Principles and Better Practices in Grant Design

Grants are one of several tools available to bridge the fiscal gap between subnational responsibilities and revenues. For other possible methods, such as reassignment of responsibilities, tax abatement, or tax-base sharing between levels of government, see notes on expenditure assignment and tax assignment.

Grant objective	*Grant design*	*Better practices*	*Practices to avoid*
To reduce regional fiscal disparities	• General nonmatching • Fiscal capacity equalization transfers	• Fiscal equalization programs of Australia, Canada, and Germany	• General revenue sharing with multiple factors
To compensate for benefit spillovers	• Open-ended matching transfers with matching rate consistent with spillout of benefits	• RSA grant for teaching hospitals	
To set national minimum standards	• Conditional nonmatching block transfers with conditions on standards of service and access	• Indonesia roads and primary education grants • Chile, Colombia, and South Africa education transfers	• Conditional transfers with conditions on spending alone • Ad hoc grants
To influence local priorities in areas of high national but low local priority	• Open-ended matching transfers (preferably with matching rate to vary inversely with fiscal capacity)	• Matching transfers for social assistance as in Canada	• Ad hoc grants
To stabilize the economy	• Capital grants provided maintenance possible	• Limit use of capital grants and encourage private sector participation by providing political and policy risk guarantee	• Stabilization grants with no future upkeep requirements

Source: World Bank, *World Development Report* (New York: Oxford Press, 1997), Box 7.4.

in some transitional economies, such taxes are collected by local governments and then shared with national governments, in this case either an undesirable disincentive for collection effort is created or, more usually, the temptation to "cook the books" is likely to be overwhelming (perhaps especially if richer areas are assigned higher sharing rates).

Practical guidance on the design of transfers is summarized in box 2.2.

Box 2.2. Criteria for the Design of Intergovernmental Fiscal Arrangements

The criteria specified here may conflict with each other, and policymakers designing grants may have to assign priorities to various factors in comparing policy alternatives.

- **Autonomy—**Subnational governments should have complete independence and flexibility in setting priorities and should not be constrained by the categorical structure of programs or uncertainty associated with decisionmaking at the center. Tax-base sharing, allowing subnational governments to introduce their own tax rates on central bases, formula-based revenue sharing, or block grants, is consistent with this objective.
- **Revenue adequacy—**Subnational governments should have adequate revenues to discharge designated responsibilities.
- **Equity—**Allocated funds should vary directly with fiscal need and inversely with the taxable capacity of each province.
- **Predictability—**The grant mechanism should ensure predictability of subnational governments' shares by publishing five-year projections of funding availability.
- **Efficiency—**The grant design should be neutral with respect to subnational government choices of resource allocation to different sectors or different types of activity. The current system of transfers in countries such as Indonesia and Sri Lanka to finance lower-level public sector wages contravenes this criterion.
- **Simplicity—**The subnational government's allocation should be based on objective factors over which individual units have little control. The formula should be easy to comprehend so that "grantsmanship" is not rewarded, as appears to occur with plan assistance in India and Pakistan.
- **Incentive—**The proposed design should provide incentives for sound fiscal management and discourage inefficient practices. There should be no specific transfers to finance the deficits of subnational governments.
- **Safeguarding grantor's objectives—**The grant design should ensure that certain well-defined objectives of the grantor are adhered to by grant recipients. This is accomplished by proper monitoring, joint progress reviews, and technical assistance or by the use of a selective matching transfer program.

Source: Anwar Shah, *The Reform of Intergovernmental Fiscal Relations in Developing and Emerging Market Economies*, Policy and Research Series 23 (Washington, D.C.: World Bank, 1994).

Decentralizing Borrowing Powers

The debt crisis of subnational governments in Brazil, the inflationary impact of subnational financing in Argentina, and city-level bankruptcies in the United States have often been used to illustrate the possible macro concerns of decentralizing borrowing powers. The argument centers on a moral hazard problem, namely, the proposition that access to financial markets by subnational governments may involve implicit or explicit central government guarantees that lead to imprudent action by lenders and subnational governments, and ultimately create unplanned fiscal liabilities for central government.

The academic literature and country experiences, however, do not suggest an a priori adverse link between decentralizing borrowing powers and central government's ability to maintain fiscal discipline and macroeconomic stability. Rather, the key seems to lie in the design of fiscal decentralization in general and, in particular, the design of the regulatory framework under which borrowing powers are decentralized.[11] The difficulty in designing and implementing this framework should not be underestimated. Nevertheless, where the necessary preconditions are in place, subnational borrowing is both feasible and desirable. Where it is not in place, borrowing should be restricted and institutions developed to support it in the longer run.

Why Is Access to Financial Markets Important?

There are three primary reasons why access to financial markets is considered important for subnational governments.

- **Financing capital expenditure—**Subnational governments often have responsibility for public investments that are lumpy in nature. Financing such capital investment through increases in current taxes would be inefficient. In addition, because the benefits of such public investments often last over several decades, equity considerations would suggest that future generations participate in the financing. Capital markets provide this inter-temporal link.
- **Matching expenditure and tax flows—**Within a particular fiscal year, expenditures incurred and tax intake may not be fully sychronized. Access to financial markets offers an opportunity to smooth out these mismatches.
- **Fostering political accountability—**The pricing of capital by markets may provide an independent mechanism to foster political accountability—markets may signal the poor performance of subnational governments through increases in interest rates or simply by blocking access.

11. For empirical evidence of the link between decentralization and subnational deficits see F. Fornasari, S. Webb, and H. Zou, "Decentralized Spending and Central Government Deficits: International Evidence," draft Discussion Paper (Washington, D.C.: World Bank, 1998). David Wildasin, ed., *Fiscal Aspects of Evolving Federations* (Cambridge, U.K.: Cambridge University Press, 1997) and Jennie Litvack, J. Ahmad, and R. Bird, "Rethinking Decentralization in Developing Countries," Discussion Paper (Washington, D.C.: World Bank, 1998) suggest that this linkage is directly related to the design of intergovernmental fiscal relations.

What Are the Mechanisms for Accessing Capital Markets by Subnational Tiers of Government?

There are at least four channels through which subnational governments can access capital markets:[12]

- Direct borrowing by central government and on-lending to subnational tiers
- Through a public intermediary such as a financial parastatal
- Direct borrowing from capital markets
- Through market decentralization of public services, where possible.

In ascertaining the merits of one channel over the other, policymakers need to consider several factors. The channel selected should minimize or eliminate the inefficient political allocation of credit. Any implicit liability by an upper-tier government should be explicitly recognized and reduced or eliminated. Finally, selection should be made with a view toward strengthening capital markets.

While borrowing through the central government certainly guarantees access by subnational governments to long-term finance, international experience suggests that the allocation of credit through this manner may eventually get embroiled in a political process.[13] Under such conditions, capital does not necessarily flow to the most productive, but those who are politically the most astute, with the result that government borrowing is inefficient and subsequent investments are unproductive. Intermediation by a public financial intermediary may also suffer from these drawbacks, with the additional disadvantage that the debt of the public financial intermediaries is an implicit obligation of the central government.

Additional complications may occur when multiple channels are used. For example, in South Africa, the government has created a public infrastructure bank that operates alongside a well-developed private capital market.[14] Unless the regulatory framework for municipal borrowing clearly delineates a complementary role for the public and private financial system, there may be a risk that the former either displaces the latter or that the public sector is saddled with the high risk, low creditworthy clients. Finally, experience suggests that central government control of borrowing creates the incentives for subnational governments to elude these

12. For an alternative taxonomy based on different forms of controls on subnational borrowing, see T. Ter-Minassin and J. Craig, "Control of Subnational Government Borrowing," in T. Ter-Minassin, ed., *Fiscal Federalism in Theory and Practice* (Washington, D.C.: International Monetary Fund, 1997).

13. World Bank, "Financial Systems and Development," Policy and Research Series no. 15 (Washington, D.C.: World Bank, 1990).

14. For more information, see Junaid Ahmad, "Structure of Urban Governance in South African Cities," *International Taxation and Public Finance* 3:2 (1996) and Chris Heymans, "Parastatals and Development Finance," in Patrick FitzGerald, Anne McLennan, and Barry Munslow, eds., *Managing Sustainable Development in South Africa* (New York: Oxford University Press, 1995), pp. 432–57.

restrictions through innovative off-budget schemes.[15] Centralization of borrowing powers may, therefore, not necessarily increase the ability of central government to control subnational liabilities.

Direct access to capital markets, by contrast, offers the potential for a more transparent, market-based relationship to develop and for a greater chance of enforcing a hard budget constraint (see box 2.3). Increasingly, an important aspect of market-based systems includes market decentralization to finance infrastructure. This includes private sector participation in the financing and delivery of government services, corporatization, and unbundling of service delivery.[16] In countries with limited local capital markets, market decentralization may enable access to international capital markets directly by the service provider, thereby facilitating the deepening of capital markets.

The macro concern of moral hazard—the assumption by capital markets that borrowing by subnational governments is ultimately backed by the central government—may also apply in the case of direct borrowing from private financial markets. Managing such risks through an appropriate regulatory framework while allowing market discipline to guide the allocation of capital may be the most efficient mechanism for allowing subnational governments access to financial markets.

How Should the Regulatory Framework for Subnational Governments Be Designed?[17]

A well-designed regulatory framework is necessary to ensure that decentralizing borrowing does not provide perverse incentives for excessive lending by markets and excessive borrowing by subnational governments, excesses that eventually may end up as liabilities of central authorities.

Such a framework requires transparency, preferably through better information systems. This includes standardized accounting procedures for subnational governments and better public information of their liabilities and their repayment capacity. However, more public information and better disclosure by itself will not be sufficient to curb moral hazard problems. Penalties would need to be associated with excessive borrowing. In particular, explicit bankruptcy procedures, for instance, the U.S. type of financial control boards or the New Zealand system of court-appointed receiverships, may need to be legislated.[18] A key in designing such processes is to

15. See T. Ter-Minassin and J. Craig, "Control of Subnational Government Borrowing," in T. Ter-Minassin, ed., *Fiscal Federalism in Theory and Practice* (Washington, D.C.: International Monetary Fund, 1997).

16. For example, organizing the delivery of water or electricity in a company structure—whether a private or public corporation—may improve access to capital markets if such organizations are better able to shield themselves from political interference than subnational governments.

17. The discussion in this section focuses on the demand side of the market: regulation of borrowing by the public sector. It does not discuss the regulatory aspects of the supply side: the framework for regulating the financial system itself.

18. In addition to bankruptcy procedures, the central government could also legislate intermediary monitoring steps with an associated penalty schedule, for example, legislating debt thresholds and penalties for crossing them, such as requiring central approval for

Box 2.3. Evolution of Capital Markets and Decentralization of Borrowing Powers

In countries without a domestic capital market, it may be preferable to have central fiscal transfers (from 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 public financial intermediaries, keeps the fiscal and financial sectors 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 the central government. In this system, the discount facility only takes the maturity risk by stretching the term of commercial bank lending to municipalities. The commercial banks, however, continue to retain the credit risk for their lending at the retail level, thereby preserving the separation of risks between the public and private sector. Colombia provides an interesting example of such an arrangement.

As capital markets emerge with financial instruments offering long-term finance, the need for a discount facility would disappear, and as long as the fiscal system was well designed, subnational governments would now be able to access longer maturities. Even in this case, however, for fiscally weaker municipalities, for instance, local governments, the transfer system would remain an important vehicle for access to funds. In addition, in relatively more developed capital markets, the use of private credit rating agencies and bond insurance agencies offers a market-based mechanism to monitor and regulate subnational borrowing, but the public sector also needs to monitor and regulate these institutions.

ensure that the bankruptcy mechanism adopted enables the delivery of basic services to continue, even if on a reduced level, while management and financial restructuring are proceeding, otherwise the pressure for central bailouts will be great.

Ensuring that subnational governments have access to their own sources of revenues that can be pledged as collateral is also necessary to reduce possible moral hazard. Without such direct fiscal backing, markets might view any capital market borrowing by subnational governments as implicitly backed by the central government. Having their own fiscal base is therefore an important prerequisite for subnational governments' access to finance and for limiting moral hazard problems.

Equally important in this context is keeping the fiscal and financial systems separate in the design of intergovernmental systems. Indeed, one can hypothesize that it is the lack of separation between the fiscal and financial systems that

future borrowing or even the loss of borrowing powers altogether. There is a danger that too many centrally imposed controls may, in fact, make central authorities implicitly liable for subnational borrowing. For this reason, simply requiring full disclosure and legislate bankruptcy procedures without introducing intermediate controls may be preferable.

has led to macro instability in some countries—as the web of implicit obligations suddenly appears as explicit budget commitments—rather than the decentralization process itself.

For example, in Argentina, provincial government deficits have been financed in part by provincial banks, many of which have gone bankrupt. As Wildasin 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.[19] It also weakened incentives for fiscal discipline at the provincial level. In the case of Brazil, evidence suggests that a soft budget constraint between tiers of government can exist through the banking system notwithstanding a sound intergovernmental fiscal system. In commenting on the situation in Brazil, Dillinger points out that the hard budget constraint imposed on the fiscal side was circumvented as states have—wittingly or not—used the financial system to obtain federal resources.[20] 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 Hoffman argue, such "policy lending" can have a negative impact on macroeconomic price stability and, presumably, on fiscal discipline at the subnational level.[21]

These examples suggest both a cautious approach and one that emphasizes the separation of the fiscal and financial systems. Several mechanisms are possible. First, the independence of the central bank is a key element of the hard budget constraint. Second, where possible, the public sector must get out of the financial system. This includes the privatization of the banking system, but privatization is by itself 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 need to be supervised with a clear prudential, regulatory framework that monitors the level and nature of their aggregate liabilities. Finally, one lesson from worldwide experiences is clear: subnational public financial institutions are not desirable. The incentives for subnational governments to abuse their relationship with their own financial institutions at the expense of macrostability is too great.[22] The relationship between provincial governments and provincial banks in Argentina stands out as a classic example of this situation.

Market decentralization may also offer an interesting mechanism for reducing moral hazard. Privatization of public infrastructure may enable the application of private sector bankruptcy laws and allow other private sector companies

19. David Wildasin, ed., *Fiscal Aspects of Evolving Federations* (Cambridge, U.K.: Cambridge University Press, 1997).

20. William Dillinger, "Brazil's State Debt Crisis: Lessons Learned," Country Department 1, Latin America and the Caribbean Region Economic Notes (Washington, D.C.: World Bank, 1997).

21. R. Lall and B. Hoffman, "Decentralization and Government Deficits in China," in J. Roy, ed., *Macroeconomic Management and Fiscal Decentralization* (Washington, D.C.: World Bank, 1995).

22. Of course, similar risks exist with national financial institutions. That is why the first option of getting the public sector out of the banking business may be the preferable policy route to follow.

to bid for the assets in case of financial difficulties, an option unavailable with public ownership. To implement such an option, however, governments need to ensure that there are multiple deliverers in any one sector. Private participation creates options for accessing financial equity in addition to debt creating an incentive for "equity to monitor debt" that is not available in public financing systems. In addition, unbundling may reduce the size of the entity concerned, thereby avoiding the "too big to fail" syndrome that is often associated with bailouts.

Finally, the back-door channels to creating financial liabilities need to be monitored, and where possible, closed. In particular, legislation must ensure that dipping into pension funds or using subnational corporations to borrow on behalf of subnational governments is not permitted or is explicitly included in subnational debt. In addition, balanced budget requirements for subnational governments may ensure that current accounts are balanced by the end of each fiscal year, so that borrowing to match expenditures and revenue streams does not lead to financing of current account deficits over time.

In sum, the combined use of information systems, access to own revenues, public legislation, bankruptcy laws, and market decentralization offers an overall institutional incentive for a hard budget constraint at all tiers of government and permits borrowing to be decentralized.

Should Foreign Borrowing Be Allowed?

The issue of direct access to international capital markets by subnational governments is further complicated by issues of macroeconomic management, general capital account liberalization, and the nature of the foreign exchange regime. This overall context will determine whether direct borrowing by subnational governments in international markets should be permitted. Given the limited consensus on this issue, there seems to be a bias toward not granting direct access to international markets by subnational governments. In any case, the issues raised in this note about the regulatory framework for decentralizing borrowing apply equally to local and foreign borrowing.

Conclusion: Implementing Financial Decentralization

Financial decentralization—allowing subnational governments to access capital markets directly—is an important complement to the devolution of fiscal powers to regional and local authorities. If properly designed, decentralization of borrowing powers can add to the gains in efficiency and governance expected from fiscal decentralization. Implementing financial decentralization, therefore, should receive equal priority in the design of intergovernmental fiscal relations.

However, as this note suggests, for financial decentralization to be properly implemented, the regulatory framework will need to be well designed. This caution does not imply an all or nothing scenario: a phased and asymmetric approach may be adopted to implement financial decentralization. Policies may include sequencing fiscal decentralization prior to allowing subnational governments access to capital markets; enabling larger urban centers, which are usually more self-reliant in terms of fiscal resources and management capacity than other local governments, quicker access to financial markets and, perhaps, even controlled and limited access to foreign markets; implementing market decentralization as a step toward financial decentralization; and replacing the implicit resource transfers through public financial institutions with explicit fiscal transfers. In sum, the challenge is to design the regulatory framework for financial decentralization and its process of implementation. Debating whether financial decentralization is good or bad may be a moot point in an era of emerging local capital markets and a greater political push in many countries to decentralize powers to subnational governments.

Civil Service Reform and Decentralization

Decentralization can be a way of improving access to services, tailoring government actions to private needs, and increasing the opportunities for state-society interactions. Subnational governments will only be effective, however, when they have access to the human and financial resources needed to undertake the services assigned to them.

Civil service reform—both capacity building and adjusting to decentralization—addresses the first of these requirements. There is fairly widespread agreement that capacity building at all government levels is an essential component of decentralization. There is less agreement over how to deliver the appropriate human resources package to the appropriate levels of government and how to coordinate human resources management across and between levels of government. Adjusting to decentralization often requires organizational reforms in the civil service in order to create appropriate incentives for workers at all levels. At the center of this debate about human resources management and incentive structures is the discussion of what level of government should have the power to determine pay scales, terms of service, and civil service structures. Policymakers must respond to the demands of various constituencies—civil servants, unions, service users, for example—as well as balance the objective of allowing subnational governments to adapt to local conditions with the objective of maintaining national standards and an equitable distribution of human resources.

How Does Decentralization Affect the Civil Service?

Decentralization creates a new set of opportunities for increasing the information that civil servants have to work with as well as strengthening their incentives to perform well. Closer contact with their customers gives bureaucrats the tools to tailor their activities to local conditions and preferences, while increased accountability to local politicians and their (vigilant) constituents creates the incentives for them to do so.

Adjusting to decentralization and taking advantage of these opportunities can be difficult. In the short term, the mechanics of rearranging the civil service—redistributing personnel, rewriting job descriptions, and so on—can be daunting. In the longer term, creating the ability and incentives for subnational governments to surpass minimum national standards for service delivery presents several challenges. First, new responsibilities fall on people with varying experience and skills. Economies of scale, such as the number of people that one skilled engineer serves, can be lost as technical duties are devolved to more and smaller jurisdictions. Second, decentralization can also exacerbate inequality: variations in living conditions (rural areas versus urban centers, for example) can lead to a skewed distribution of human resources as the best civil servants choose to live in the more developed areas. Also, some regions may be better able to attract the best candidates with higher pay. Third, local politicians and civil servants gain more power to dispute central mandates. Although this local flexibility is often seen as a benefit of decentralization, there is no guarantee that local input will be better for service delivery than nationwide policies. Civil service reform in decentralizing countries should involve not only the building of human resources, but also institutions to ensure use and equitable distribution of these resources.

RISING TO THE CHALLENGES. Decentralization requires rearranging, and occasionally expanding, the bureaucracy. Local governments need trained, competent people in order to carry out new responsibilities, while central governments need to shift the skills mix of their workers as their role changes (in most cases) from implementor to technical consultant and overall coordinator. Several factors prevent simply redistributing the human resources and skills present in a centralized system across tiers of government and subnational jurisdictions.

- There may not be enough skilled people to go around. Pre-existing shortages of human resources can be exacerbated when responsibilities are divided up among smaller jurisdictions.
- The skilled people may not want to relocate where they are needed. Certain areas of the country are inevitably more pleasant to live in than others and are thus better able to attract skilled workers.

The degree of local capacity determines the kind of human resources management strategies that will be feasible and desirable. Decentralization of human resources management is more likely to succeed where lower-level authorities have the financial and managerial ability to set competitive compensation packages and salary levels that will attract local talent. In these cases, the flexibility advantages of allowing local governments to set hiring levels might outweigh the risk of increasing interregional inequalities. Where talent and skills are lacking at the local level, a unitary hiring system might be preferred to ensure that the necessary skills are present locally in all regions. In these cases, where the center retains more control over human resources, care should be taken to ensure that the management options of local stakeholders are not curtailed. Also, care must be taken to ensure the national standards do not place unrealistic financial burdens on local governments.

SHORT-TERM MECHANICS: DEFINING THE GOAL. All levels of government should be encouraged to define and plan for the types of workers they will need to carry out new responsibilities. In the short term these sorts of rough plans substitute for the human resources management staff and computerized personnel system that so many countries lack and can help eliminate duplicate workers, unnecessary hires, and other expensive mistakes. At the very least, such plans can be an exercise in longer-term planning and role definition.

BUILDING LOCAL CAPACITY. Local (or at least subnational) capacity is one of the most important factors in creating a well-functioning, decentralized civil service. The starting point for reforms varies from country to country. In countries where local government institutions are embryonic or exist only at an informal level, the institutional and legal framework will have to be created before any administrative reform or training is undertaken. (See the section on local technical and managerial capacity.)

In countries where local institutions already exist, the challenge is to reinforce their technical and managerial capacity. The more experienced central government has an important role in coordinating and funding training through universities and seminars. Joint projects, in which more experienced central government civil servants work with local officials to transfer skills through practice, can also be an effective way to train subnational civil servants.[23] More than training, however, incentives for self-improvement can have an important impact on local government performance. In Colombia, for example, accountability to constituents pushed local mayors to concentrate more on training and hiring effective civil servants.[24] In Northeast Brazil, community oversight and fear of job loss helped motivate civil servants to comply with work regulations and do the best job possible.[25]

In more advanced countries, the primary challenge is to use existing resources efficiently and preserve economies of scale. The need for specialized personnel is related in part to the size of the territory covered by the entity and it might be counterproductive or cost inefficient to have specialists or technical personnel in jurisdictions below a certain size. One way to address this problem is to allow local governments to form associations and pool their resources to cover activities requiring specialized personnel. Another is to create a central consultancy service that the local governments can use as a source of technical and managerial advice when needed.

Preventing inequalities. Decentralization creates more opportunities for local autonomy and responsiveness to more specialized constituencies, but it also gives subnational governments more room to fail if specific steps are not taken to ensure a nationwide minimum level of local technical and managerial capacity. Devolution of power to subnational governments highlights variations in regions' ability to pay an adequate number of civil servants and attract skilled people who are capable of implementing the budget efficiently. The poorer regions often lose these competitions, for their budgets do not allow high salaries, and their level of infrastructure and services do not create pleasant living conditions. As more skilled and experienced civil servants migrate to comparatively well-off areas, the gap between regions can expand.

Countries have addressed these interregional variations in a variety of ways. India, for example, has created a cadre system in which highly skilled civil servants rotate between more and less developed regions. Ethiopia takes a less institutionalized approach: the Prime Minister's Office sends skilled civil servants from the central government or more developed regions to the less developed areas of the

23. The international donor community can also get involved in capacity building with these sorts of joint projects. Creating more opportunities for interaction between local civil servants and international consultants can transfer much needed technical skills.

24. Tim E. J. Campbell, "Innovations and Risk Taking: The Engine of Reform in Local Government in Latin America and the Caribbean," Discussion Paper no. 357 (Washington, D.C.: World Bank, 1997).

25. Judith Tendler, *Good Government in the Tropics* (Baltimore, Maryland: The Johns Hopkins University Press, 1997). The state government implemented a community monitoring system whereby candidates who had applied but not gotten civil service jobs were supposed to watch those who had been hired and report infractions such as absenteeism and lack of responsiveness to the community.

country for one to two years. Another possible option for addressing inequalities is to emphasize capacity building of civil servants from poorer areas.

In general, some room for variation in conditions of service, pay scales, and so on allows subnational governments the flexibility to hire a civil service that matches a community's needs and budget constraints. National salary, eligibility, and performance standards can ensure consistent quality, but they can also lead to personnel expenditures (especially for locally administered education and health sectors) that exceed some local capacities.[26] Flexibility also allows regions to develop unique, cost-effective ways of attracting qualified civil servants: one region might attract teachers, for example, by providing housing near schools. This could be built with community labor and would place less strain on the budget than a high salary scale would. On the other hand, decentralization of the civil service might magnify the effects of regional budget constraints—a poorer region might be forced to hire fewer civil servants than another. Allowing regional variation in civil service codes also raises the possibility of bidding wars for the most skilled civil servants.

PRESERVING NATIONAL POLICIES WHILE TAKING ADVANTAGE OF NEW INFORMATION. Increased citizen control and augmented information for policymakers are two of the most commonly recognized benefits of decentralization. The challenge is to balance these bottom-up pressures with some sort of accountability to higher levels of government in order to ensure that local policies are compatible with larger-scale national efforts.

Decentralization, especially political decentralization, creates a class of government workers that, based on the specific information that they receive (feedback from their clients and constituencies), may have different preferences than workers at the next higher level. This divergence in views and convictions can create conflict within the civil service that will require mechanisms to manage effectively. Benchmarks, essentially lists of responsibilities or standards to meet, can effectively balance these bottom-up influences.

Clear paths for information flow are the first step in ensuring coordination between different levels of government and citizens. Any reform effort to ensure sound utilization of public resources and minimize corruption should include the creation of a strong legal framework to address issues related to financing and reporting, to determine what type of control mechanisms (especially financial) are necessary and who is accountable for them, to evaluate hiring practices and compensation schemes, and to address issues related to the procurement of public works. Clear reporting procedures are needed from lower to higher levels of government (central government, in the case of regional administrations, for example) and across government agencies at the same level. In the medium and long term, audit courts can be a useful regulatory mechanism. Transitions have to be carefully planned to avoid conflict between new reporting arrangements and the mechanisms of the previous system.

26. Grant transfer systems (see section on intergovernmental grants) will need to take different financing capacities into account in these and other types of mandated expenditures. Indonesia, Pakistan, and the Philippines are examples of decentralized states with essentially uniform terms and conditions of service for government employees in different regions.

Information and Monitoring in Decentralized Systems

Accountability is a prerequisite for improving public sector performance, and information is the key to accountability. The systematic collection, analysis, and reporting of information are critical elements of decentralization programs because information can be used to verify compliance with policy goals, to analyze alternative outcomes, and to guide future decisions. Information on financial flows (that is, budgeting and expenditure reporting) and other inputs, outputs, and outcomes is essential both at the local level—to inform local constituents and to encourage public participation in the political process—and at the central level—to monitor and supervise local activities funded (at least partially) by central sources.

Monitoring Mechanisms

Unless the public knows what public goods and services are provided, how well they are provided, who the beneficiaries are, how much the goods and services cost, and who paid for them, local constituencies will not encourage effective government. Central monitoring and evaluation of local performance has much the same effect, except that national interests replace narrower local interests. Without some central monitoring, there can be no assurance that functions of national importance are adequately performed once they have been decentralized, that the macroeconomic implications of decentralization are understood, or that the effects of proposed changes in intergovernmental fiscal or administrative relations are adequately analyzed.

Many decentralizing countries have weak or inadequate mechanisms for citizens and higher levels of government to monitor, evaluate, and support decentralization. While this does not prevent decentralization from achieving some of its goals, it does limit its ability to create large efficiency gains. Improvements in financial accounting and reporting and the establishment of analytical capabilities for monitoring and evaluation can strengthen monitoring and assessment of subnational finances.

But the need for careful monitoring goes beyond finance. It depends on the service delivery objective. For example, different aspects of decentralization may have different effects on the construction and maintenance of various types of infrastructure, health care programs, or education system. If the objective is for safety nets to reach the poor, information is required on who the poor are and where they are located, and how much of the benefits from the program are reaching this target group. In most cases, countries spend significant resources on safety nets but fail to collect data and monitor who receives the benefits and how they were affected by them. (A notable exception is the valuable evaluation of the poverty targeting of an Argentina safety net program.)[27]

27. Martin Ravallion, "Reaching Poor Areas in a Federal System," Policy Research Working Paper 1901 (Washington, D.C.: World Bank, 1998).

Financial Accountability and Reporting

To improve financial accounting and reporting, detailed fiscal data should be regularly collected and reported for subnational governments. Ideally, these data would be derived from uniform financial and reporting systems. At a minimum, these data should be collected and processed on a regular and timely basis and should exhibit the following characteristics:

- **Breadth of coverage—**Information should be broadly representative, across units of subnational government and across financial classifications (revenues, expenditures, debt).
- **Consistency—**Information should have minimal reporting and classification errors.
- **Comparability—**The same types of activities should be reflected across units of government.
- **Clarity—**Actual activities should be reported rather than budgeted activities, and ideally, data should be audited.

The development and implementation of financial reporting and information systems often require substantial technical assistance, training, time, and resources. Implementation of these systems may also require that central institutions be established to develop and maintain the reporting systems, to train and support local officials, and to monitor and analyze developments in subnational finance.

Establishing a census of governments—similar in coverage to censuses of population, industry, and employment in many countries—and publishing subnational financial data would establish the foundation for a monitoring system and provide important inputs for revenue estimating, economic research, and assessments of creditworthiness. The U.S. Advisory Commission on Intergovernmental Relations, for example, compiled comprehensive data on subnational finance and institutions from U.S. census data, surveys of local government professional associations, and other sources and published them annually in *Significant Features of Fiscal Federalism*. Reductions in federal funding led to discontinuation of the publication in 1995.

It is difficult to monitor decentralization consistently across countries. For example, fiscal information such as that reported in the IMF's *Government Finance Statistics* is often used to track trends in decentralization. The problem with these data, however, is that analysts often use the percentage of total public expenditures undertaken at the local level as an indicator of decentralization. In some countries, local governments decide on the allocation of these resources, but in others these expenditures are mandated at the central level and only implemented at the local level. The first arrangement is consistent with decentralization; the second is not. For now, however, these are often the best data available for cross-country comparisons. In 1998, the Decentralization Thematic Group at the World Bank initiated a project to coordinate several cross-country data collection efforts across the Bank as well as with several outside partners to form one comprehensive, detailed database of fiscal and institutional variables at the national and subnational levels.

Local Technical and Managerial Capacity

The recent international trend toward decentralization has provoked a lively debate about the capacity of local governments and communities to plan, finance, and manage their new responsibilities. Assessing, improving, and accommodating varying degrees of local capacity have become more and more important as decentralization policies transfer larger responsibilities, as well as budgets, from national governments to local governments and communities.

While a common rationale for decentralization is that local governments' proximity to their constituents enables them to better manage resources and match their constituents' preferences, it is not clear that local governments and communities have the capacity to translate this information advantage into an efficiency advantage. Small, inexperienced, local governments may not have the technical capacity to implement and maintain projects or the training to effectively manage larger budgets.

This section discusses two main issues in the local capacity debate: what local capacity is and what to do about varying degrees of local capacity once it has been identified. "Local government" is taken to mean the level of government at which some degree of everyday face-to-face interaction between citizens and government is possible.

Assessing Local Capacity

Decentralization planners have used the general guideline that central agencies should focus on creating and sustaining the enabling environment and strategic priorities, while local organizations should concentrate on tailoring the specific mechanisms of service delivery and public expenditure packages to fit local needs and circumstances. In reality, however, the varying degrees of local capacity—both in local government and in civil society and the private sector—obviously affect decisions about which levels of government can best perform which tasks. In most cases decentralization of basic services does not mean the wholesale transfer to local agencies of all tasks associated with those services. An assessment of local capacity is an integral part of designing decentralization.

What Is Capacity?

Measuring local capacity can be difficult, and the debate over quantifying it has often been motivated by political concerns as well as technical considerations about the local government's ability to provide services. Central governments have used the "lack of capacity" excuse for refusing to transfer their authority, financial resources, and accompanying privileges to local units. For example, Fiszbein found in Colombia that "what was being characterized [by national agencies] as poor planning in *municipios* was in fact a genuine disagreement between local and national priorities."[28] The *municipios* were actually demonstrating considerable local

28. Ariel Fiszbein, "Emergence of Local Capacity: Lessons from Colombia," *World Development* 25:7(1997):1029–43.

capacity by turning down conditional matching grants from central agencies and borrowing funds locally at market rates in order to implement their own priorities.

For this reason, it is useful to set out some of the relevant issues in objectively measuring local capacity. There are four general skill areas: identifying and analyzing local problems in order to plan appropriate responses, mobilizing and managing resources, communicating and coordinating policy implementation, and resolving local conflicts.[29] The fact that a community and its government exist indicates the presence of at least some of these skills. The challenge is to identify the latent capacity in the local government, civil society, and private sector and bring it into the development programs.

The first task is to identify the specific tasks that local governments and citizens will need to carry out. In the area of policy implementation, for example, a checklist of responsibilities might include writing specifications for the technical elements of programs, evaluating the impact of the program on the local environment, and contracting for services or buying equipment.

The second task is to create appropriate, comprehensive indicators to measure local groups' ability to carry out the required functions. There are several issues to consider in measuring capacity:

- **Outputs or outcomes—**Output measures can be defined as the number of services delivered (for example, school attendance, vaccination coverage, kilometers of road built or vehicle traffic) while outcomes refer to the ultimate objective (for example, literacy, morbidity or mortality, access to markets). There are pros and cons of using these different types of measurements. While both outputs and outcomes reflect supply and demand factors, output indicators are easier to measure and reflect more directly the service delivery efforts undertaken. On the other hand, they are only an intermediate objective and if they fail to achieve the ultimate objective, a great deal of money, which could have been spent on other interventions, can be wasted.
- **Variable ability—**One of the most important tasks in planning decentralization is to identify and account for the differing skill levels of local governments. Variations in the ability to plan and execute projects, for example, can lead to differing implementation rates and ability to use revenue, which in turn can exacerbate inequalities.
- **People or institutions—**Does local capacity consist of individuals who may or may not continue to play a role in the government or are there institutionalized mechanisms (such as competitive pay, prestige, contracting arrangements, or training procedures) for ensuring a continuous supply of technical and managerial expertise? Important factors to look at in assessing the community's capacity are depth and history of civil society organizations, number of private contractors, and concentration of skills. (Is there only one contractor, who could move at any time, or are there several firms that could provide technical help?)

29. Norman Uphoff, "Institutional Capacity and Decentralization for Rural Development," paper presented at the Technical Consultation on Decentralization, Food and Agricultural Organization, Rome, 16–18 December, 1997, suggests these four skill areas.

- **Bureaucratic and technical infrastructure—**The processes by which information is received, processed, and stored underlie most local government functions. The existence of appropriate databases and filing systems, for example, is essential to the ability to collect taxes or user fees.
- **The role of civil society—**Nongovernmental organizations can often be a source of trained, experienced personnel, and local construction, accounting, and other firms can provide services on a case-by-case basis. The local government's relationship with the private sector and its demonstrated ability to contract out services are an important, often overlooked part of capacity. In assessing the community's longer term capacity, the depth and history of civil society organizations (is there one skillful community leader or a network?) as well as the number of private contractors and concentration of skills should be considered.

Decentralize or Build Local Capacity? Which Comes First?

The traditional approach to decentralization has been to build capacity before transferring responsibilities or revenues. This cautious method was motivated by worries about irresponsible spending, local corruption, regional inequities, and service collapse as well as by many central governments' reluctance to devolve authority. Some analysts even argued that the lack of local capacity, among other factors, made decentralization ineffective and even undesirable in developing countries.[30]

This traditional approach is changing, however, as increasing evidence shows that the capacities of all levels increase as decentralized service systems mature. There is a growing appreciation that "management is a performance art" better learned by doing than by listening. Some researchers report that local government capacity increased slightly but perceptibly in the years following some modest degree of decentralization in Indonesia, Morocco, Pakistan, and Thailand. How local governments would have handled more complete decentralization is unknown. Ongoing research in Bolivia shows that local governments' education investments are more rational and more in line with local needs than all the national government's expenditure.[31] In general, much of the evidence indicates that decentralization has increased local participation and hence local government leverage in gaining access to national resources and has encouraged the development of public and private planning and management skill.

Implementing the Answer: Doing both Simultaneously

Decentralization can, in itself, be the best way to build local capacity. Central support can be important to maintain equity in spending across jurisdictions and ensure proper attention to training. One researcher points out that effective delivery of local services rests on partnerships crossing levels of government and

30. R. Bahl and J. Linn, "Fiscal Decentralization and Intergovernmental Transfers in Less Developed Countries," *Publius: The Journal of Federalism* 24 (Winter 1994).

31. Jean-Paul Faguet, "Decentralization and Local Government Performance," paper presented at the Technical Consultation on Decentralization, Food and Agricultural Organization, Rome, 16–18 December, 1997.

the public, private, and civil sectors. Nevertheless, capacity building should not be a supply-driven endeavor that provides the same support package to widely varying local jurisdictions.[32] It is also not always clear that national capacity is greater than local capacity. One study, for example, showed that Italians rate local government effectiveness higher than national government capacity.[33]

DEMAND-DRIVEN CAPACITY-BUILDING PROGRAMS CAN STRENGTHEN LOCAL COMMUNITIES AND NETWORKS OF SKILLS. One way to enhance local capacity is through training and practice. Local institutions can be allowed to use a portion of program funds, or their own funds, to contract for the technical expertise that they feel is appropriate to their specific requirements. This technical help can often be found locally and can be acquired quicker and cheaper than from central or regional sources. Similarly, communities (or regional groupings of communities) can be given block grants for their own capacity-building training programs. They can purchase the training they need to fill the gaps that they have identified in their own management and technical capacity. They can decide whether to buy the training from local, regional, or central institutions. Using local sources enables a local network of technical expertise to develop. This local network can be tapped more efficiently for maintenance of existing and new programs in the future.

LOCAL PARTICIPATION CAN BE A STRONG MOTIVATOR FOR CHANGE. Recent evidence from Bolivia and Colombia shows that citizen oversight can be an important impetus for local governments to actively improve their capacity.[34] Regular, fair elections and citizen councils can increase the pressure on local leaders to turn popular demands into outputs.

CLARITY IN RESPONSIBILITY ASSIGNMENT IS ESSENTIAL. India's technically and managerially over-ambitious Small Farmers' Development Agency and Sri Lanka's lack of guidance for the appropriate uses of district budgets, for example, led to low levels of success. The more successful, albeit modest, decentralization efforts in Indonesia and Thailand, however, had clearer procedures for local budget allocation and responsibilities.

Conclusion: Building Capacity through Decentralization

The prevailing wisdom today can be summed up in the following statement made at the Technical Consultation on Decentralization and Rural Development, FAO, Rome, December 1997: "Rather than plan and make large upfront investments in

32. Judith Tendler, *Good Government in the Tropics* (Baltimore, Maryland: The Johns Hopkins University Press, 1997).

33. R. Putnam, *Making Democracy Work* (Princeton, New Jersey: Princeton University Press, 1993).

34. Ariel Fiszbein, "Emergence of Local Capacity: Lessons from Colombia," *World Development* 25:7(1997):1029–43; Jean-Paul Faguet, "Decentralization and Local Government Performance," paper presented at the Technical Consultation on Decentralization, Food and Agricultural Organization, Rome, 16–18 December, 1997.

local capacity building as a prerequisite for devolution of responsibility, there was a broad consensus that it would be quicker and more cost-effective to begin the process of devolution, permit learning by doing and build up capacity through practice." The evidence increasingly shows that local capacity can be built by the process of decentralization, particularly when appropriate programs to increase interaction with the private sector are included in decentralization design.

3
Service Delivery

This chapter is divided into six notes, each focusing on a different sector: education; health care; safety nets; infrastructure; irrigation, water supply, and sanitation; and natural resources management and environment.

It should be stressed that the other notes in this volume are relevant and extremely important for those involved with the decentralization of a particular sector. Decentralization is often undertaken as part of a sectoral reform; yet its impact on efficiency will depend on political, fiscal, and administrative accountability, which is part of the broader framework of intergovernmental relations. Its impact on equity will depend greatly on the design of intergovernmental transfers. Undertaking a sectoral decentralization dialogue without examining the intergovernmental landscape can lead to unintended consequences such as local corruption or growing geographic disparities. In all sectors, much has yet to be learned about the different outcomes derived from varying types of decentralization implemented in disparate institutional settings. Nevertheless, a number of studies are underway within and outside the World Bank; the Bank will disseminate findings as they become available.

Decentralization of the Education Sector

Today most countries are experimenting with or contemplating some form of education decentralization. The process transfers decisionmaking powers from central ministries of education to intermediate governments, local governments, communities, and schools. The extent of the transfer varies, however, from administrative deconcentration to a much broader transfer of financial control to the regional or local level.

While there are solid theoretical justifications for decentralizing education systems, the process requires strong political commitment and leadership in order to succeed. The path, depth, and ultimately the outcome of decentralization reforms depend on the motivations for reforms, the initial country and sector conditions, and the interaction of various important coalitions within the sector.

Why Decentralize Education?

In a world where most governments have experienced the pitfalls of centralized provision of education services—mainly opaque decisionmaking, administrative and fiscal inefficiency, and poor quality and access to services—the theoretical advantages of decentralization are extremely appealing. Two sets of motivations are often in play. On one hand, many people believe that the process of decentralization will substantially improve efficiency, transparency, accountability, and responsiveness of service provision; better reflect local priorities and encourage participation; and eventually improve coverage and quality. On the other hand, governments with severe fiscal constraints are enticed by the potential of decentralization to increase efficiency and lower costs. Beneficiary cost recovery schemes such as community financing have emerged as a means for central governments to offload some of the fiscal burden of education service provision. In practice, the objectives often compete and the net outcome depends considerably on the extent of accountability—the more that national and local leaders are accountable to their populations, the more likely that decentralization will lead to better, more responsive services and will not be used solely as a cost-cutting measure.

Deciding Who Controls What

There is ongoing debate about the appropriate locus of decisionmaking within the education sector. The debate remains unresolved because the process requires that policymakers rationalize and harmonize a complex set of complementary functions that includes curriculum design, teaching methods, student evaluation, textbook production and distribution, teacher recruitment and pay, school construction and rehabilitation, education financing, and parent-teacher linkages. The choices of who does what are further complicated because each of these functions has to be evaluated for primary, secondary, and tertiary education, and often for preschools and adult literacy as well. Some emerging areas of consensus are summarized in the following paragraphs.

SETTING STANDARDS. The central government is generally better equipped to address equity issues and ensure a common minimum educational standard. Distribution of teachers and technical assistance to underperforming areas are commonly central functions. Some federal governments (for example, the United States) have successfully delegated monitoring and standards to states or provinces.[1]

Curriculum design and teaching methods. The central government generally plans the national curriculum within the national ministry of education. In heterogenous societies such as Nigeria or Ethiopia, local governments are given some latitude to localize curriculum, by introducing indigenous languages, for example.

Student evaluation. National-level examination systems can shape the general direction of local evaluation and monitoring, but teachers, schools, and districts generally evaluate on a day-to-day basis. Also, developing and disseminating school-based performance plans increases the information available so that communities can take an active part in monitoring education quality.

Textbook production and distribution. Textbook production and distribution is usually centralized in order to harmonize textbooks with curriculum design and development process as well as increase cost efficiency due to scale economies in centralized procurement, production, and distribution.

Teacher recruitment and promotion. Teachers are central government civil servants in most developing countries, with conditions of service determined by the public service commission or an independent teacher service commission. In a few countries, mostly federal systems such as Brazil and India, where responsibility for provision of education is fully devolved, some teachers, mainly in primary and secondary education, are civil servants of intermediate governments.

In many cases, including federal states such as Pakistan, teachers have resisted reforms that would have placed them under the jurisdiction of local or intermediate governments, on the grounds that they lose interjurisdictional mobility, comparable conditions of service, and prestige. Constructive dialogue with the relevant teacher unions and groups is an important priority in education reform, because teacher resistance to reforms of conditions of service designed to make them formally accountable to intermediate and local governments remains a common impediment to system reform.

Education financing. A large share of education services, particularly primary and secondary schooling, are publicly provided and financed in most countries though some degree of private financing and provision is increasingly common. In devolved education systems where subnational governments have statutory or constitutional responsibility for some education subsectors, central governments either assign taxes or transfer resources sufficient to cover these and other devolved responsibilities. Some central and intermediate governments also provide

1. Eric A. Hanushek and Dale W. Jorgenson, eds., *Improving America's Schools: The Role of Incentives* (Washington, D.C.: National Academy Press, 1996) contains a variety of essays on the organizational structure and assignment of responsibilities in the U.S. school system.

additional matching grants to local governments to increase local expenditures on priority areas. In deconcentrated systems, field offices receive their budgets from the central ministry through the next highest level.

Many governments have also implemented community management and cost-recovery schemes in response to shrinking central fiscal resources and growing demand for basic education. Partial community financing in the form of contingency fees, reduced (subsidized) school fees, PTA contributions, and ad hoc community contributions in cash or kind are becoming quite common.[2] In rare cases communities are entirely responsible for school financing, usually for a subset of schools. In China, for example, there are government schools (*gonban)* and community-run schools (*minban)*.

On the management side, communities are increasingly given substantial control over the day-to-day operation of schools. In many countries, local school committees and district education boards and committees composed mainly of community representatives have been set up for this purpose. In rural El Salvador, the elected members of a community education association are vested with legal responsibility for enrolling a specified number of students, establishing classrooms or new schools, and hiring and supervising their teaching staff.[3] Bhutan and Zambia also provide good examples of this trend. Ireland, the United Kingdom, and the United States also have highly developed school-level management systems. PTA roles are highly variable across schools, community income levels, and countries.

CONSTRUCTION AND MAINTENANCE. Although in a few cases, such as Tanzania, the central government finances both construction and maintenance, this is traditionally among the most decentralized education subfunctions. Responsibilities for construction and maintenance are often divided between government levels: for example, the province provides resources for construction and major rehabilitation, and the local government conducts routine maintenance; communities and their representatives share costs. Responsibilities also tend to be divided according to the level of schooling: local governments are responsible for primary schools, mid-level governments for secondary schools, and central governments for tertiary education.

TEACHERS' SALARIES. Salaries, even in highly centralized systems, are usually paid from the recurrent budget of the administrative level to which teachers report. The true extent of local control over teachers depends on whether or not the teachers are members of a unified national civil service with pay scales set by the relevant service commission.

Community involvement in financing teachers' salaries can help make schools more responsive to community needs, but the practice is controversial with teachers'

2. For an evaluation of the incentive effects of even marginal community cofinancing, see Emmanuel Jimenez and Vicente Paqueo, "Do Local Contributions Affect the Efficiency of Public Primary Schools?" *Economics of Education Review* 15:4 (October 1996):377–86.

3. World Bank, Development Research Group, "El Salvador's Community-Managed Schools (EDUCO) Program: A First Report," Working Paper Series on Impact Evaluation of Education Reforms 4 (Washington, D.C., 1997); World Bank, Development Research Group, "Do Community-Managed Schools Work? An Evaluation," Working Paper Series on Impact Evaluation of Education Reforms 8 (Washington, D.C., 1998).

unions because it can create inequities in salaries and student-teacher ratios among poorer and richer communities.

Impacts of Decentralization

The limited available evidence about the impact of decentralization on education services is mixed depending largely on why and how decentralization was undertaken. In some cases, central governments have delegated responsibilities to local governments and communities without providing adequate targeted support to poorer areas. In Brazil the central government has increased overall access (enrollments) but has done little to reverse persistent regional inequities in access to schooling, per capita expenditures, and quality. Chile's experience also suggests that decentralization does not by itself remove inequalities between localities of varying incomes, and quality in poorer communities continues to lag. These results are supported by experiences in New Zealand and Zimbabwe.[4] However, the design of these decentralized systems has been criticized.

The initial evidence suggests that decentralization to subnational governments (that is, provinces and states) may not be sufficient and that increased autonomy for communities and school actors may be necessary to improve schools and learning. By increasing the participation of parents, community-managed schools in El Salvador show significantly lower rates of student and teacher absenteeism.[5] While this type of management does not appear to have improved student performance in tests according to a recent evaluation, it may be just a matter of time before better student attendance translates into higher student achievement. In Nicaragua, controlling for similar household background and school inputs, students in schools that make more of their own decisions about school functions perform better in tests.[6] These results

4. For more information on New Zealand, see Liz Gordon's "Controlling Education: Agency Theory and the Reformation of New Zealand Schools," *Educational Policy* 9:1 (March 1995):54–74 examines the central tenets of agency theory, describes how the approach has been applied in the New Zealand school system, and through a case study report analyzes the effects of this approach on the schools. Lyall Perris's "Implementing Education Reforms in New Zealand: 1987–97," *The Education Reform and Management Series* 1:2 discusses the economic and political context for the changes, describes the interplay of interests during the implementation process, and concludes with a list of "lessons" to be learned from the reforms' pitfalls and as-yet unresolved issues. For information on Chile, see T. R. Perry, "Achieving Balance in Decentralization: A Case Study of Education Decentralization in Chile," *World Development* 25:2(1997):211–25.

5. World Bank, Development Research Group, "El Salvador's Community-Managed Schools (EDUCO) Program: A First Report," Working Paper Series on Impact Evaluation of Education Reforms 4 (Washington, D.C., 1997); World Bank, Development Research Group, "Do Community-Managed Schools Work? An Evaluation," Working Paper Series on Impact Evaluation of Education Reforms 8 (Washington, D.C., 1998).

6. Bruce Fuller, Magdalena Rivarola, Elizabeth King, and Berk Ozler, "Nicaragua's School Autonomy Reform: A First Look," Working Paper Series on Impact Evaluation of Education Reforms 1 (Washington, D.C.: World Bank, 1996); World Bank, "Views of Parents, Teachers, and Directors," Working Paper Series on Impact Evaluation of Education Reforms 5 (Washington, D.C., 1998); World Bank, Development Research Group, "What's Decentralization Got to Do with Learning?" Draft paper presented at the Annual Meetings of the American Educational Research Association, Washington, D.C., 1998.

are derived from ongoing impact evaluations. Because the impact of management reforms such as these may take time to unfold, further empirical analysis is needed.

Conclusion

Decentralization of education systems demands harmonization of a complex set of functions at each level—primary, secondary, tertiary, and nonformal education. Issues of how far to devolve decisionmaking in each case and to whom continue to be debated. There are a number of ongoing experiments worldwide, ranging from devolution of limited functions to intermediate governments and local governments to community-based management and financing of schools. The current consensus is that tertiary education and specific functions such as curriculum design and standards setting are best retained by the center, that secondary and primary education should be devolved as far as possible, and that local participation in school management improves accountability and responsiveness and fosters resource mobilization.

Decentralization of the Health Sector

The general argument for decentralizing health care is that greater community participation in local health activities can lead to improved service quality and coverage. Yet exactly how these benefits can be realized and just what impact different kinds of reforms will have are not well understood. Several features of health care services (the controversial nature of some services such as family planning, the importance of formal training and supervision for personnel, the need for integrated referral services) make health sector decentralization more complex and potentially more difficult than in other service delivery areas. Since decentralization of health care services is often politically driven, the theoretical benefits tend to get more attention than results of actual experiences, which are mixed. One lesson that does seem clear from existing experiences is that without proper planning and acknowledgment of the lessons learned by other countries, decentralization of health care can be disappointing at best and detrimental at worst.

What Is Decentralization?

The term "decentralization" is used to describe a wide variety of power transfer arrangements and accountability systems. Policies range from the transfer of limited powers to lower management levels within current health management structures and financing mechanisms to extensive sector reform efforts designed to reconfigure the provision of even the most basic services. In the first case, decentralization may later become the driving force for health sector reform; in the second, it is driven by the wider sectoral reform efforts. The parameters for decentralization—the speed, pressures, and scope of issues to consider—vary considerably.

The Promise of Decentralization

Health sector decentralization has become appealing to many people because it has several theoretical advantages.[7] The following are sometimes cited as justifications for decentralizing health care:

- A more rational and unified health service that caters to local preferences
- Improved implementation of health programs
- Lessened duplication of services as the target populations are defined more specifically
- Reduction of inequalities between rural and urban areas
- Cost containment from moving to streamlined, targeted programs
- Greater community financing and involvement of local communities
- Greater integration of activities of different public and private agencies
- Improved intersectoral coordination, particularly in local government and rural development activities.

7. Anne Mills, "Decentralization and Accountability in the Health Sector from an International Perspective: What Are the Choices?" *Public Administration and Development* 14 (1994):281–92.

The Caveats

There is little concrete evidence to date to confirm that these potential benefits can always be realized. Few developing countries have long-term experience with health sector decentralization, and its impact on the management of the sector and on the services it delivers has rarely been evaluated. The impact of health decentralization will depend on which specific health services are decentralized in what kinds of institutional environments and under which intergovernmental fiscal policies. Yet, the debate about whether decentralization does indeed improve equity, efficiency, accountability, and quality in the health sector continues at a general level without data to inform it. Although anecdotal and country-study evidence confirms that poorly designed and hastily implemented decentralization has serious consequences for health service delivery, we do not have a clear analytical framework to isolate or generalize the factors behind successful and unsuccessful decentralization.[8]

General Guidelines

Experiences that have been documented show that achieving the benefits of decentralization depends heavily on policy design. In general, careful attention must be given to health service needs and priorities in deciding which functions and programs to transfer and which to retain under central control. If a function is critical to the attainment of central-level goals and its sustainability at the local level cannot be guaranteed, it should not be decentralized. With this in mind, the following paragraphs summarize general guidelines for assigning responsibilities to central and local levels and outline a framework for planning decentralization.

PROGRAM DESIGN. The central government often has a comparative advantage in creating and disseminating information and establishing parameters for priority national programs, such as family planning and vaccination programs, with externalities that reach beyond individual communities. Local governments, on the other hand, are better positioned to select the details of service delivery mechanisms that suit local conditions.

FINANCING. The high cost of health services generally requires central government transfers to ensure local government's ability to carry out responsibilities. Conditions, such as minimum levels of expenditure on maintenance and training, are often attached to these resources to ensure consistent quality and sustainability. Subnational governments are better able to set user charges and other cost-recovery mechanisms and address their communities' needs by planning expenditure allocations within the parameters set by national standards.

8. Lucy Gilson, Peter Kilima, and Marcel Tanner, "Local Government Decentralization and the Health Sector in Tanzania," *Public Administration and Development* 15 (1994):451–77; Riitta-Liisa Kolehmainen-Aitken and William Newbrander, *Decentralizing the Management of Health and Family Planning Programs*, Lessons from FPMD Monograph Series (Boston: Management Sciences for Health, 1997).

STANDARDS SETTING. Central governments usually have the sole mandate for setting standards for licensing health care professionals, for registration and quality control of drugs, and similar functions. The capacity for licensure rarely exists at the local level, and in countries (such as India) that have decentralized this function, pharmaceuticals of questionable quality and safety freely cross from states with a poorly managed drug registration system to other, better managed states.

SERVICE DELIVERY. Although one can say, as a rough approximation, that most health care services should be decentralized to the lowest level of government whose jurisdiction includes the beneficiaries, the complex linkages between different services require careful planning of appropriate organizational roles, relationships, and organizational structures. Serious distortions and hindrances to health service delivery are created if functional roles and organizational structures are devised without full participation of health managers. In the Philippines, the integrated district health office concept that had taken years to develop was destroyed when provinces were handed responsibility for managing hospitals and municipalities became responsible for primary health care. No linkages were created between these two levels of health service, even though the patient load and quality of service in one are highly dependent on the other. In Bolivia and Zambia, the small size of many local governments has similarly separated primary care from its secondary referral facilities. In Papua New Guinea, the failure to specify clearly the new roles and responsibilities for subsidy payments to church-run health services resulted in a severe funding crisis, which forced the churches to close many of their health facilities for a time. Because churches provide about half of all rural health care in Papua New Guinea, and their services are well integrated with the public sector, large numbers of rural residents were deprived of any access to health services.

LEGAL RESPONSIBILITY. The legal and regulatory implications of decentralization for the work of health personnel must be considered to avoid placing health staff at risk. In the Philippines, the legal protection of local government health staff under national malpractice legislation has been questioned. After decentralization in Papua New Guinea, provincial health inspectors could no longer legally enforce national legislation concerning the cleanliness of markets, restaurants, and workplaces.

A First Attempt at a Framework for Assigning Expenditure Responsibility

Local governments' freedom to adapt to local conditions must be balanced by a common vision about the goals of the health sector and the purpose of decentralization in furthering those goals. Decentralization policy should include some coordinating mechanism.

The prominence of local political interests increases as decentralization transfers more responsibility to this level. While responsiveness to local demands is a benefit of decentralization, it brings two main disadvantages. First, local officials frequently change and may therefore be uninformed about key national health policies. Second, local groups may also oppose national policies. One provincial governor in the Philippines banned a donor-funded project in support of family planning services. (It is certainly acceptable and indeed desirable if decentralization enables local governments to design programs according to local preferences; however, services of national priority, such as family planning, should be mandated and funded by the central government.)

Adequate financing and clear delineation of new financial flow mechanisms are essential. In the preoccupation with defining an essential package of basic health services or a new decentralized health service model, the crucial issue of financing the decentralized health system may be overlooked. A significant financial gap between what is available and what is being planned can compromise the health sector's ability to provide equitable, efficient, and good quality services under decentralization. South Africa and Zambia are both facing this issue in their current decentralization efforts. Several guidelines emerge from experience:[9]

- Revenue allocation must take existing local expenditure responsibilities and own resources into account. In Bolivia and the Philippines, for example, the fixed funding formulas used to allocate national revenue between local governments failed to take into account the existing level of health facilities that these governments inherited and the services they were expected to provide. Local governments that inherited expensive new responsibilities, such as hospitals, often were not able to maintain the level of service previously provided.
- Local freedom to allocate funding should be tempered by nationally set minimum requirements. The degree of freedom that the local level has in deciding what resources to devote to health services, together with local budgetary realities and financial procedures, greatly influences the operation of the health system. In Papua New Guinea, tight budgets and weak planning capacity led several provincial governments to stop paying for nurse aide training, which had been decentralized to them. Within four years the training capacity for this important staff category fell from 13 government schools with 135 annual graduates to 3 schools with 13 graduates resulting in a severe shortage of skilled workers.[10]
- Any central policies must consider local conditions and capacities.[11] In the Philippines, the discrepancy between the cost of health staff benefits promised under centrally negotiated labor agreements and the local government capacity to pay has seriously eroded staff morale, while cumbersome local

9. For more information on these and other examples, see C. Collins and A. Green, "Decentralization and Primary Health Care: Some Negative Implications in Developing Countries," *International Journal of Health Services* 24:3(1994):459–75.

10. J. Thomason, "Disbursement, Decentralization, and Development: Lessons from the First Rural Health Services Project in Papua New Guinea," *Public Administration and Development* 8(1998):391–99; D. Campos-Outcalt, K. Kewa, and Jane Thomason, "Decentralization of Health Services in Western Highlands Province, Papua New Guinea: An Attempt to Administer Health Service at the Subdistrict Level," *Social Science and Medicine* 40:8 (1995):1091–98.

11. The Special Edition of *The Family Planning Manager* IV:2 (March/April 1995) contains multiple case studies.

financial procedures have jeopardized the timely availability of essential medical supplies. Some local governments require up to 40 separate signatures before a purchase order can be sent to a supplier!

Capacity constraints cannot be ignored in either central or decentralized management levels. Ignoring capacity constraints at either central or local levels and giving inadequate or delayed attention to training staff for their new roles are very serious omissions with predictable effects on health services. Decentralization brings a heavy new management burden, especially to the lower levels. Qualified health managers are in short supply in many countries, and regional variations in the supply of health workers can exacerbate existing inequities.[12] Furthermore, management training capacity may be insufficient to meet rapidly expanding training needs. Madagascar, for example, has begun to transfer planning, management, and budgetary authority to 111 health districts without having a sufficient number of qualified health managers to serve all these districts.

Decentralization changes the roles of the central ministry staff from line management to policy formulation, technical advice, and program monitoring. The central-level managers also require systematic retraining and reorientation, which many countries have overlooked. In other cases, staff cuts at the central ministry of health have been so severe that the center's capacity to function effectively is in question. In Nepal, for example, initial staff cuts at the central level paralyzed the expanded program on immunization.

Conclusion: The Essentials

In summary, decentralization creates major challenges for health service provision. Active involvement of health managers in the decentralization design, clear national resources allocation standards and health service norms, and an ongoing system for monitoring are essential for guarding equity and quality and for improving efficiency.

12. M. Gonzalez-Block, R. Leyva, O. Zapata, R. Loewe, and J. Alagon, "Health Services Decentralization in Mexico: Formulation, Implementation, and Results of Policy," *Health Policy and Planning* 4:4(1989):301–15, gives an example of how differing local capacity can create new inequities in health service availability.

Decentralization and Safety Nets

Safety nets protect a person or household in three types of situations:

- When there is chronic incapacity to work and earn (the severely disabled, elderly, young orphans)
- When there is an unpredictable "idiosyncratic" shock (sudden death or serious illness of breadwinner)
- When there is an unpredictable community "covariate" shock (economic recession, bad harvest, flood).

Hence safety net programs serve two important roles: redistribution in situations of chronic incapacity (income transfers, food supplement programs) and insurance in times of unpredictable shocks (public works programs, drought relief). A key challenge in the design of safety nets is to maximize the benefits to the needy and vulnerable while minimizing the administrative and political costs as well as the disincentive effects. The high cost of obtaining accurate information about the incomes and needs of the poor, for example, creates a significant barrier to improving the targeting of services and transfers to the poor.[13]

Experience with Decentralized Safety Nets

Some have argued that decentralizing poverty monitoring and management of antipoverty programs from the national to the local level can reduce costs and improve targeting. Local governments and administrators may be better informed about members of their community and thus better able to identify their poor.

There is some empirical evidence about this, but experiences seem to differ depending on which level of local government is involved. For example, in Albania, where social assistance allocations are determined at the commune level (population of about 2,500), local authorities appear to have more information than is available through formal monitoring systems. This enables them to target the poor more effectively. District officials in Karnataka State, India, have attributed a tenfold increase in information flow from communities to decentralization. This has helped to increase the warning time before natural disasters and has improved the government's ability to respond to and fend off potential disasters. In contrast, where decentralization has focused at the provincial or state level (rather than the district or commune level), targeting has not been as successful; for example, in Vietnam, despite more centrally funded transfers going to the poorer provinces, the poorer areas and people within

13. Subbaro and others, *Safety Net Programs and Poverty Reduction: Lessons from Cross-Country Experience,* Directions in Development Series (Washington, D.C.: World Bank, 1997); T. Besley and R. Kanbur, "Principles in Targeting," in Michael Lipton and Jacques van der Gaag, eds., *Including the Poor,* Regional and Sectoral Studies Series (Washington, D.C.: World Bank, 1993); D. van de Walle, "Incidence and Targeting: An Overview of Implications for Research and Policy," in D. van de Walle and K. Nead, eds., *Public Spending and the Poor* (Baltimore and London: The Johns Hopkins University Press, 1995).

the provinces do not necessarily receive additional resources. This is because the provinces use different criteria for distributing funds within their jurisdiction than the center does.[14] In Argentina wealthier provinces appear to be more effective at targeting federal safety net subsidies to their poorer areas than do poorer provinces.[15]

Many of the benefits of decentralization seem most apparent at the village level and least apparent when decisionmaking rests at the provincial level. Decentralization at the village level can lead to greater participation and more effective local development strategies and thus can enhance the delivery of services targeted to the poor. But the evidence is mixed. In some cases, there is also evidence of corruption at the local level.

In some countries, particularly the transition economies of the former Soviet Union, national governments have decentralized safety nets with the goal of lowering the national deficit. But often expenditure responsibilities have been decentralized without adequate provisions for revenue sources. Such unfunded mandates lead to a deterioration in the quality and quantity of services.

Ways to Decentralize Safety Nets

There are many different ways to decentralize a safety net program. It is difficult to generalize about the potential advantages or disadvantages of safety net decentralization, because these will differ according to the aspect of the program being decentralized. Different levels of government can be given responsibility for different aspects of program design and implementation (for example, eligibility criteria, financing, and administration). The design of intergovernmental grants is also key to determining how each level of government will participate in the program.

Eligibility criteria. Eligibility criteria can be set at the national level or decentralized to the subnational level. The main advantages of nationally consistent targeting criteria are that central funds can be distributed to the greatest number of nationally defined absolute poor or vulnerable people, regardless of where they live. Centrally established criteria also make it possible to evaluate programs consistently across areas to assess their effectiveness, and they may limit the ability of local elites to monopolize benefits. The main disadvantage to central eligibility criteria is that the identification of vulnerable groups may not reflect local values and preferences. This need not be a problem if the locality can raise additional local funds to supplement the central allocations, but if the locality is very poor, it may not be able to do so. However, depending on local power dynamics, local eligibility criteria may actually not be desirable. Local criteria may be appropriate for distributing locally raised revenues, but nationally uniform eligibility criteria are generally recommended for the distribution of national funds for poverty alleviation or safety nets.

14. Govinda Rao, Richard Bird, and Jennie Litvack, "Intergovernmental Fiscal Relations and Poverty Alleviation in Vietnam," Policy Research Working Paper 1430 (Washington, D.C.: World Bank, East Asia and Pacific, Country Operations Division, 1995).

15. M. Ravallion, "Reaching Poor Areas in a Federal System," Policy Research Working Paper 1901 (Washington, D.C.: World Bank, 1998).

APPLYING THE CRITERIA. Based on criteria set by the center or a subnational level, individuals or households can be identified for participation by central administrators in the locality; local officials from the provincial, district, or village level; or members of local nongovernmental organizations (NGOs). Generally, project implementation is best undertaken at the lowest possible level, with monitoring by higher levels to ensure that standard eligibility criteria are being followed.

FINANCING. A well-functioning social safety net is an important element of a broad-based, inclusive growth strategy. Given the objectives of a safety net identified earlier, the central government has an important role in financing it. For example, areas that require the greatest assistance often have the least local revenues with which to support safety nets; subnational levels are often unable to deal with covariate risk. Nevertheless, subnational governments are also often concerned about household vulnerability and the need for safety nets and sometimes are able to raise substantial revenues to supplement central funds. Such cofinancing of safety nets (between levels of government) can be encouraged through the design of matching intergovernmental transfers. For example, the centrally sponsored safety net schemes in India are generally matched by the states.

Intergovernmental transfers can be either general or conditional. For general transfers, a sum of funding is provided to the local government to deliver a range of services, but actual expenditures are determined at the local level (Hungary, Latvia). Because a minimum level of services is desired by the central government, it is usually recommended that safety nets not be funded through general grants. Conditional transfers that require the subnational level to spend the designated funds on safety nets are preferable. Conditional transfers can be matching or nonmatching grants. The central government can encourage subnational governments to raise local funds for safety nets by using matching transfers, and it can vary the matching rates depending on local fiscal capacity. For example, a wealthier province might receive one central dollar for every three dollars it raises and spends on safety nets, while a poorer province might receive three central dollars for every one dollar it raises and spends on safety nets (see the section on intergovernmental transfers and grants).

While these methods, combined with centrally determined eligibility criteria, can encourage local governments to deliver safety nets, another option is for the central government to administer the program itself through a representative in the locality. This may be desirable if the central government cares strongly about access to these services and has concerns about performance at the local level.

In short, decentralization of safety net financing can involve several different arrangements. The central government can devolve resources to the province to cover a range of expenditures, including safety nets. Each province then determines how much it will spend on safety nets. Or the central government can set the criteria by which the province selects the poor areas to receive funds and create incentives that will reward provinces for allocating the funds to the poorer areas within their jurisdiction. A third option is for the center to simply ask the provinces to pass on the central funds to the villages and households that it has identified as vulnerable. The second option is likely to be most effective.

MONITORING. To determine if funds are being targeted to the appropriate individuals and areas, it is important to have information on program expenditures and household and village characteristics. Although there are many different design possibilities for decentralized safety net programs, ultimately the central government, whether it is involved in financing safety nets or not, should monitor the programs. Information is best collected regularly and maintained at the subnational level. (See the section on information and monitoring in decentralized systems.)

Decentralization of Infrastructure

Technological developments that diminish economies of scale and political pressures for decentralization have led to increased subnational government participation in providing and financing roads, water and sewerage systems, transit, power, and telecommunications networks, as well as other public infrastructure. The advantages of this decentralization are becoming more apparent: subnational governments are better positioned to identify local preferences for infrastructure technology or service quality, accountability is enhanced with local decisionmaking, and voters have more information on the price and quality of services, thereby increasing competition in the sector. Theoretically, decentralization can also improve equity in the distribution of infrastructure as smaller governments away from the political center gain more latitude and funding to serve their constituents. Still, decentralized provision and financing of infrastructure does not guarantee improvements in the quality or distribution of infrastructure. Local performance depends on the incentives facing decisionmakers, which in turn depend on the financial, institutional, and political environments in which decentralization occurs.

This section outlines some general guidelines for assigning responsibility for public infrastructure to central, subnational, and local governments and to community groups and the private sector. It describes the institutional settings that can create the right incentives for decisionmakers. It also examines some of the evidence about decentralization's effects on infrastructure provision.

Assigning Responsibility in Infrastructure Policy

Services may be provided, financed, or both by many different public sector institutional structures; they can be provided by the private sector under various contracting arrangements; or they can both be provided and financed by the private sector alone (see box 3.1).

Each type of infrastructure investment has particular characteristics—economies of scale, exclusivity, and spatial concentration of beneficiaries, for example—that affect the desirable degree of decentralization. Provision of infrastructure can be broken up into a number of decisions and separable responsibilities: planning networks, choosing locations, setting standards, constructing and operating facilities, regulating, and maintaining systems.[16] The basic logic behind assigning these tasks is that the central government should have primary responsibility for ensuring the quality and consistency of infrastructure networks that affect the well-being of citizens in multiple jurisdictions, while local or subnational governments should provide services that can vary between jurisdictions to suit local needs without disrupting national development policies. The private sector can play an important role in building, operating, and maintaining different types of infrastructure. The assignment of responsibilities should ensure that the benefits and costs of decisions are borne by those who make the decisions.

16. World Bank, *World Development Report* (New York: Oxford University Press, 1994).

Box 3.1. 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: Richard M. Bird, "Fiscal Federalism and Federal Finance," in *Jornadas de Finanzas Publicas* (Cordoba, Argentina: National University of Cordoba, Faculty of Economic Sciences, 1995).

DESIGN. Each level of government has a comparative advantage in designing infrastructure: the central government has the nationwide perspective and jurisdiction to ensure compatibility across the entire network, while the lower-level governments face lower transactions costs in gathering and aggregating place-specific information. Local initiative can also lead to innovative, more efficient designs. Private contractors can often serve as a source of technical expertise in design.

Construction is one of the most commonly decentralized functions, for it is relatively simple and place-specific. The private sector is often involved in this area as well. In the Republic of Korea, local governments have acted as developers—consolidating large parcels of land, building infrastructure, then returning part of the land to the original owners and selling the rest to recoup development costs.

FINANCING. Central governments usually provide the bulk of finance for infrastructure investment, while lower-level governments and the private sector participate more often in financing small improvements, modifications, and local additions to the national networks. Many central governments also provide transfers to local governments for local infrastructure investment or maintenance in order to ensure a minimum level of infrastructure for both reasons of efficiency (externalities) and equity. These transfers can be quite a large percentage of infrastructure funding.

Local governments can support capital investment and maintenance through several channels including: (1) general transfers from the center, (2) specific purpose transfers from the center, (3) local taxes, (4) earmarked user fees for specific types of infrastructure (for example, water charges), and (5) subnational borrowing (see separate notes on intergovernmental transfers, taxation, and subnational borrowing). Their use of these different channels will depend on the system of intergovernmental finance and the legal and regulatory system that sets the rules for local finance (see constitutional, legal, and regulatory framework note). User fees are a particularly important source for local infrastructure finance because local governments can identify users and collect user fees in their jurisdiction quite easily. (Note that overreliance on earmarked user fees for infrastructure finance can starve local governments of an important source of finance with which to finance other public goods such as social services and address equity concerns.) Valorization, a system of local taxation in which the cost of public works is allocated proportionally to affected properties, has become more common. [17]

In developing countries, in particular, maintenance tends to be neglected at all levels, because the results of money spent are not as immediately apparent and the pressures to extend the infrastructure network to underserved areas tend to be strong. Central government transfers are often earmarked for specific capital expenditures for infrastructure, but maintenance is provided under a general block grant, which can then be used for many competing needs.

17. This method of taxation has varying success rates, however, and studies in Colombia indicate that participation and careful planning are essential and that central government funds may be required for initial financing.

Informal financing of infrastructure, whereby private citizens contribute time, money, and technical expertise to build and maintain community infrastructure where governments have failed, is attracting increasing attention. Residents of the Orangi district of Karachi, Pakistan, have invested money and labor to install a sewerage system and build schools, health care posts, and other facilities. In Lima, Peru, local community associations have financed such public works through informal taxation. Throughout Vietnam, commune residents have assumed the responsibility for maintaining local infrastructure through household contributions and in kind payments (most notably labor).

REGULATION. The central government usually plays a coordinating role in setting standards and monitoring compliance. This ensures compatibility and consistent quality across the national network and enables a wide variety of potential service providers. The outcome of decentralizing regulation depends on the political circumstances. On the one hand, turning regulatory authority over to local governments will generally facilitate the adaptation of regulation to local conditions and preferences. On the other hand, devolution can lead to interest group capture if local governments do not have adequate regulatory capacity and broad-based accountability mechanisms are not in place.

An Enabling Environment for Effective Local Provision

Decentralization's potential impact on infrastructure performance is quite similar to its impact on other sectors: it depends largely on the degree of subnational political and financial autonomy, whether accountability is well established, and whether the correct incentives are offered for a long-term view of infrastructure investment, maintenance, and use. Because decentralization increases the number of actors involved in infrastructure provision, the institutional settings and range of incentives for subnational governments increase and more attention must be paid to the signals implicit in financing arrangements, regulatory structures, and other interactions between levels of government and citizens. Some core elements of successful institutions for decentralization include accountability and technical support.

ACCOUNTABILITY. The links between the central government, local government, the private sector, and citizens must be designed to ensure that providers of infrastructure are accountable to those who pay for the services as well as those who benefit from the services. Participatory mechanisms should be structured so that the entire community can participate in infrastructure decisions, particularly regarding location and financing issues, which have substantial distributive implications. Enhancing the availability of public information regarding budgetary and procurement decisionmaking is important for community participation and accountability. The World Bank's Economic Development Institute is currently conducting workshops with local governments worldwide to enhance participatory budgeting and open procurement processes.

TECHNICAL SUPPORT. Inexperienced subnational and local governments often require some form of technical support as they take on new responsibilities. Local governments' technical capacity varies widely across jurisdictions, and national assistance may be required to maintain consistent infrastructure quality.

A variety of public-private partnerships can be useful in building up local capacity. Colombia, for example, met these technical needs in several ways when it devolved primary responsibility for the provision of drinking water and sanitation services to local governments in 1987. It contracted training out to nongovernmental organizations, private consultants, and universities in addition to drawing on public sector specialists from the Ministry of Public Works and Army Corps of Engineers.[18]

Technical support is particularly important in maintaining regulatory quality during decentralization. Among possible arrangements are training programs run by national agencies, mutual assistance through regulatory associations (such as the U.S. National Association of Regulatory Utility Commissioners), and twinning relationships that pair inexperienced regulators with more experienced domestic or international regulators.

Decentralization and Infrastructure Performance

Available data and cross-country studies indicate that decentralization can have varied effects on the infrastructure sector (table 3.1). Choices about the optimal level of decentralization are sector- and country-specific.

Estache and Sinha show that both aggregate and subnational infrastructure expenditure increase as decentralization proceeds, particularly in developing countries. This could be an indicator that local governments prefer more infrastructure than would have been provided by the central government, but it could also be a sign that infrastructure expenditure is not as efficient.[19]

Humplick and Estache found that performance indicators generally improve slightly or stay the same when infrastructure sectors are decentralized, although they do observe a few negative effects (the strongest being lower labor efficiency in the electricity sector). They also show that decentralization can result in more variable performance across jurisdictions, but it is not clear whether this is a symptom of varying local capacity or of varying local preferences.[20]

18. World Bank, *Colombia: Decentralizing Revenues and the Provision of Services; A Review of Recent Experience*, Report no. 7870–CO (Washington, D.C.: 1989).

19. A. Estache and S. Sinha, "Does Decentralization Increase Public Infrastructure Expenditure?" In A. Estache, ed., *Decentralizing Infrastructure: Advantages and Limitations*, Discussion Papers 290 (Washington, D.C.: World Bank, 1995).

20. F. Humplick and A. Estache, "Does Decentralization Improve Infrastructure Performance?" in A. Estache, ed., *Decentralizing Infrastructure: Advantages and Limitations*, Discussion Papers 290 (Washington, D.C.: World Bank, 1995).

Table 3.1. Main Effects of Decentralization on Roads, Electricity, and Water Supply

Sector	*Desirable effects*	*Undesirable effects*	*Neutral effects*
Roads	• Condition of *unpaved* roads improves. • Overall performance of roads improves.		• Condition of *paved* roads is unchanged. • Share of *paved* roads in total network is unchanged.
Electricity	• Generation capacity improves. • Tariffs are lower.	• Number of employees per gigawatt/hour is high if there is no vertical unbundling.	• Customers served per employee unchanged. • System losses unaffected (but spatial decentralization preferred to functional decentralization).
Water supply	• Percentage of water loss decreases.		• Production costs unchanged. • Operation costs unchanged. • Percent access to service unchanged. • Incidence of water borne diseases unchanged.

Source: F. Humplick and A. Estache, "Does Decentralization Improve Infrastructure Performance?" in A. Estache, ed., *Decentralizing Infrastructure: Advantages and Limitations*, Discussion Papers 290 (Washington, D.C.: World Bank, 1995).

Decentralization of the Water Supply

Water is increasingly being managed as an economic, rather than a social good, and various forms of decentralization are being used to support this new approach. Governments and other reformers are now trying to link service levels and costs, provide incentives that increase the efficiency of water use, reduce costs, and increase the sustainability of water service systems. This section briefly summarizes some of the lessons that are emerging from these varied attempts at decentralizing water services. In particular, it will focus on some of the lessons from decentralized water supply, sanitation, and small-scale irrigation.

The Rationale for Decentralization: Water as an Economic Good

In theory, decentralized water services should improve governments' ability to treat water as an economic good and to assess user charges that will create incentives for efficient water use as well as finance improved service delivery. Lower-level governments, closer to beneficiary populations, have an informational advantage in identifying citizens' preferences as well as the flexibility to respond to local conditions. As local governments act on this information to improve quality, reliability, and variety of services, consumers will be willing to pay more for services. These increased user charges can, in turn, be used to finance expansion, improvement, and maintenance of the existing network.

Evidence from new decentralized approaches confirms that users are willing to pay for water services that are tailored to their needs. A 1993 World Bank study found this to be true across income levels. It showed that even poor rural farmers and households are willing to pay for levels of service above the minimum usually supplied under centralized systems. However, the key is proper incentives and demand responsiveness. Users will pay more when assured of choice and voice in system design and operation.

However, decentralization alone will not resolve all the problems associated with water services provision. Supporting institutional reforms are important. For example, the quality and representativeness of institutions to which powers and responsibilities are devolved matter greatly as elite capture is often a problem. Reformers must ensure that subnational entities such as provincial and district governments and community-based user groups to which new powers are given make decisions that reflect the will of a majority of their constituents. Strengthening the decisionmaking processes within decentralized institutions ensures genuine choice and voice. These in turn are necessary conditions for realizing the full benefits of decentralization.

The Evolution of Decentralized Water Services

Water was treated primarily as a social good under the centralized, supply-driven approach. Its positive health, environmental, and social externalities seemed to justify the view of both government and communities that free water was a fundamental right of the people. However, inadequate resources constrained governments' ability to fulfill this goal. They struggled to provide a minimum level of services with low-cost technologies, and with the center absorbing both capital and recurrent costs, the approach was unsustainable. Both coverage and quality of services suffered greatly.[21]

Under the centralized approach, water services were usually delivered through a deconcentrated system, that is, through field offices established within intermediate and local jurisdictions, staffed with civil servants (usually engineers) from the central ministry responsible for water services. These staff were responsible for delivering water. Engineers devised schemes based mainly on technical considerations such as viability of the water source and area or population to be served; they did not normally seek the active participation from intended users, and staff managed systems with little effort to identify or address users' preferences. Not surprisingly, this approach created few incentives for users to assist government in maintaining or financing water services.

Worldwide, the failures of centralization and increasing water scarcity in some regions created considerable pressure for decentralization. Three new principles, *The Dublin Principles,* were issued by the International Conference on Water and the Environment, held in Dublin in 1992:[22]

- The Ecological Principle, requiring holistic water management
- The Institutional Principle, requiring participatory water management including devolution of responsibility "to the lowest appropriate level" and greater involvement of NGOs, the private sector, and women
- The Instrument Principle, requiring that water be managed as an economic resource.

Decentralizing Water Supply, Sanitation, and Irrigation

Three main trends in decentralization of water services have emerged: private sector participation (PSP), delegation, and devolution.

PRIVATE SECTOR PARTICIPATION. PSP is a spectrum ranging from full privatization to contracting out for services. In PSP governments hand over all or part of water service provision to private companies. The approach is used in both irrigation and water supply and sanitation. In the latter, PSP is increasingly common in the urban sector and has led to better quality services and higher operational efficiency in countries such as Argentina and Chile. PSP does not work as well for rural water supply because private, profit-seeking companies tend to neglect harder-to-reach segments of the population. Rural needs often go unaddressed.

21. Mike Garn, "Managing Water as an Economic Good," in *Proceedings of the Community Water Supply and Sanitation Conference*, World Bank/UNDP-World Bank Water and Sanitation Program, Washington, D.C., May 5–8, 1998.

22. J. Briscoe, "Managing Water as an Economic Good: Rules For Reformers," *Water Supply* 15:4(1997):153–72.

DELEGATION. Under the delegation model, governments transfer water management to public or semiprivate water companies.[23] These companies are responsible for providing services within a specified region. As in the case of Tunisia, this approach has often worked well. However, as in the pure private sector, there are strong incentives to underserve rural areas. Typically, public and semiprivate companies are also plagued by the same inefficiencies and incentive problems of other government agencies, partly because of strong worker rights and few performance incentives.

DEVOLUTION. Two important levels of devolution have evolved in water services management: Devolution to local governments, and devolution to community-based user groups. The latter is more common and, depending on the country, is often incorporated into the first type.

Small-scale irrigation and rural and urban water supply and sanitation are often devolved to local governments. Ideally, responsibilities vary with capacity: the strongest local governments can undertake activities ranging from interaction with communities to technical planning to supervising construction. Other local governments might focus more on interacting with the communities while relying on staff from central or intermediate governments for technical support. Sometimes stronger urban municipalities provide services to neighboring rural areas.

The new push toward participatory management processes has enabled decentralization to user groups. These groups comprise the intended beneficiaries, who weigh all technically feasible options, consider capital and recurrent cost implications, make choices, and then manage systems. The approach pays dividends for both governments and communities: communities get what they need, and governments are relieved of the long-term operation and maintenance (O&M) burden. User groups are common to irrigation and rural water supply and sanitation. Generally they are referred to as water users' associations (WUAs) in the former and water and sanitation committees (WSCs) in the latter.[24]

Dividing Responsibilities

A number of management options ranging from full agency control to full WUA or WSC control are used in water systems. Forms of joint agency-user management are the most popular.

INTERMEDIATE AND CENTRAL GOVERNMENT FUNCTIONS. Table 3.2 shows that, except for complete devolution to user groups, regulatory functions remain the domain of central agencies. However, in four of the six management options, an agency also owns the structures and water. As a general rule, the regulatory and operating functions should always be assigned to different agencies to avoid creating self-regulating monopolies. Whatever the management arrangement, central agencies have an important role in establishing the legal and regulatory frameworks with

23. Delegation to the semiprivate utilities can also be considered as a form of PSP.
24. World Bank, "Water Resources Management: A World Bank Policy Paper" (Washington, D.C., 1993).

Table 3.2. Division of Responsibilities between Agency and Water Users

Activity	*Full agency control*	*Agency O&M (user input)*	*Shared management*	*WUA/WSC O&M*	*WUA/WSC own (agency regulated)*	*Full WUA/ WSC control*
Regulation	Agency	Agency	Agency	Agency	Agency	WUA/WSC
Ownership of structures, water	Agency	Agency	Agency	Agency	WUA/WSC	WUA/WSC
O&M responsibility	Agency	Agency	Both	WUA/WSC	WUA/WSC	WUA/WSC
User representation	Agency	WUA/WSC	WUA/WSC	WUA/WSC	WUA/WSC	WUA/WSC

Source: Ashok Subramanian and others, eds., "User Organizations for Sustainable Water Services," Technical Paper 354 (Washington, D.C.: World Bank, 1997).

respect to water rights, water pricing policies, and environmental standards. Setting laws governing the status of user groups, coordinating various types of users, and resolving disputes are also important roles which central or intermediate governments should assume in order to enable the sector to run smoothly.

Central and intermediate governments also have a financial and technical comparative advantage in managing and financing capital-intensive trunk systems. End users are better able to manage feeder systems that require local knowledge and ingenuity, local resource mobilization, and enforcement of contracts among secondary and tertiary users (for example, irrigation channels, water and sewage networks).

Role of water user groups. Water user groups are usually formed around a group of potential users, farmers, or rural or urban households to access water resources. Two types of groups are common, water users' associations (WUAs) in irrigation, and water supply and sanitation committees (WSCs) in rural (or poor urban) water supply and sanitation. These groups usually have some sort of legal character (that is, they are legally registered, have elected leadership and a constitution) and are held together by common interests of members, the public good characteristics of the service, and the expected gains from collective action. User groups work well and fully internalize costs and benefits of schemes when they are forced to bear the cost of failure. Therefore, there must be a credible threat that public agencies will not rescue user groups and their systems if groups fail to mobilize the necessary funds for operation and maintenance.

Financing. Although high-level capital-intensive systems are usually financed on a grant basis or with high levels of subsidy by central or intermediate agencies, user charges are increasingly common for operations and maintenance of feeder systems. Experience suggests that in order for feeder systems to be sustainable, users must commit to paying the full cost of O&M, in cash, kind, or a combination. User charges are also sometimes used for partial capital cost recovery. Since cost recovery links choice with costs, when presented with all technically feasible options, users will reconcile their needs with levels and types of services that they can afford to maintain.

While O&M should be financed by users, there is considerable good experience with capital subsidies for water supply, sanitation, and irrigation. Subsidies offset some of the substantial startup costs associated with water services provision. Governments often agree to subsidize capital costs to the value of a certain amount per beneficiary, or establish a subsidy ceiling per water system. Users then provide any additional funds required. The subsidy is borne by the level of government with functional responsibility. Subsidies should be designed with care so as to avoid perverse incentives such overbuilding, or inertia while waiting for government funds.

The structure of tariffs used to support operations and maintenance are important for determining equity and efficiency. For example, in developing countries, an increasing block tariff (IBT) is often applied to improve access and discourage wasteful water use. This is a price structure in which a commodity is priced at a relatively low initial rate up to a specified volume of use, then at a higher rate for additional consumption. However, IBTs are usually set too high and subsidize those who do not need the subsidy. The poor may face a lower rate than the nonpoor, but utility companies have little incentive to provide the lower-level service.[25] Also, in many developing countries, households do not have individual water meters (that is, several households share one meter). Thus the overall impact of the IBT is actually to worsen equity.[26] Informational constraints make it advisable to leave tariff setting and collection to municipalities because they can better monitor water use and evaluate users' willingness and ability to pay.

Some Results

Successes of the decentralized approach have been recorded in water supply, sanitation, and irrigation. In Mexico, after government transferred the management of irrigation systems to users' associations, recovery of O&M costs increased from 30 percent to about 80 percent. In Egypt, cropping intensity nearly doubled in farmer managed systems that were introduced, and user associations also were able to reduce some environmental impacts, such as salinity level of water applications.

There have also been many successes in water supply and sanitation, and some have been recorded in rural areas, which are usually more difficult to reach. The Ghana Community Water and Sanitation Project reports that 78 percent of the target population is now benefiting from improved water sources. Successful water supply and sanitation programs are also under implementation in Benin, Bolivia, Ecuador, India, and South Africa, to name a few cases.

25. An alternative approach is for government to subsidize the poor directly with vouchers that they can redeem to the utility.

26. Dale Whittington, "Possible Adverse Effects of Increasing Block Water Tariffs in Developing Countries," in *Economic Development and Cultural Change* (University of Chicago Press, 1992).

Natural Resources Management and Decentralization

Sound natural resources management is an essential part of sustainable development. Yet in the past, growth of the rural sector has been associated with a variety of environmental and resources problems including excessive deforestation and forest degradation, water depletion, waterlogging and salinization, fish stock depletion, soil degradation, health effects, and biodiversity losses. These problems are often associated with inappropriate incentive systems and institutional settings, insufficient investment in resource-poor areas, inadequate attention to poverty and social concerns, and political economy systems in which the rich and powerful extract rents.

Intensifying agriculture without damaging natural resources and the environment is a critical goal for rural development. A growing population requires more productive agriculture in the short and medium term, while longer-term concerns for future generations require that these productivity gains not occur at the expense of natural resource conservation.

The trend toward decentralization—the redistribution of property rights and bargaining powers among levels of government and groups in society—in many countries adds a new dimension to this long-standing concern. This section addresses the key question of how various forms and degrees of decentralization might affect natural resources management.

Pros and Cons of Decentralization

Many past attempts at sound resources management and conservation have failed because an overly centralized approach was pursued involving top-down planning by technicians and bureaucrats without concern for the opinions or well-being of the people affected by their decisions. Complete decentralization, on the other hand, can also be counterproductive for sustainable resources management and conservation. Communities then have no incentive to consider their actions' effects on their neighbors or successors; under those conditions, local people, perhaps in cooperation with outside entrepreneurs, may simply degrade and deplete the resources faster and more efficiently.

Mobilizing local interests can improve a program's chances of success. Decentralization facilitates local involvement and participation, which are important for project sustainability because they build local ownership and result in more user-friendly projects. Decentralization could involve giving local groups the authority to manage resources and to tax and spend in order to do so. But not all functions of government can usefully be decentralized, and broader groups may be in a better position than local ones to appreciate long-term or large-scale issues and to act as disinterested arbiters of disputes that cannot be solved locally. This outside perspective is vital in resources management and conservation, which fundamentally concerns avoiding or managing conflicts of interest arising from externalities.[27]

27. Ernst Lutz and Julian Caldecott, eds., *Decentralization and Biodiversity Conservation: A World Bank Symposium* (Washington, D.C.: World Bank, 1996).

Empowerment of local groups should therefore be balanced by a continuing role for central government to deal with market failures and to ensure both social equity and environmental protection. The challenge is to find the type and degree of decentralization that is most appropriate for the resource in question.

The Levels of Intervention, Typology, the Unit of Account, and Externalities

Sound resources management is taken to mean improving the allocation and use of natural resources. These resources are consumed at various levels of society, which can be classified broadly as individual farmers and other local users, individual communities, a group of communities (such as in a watershed), regions, and the national and international community. Many different costs and benefits are associated with managing resources in a particular way at each level of society, and managing them to maximize benefits at one level may impose costs on other levels. What is internal to one level may be external to another. Thus each level of society has its own interests in how resources are used, and payments from one to another could in principle be used to compensate losing parties so that all sides are satisfied. Such transfer payments may take the form of a rural development project offering alternative benefits through investments in infrastructure, education, or other priority projects specified by the community. In return for such investments, the villagers agree to adhere to natural resources management plans. Such approaches are pursued, for example, in the Laos Natural Resources Management Project and the India Eco-Development Project. Similar compensation arrangements via transfer payments are the rationale behind many of the integrated conservation-development projects that have been undertaken in recent years with mixed success.

The larger the extent and geographic spread of negative external effects, the more there is a need to involve stakeholders and government units from higher levels in finding better solutions to resources management problems.

Farm and user level. Local farmers and users are making decisions in light of their own objectives, production possibilities, and constraints. Understanding the incentives facing individual farmers and resources managers is necessary, therefore, if patterns of resources use are to be understood and appropriate responses to problems formulated.[28] Farmers generally seek to maximize the present value of the stream of expected net returns to agricultural production and resources exploitation. With regard to adoption of conservation measures, the issue is whether returns under the optimal path of the new, more conserving system are sufficiently greater than returns under the path of the current, more degrading

28. Ernst Lutz, Stefano Pagiola, and Carlos Reiche, eds., "Economic and Institutional Analyses of Soil Conservation Projects in Central America and the Caribbean," Environment Paper 8 (Washington, D.C.: World Bank, 1994); Dean Current, Ernst Lutz, and Sara Scherr, eds., "Costs, Benefits, and Farmer Adoption of Agroforestry: Project Experience in Central America and the Caribbean," Environment Paper 14 (Washington, D.C.: World Bank, 1995).

system to justify the cost of switching. Motivational factors other than strict private cost-benefit considerations also play a role.

In the context of farm management, unless there are important offsite effects or the price signals received by farmers are significantly distorted, subsidies to encourage use of conservation measures would not bring increased economic efficiency. Pesticides can have serious external effects; public policy should therefore encourage integrated pest management. This approach requires less reliance on the intensive use of external inputs and greater dependence on management skills and location-specific knowledge of agroecosystems.

Similar to agricultural production decisions, individuals and enterprises deforest because it is their most profitable alternative (without considering social costs). To get these private actors not to deforest in situations where forest clearing is inappropriate, deforestation must be made less profitable, or other alternatives, based on retaining forests or completely outside forest areas, must be made more profitable through appropriate incentives and regulations.[29]

One important element for getting incentives right at the farm and resource user level is to provide access to land and security of tenure. This is expected to increase the environmental sustainability of agricultural production and to reduce rural violence. Therefore, even though land reform is politically sensitive and difficult to implement, it is important that these issues be tackled.[30]

GROUP, COMMUNITY, AND WATERSHED LEVEL. Conserving or improving natural resources often requires collective action by groups of users or communities.[31] Community-driven development is a process in which community groups initiate, organize, and take action to achieve common interests and goals. Cooperation is not necessarily easy to initiate or sustain, even when local organizations are involved. Multiple uses for any given resource create multiple stakeholders, often with competing priorities. For this reason, conflict among stakeholders over the rights and conditions for use of a given resource is a common feature of resources management. Thus, one of the key functions of local organizations is to build the social

29. David Kaimowitz, Neil Byron, and William Sunderlin, "Public Policies to Reduce Inappropriate Deforestation," in Ernst Lutz, ed., *Agriculture and the Environment: Perspectives on Sustainable Rural Development* (Washington, D.C.: World Bank, 1998).

30. Land reform remains a hotly debated issue in a number of countries (Brazil, Colombia, El Salvador, Guatemala, South Africa, and Zimbabwe are some examples). In Brazil, Colombia, and South Africa land transfers are made in a decentralized manner, based on voluntary negotiation and agreement between buyers and sellers; the government's role is restricted to the provision of a land purchase grant to eligible beneficiaries. (Klaus Deininger, "Making Market-Assisted Land Reform Work: Initial Experience from Colombia, Brazil, and South Africa," in Ernst Lutz, ed. , *Agriculture and the Environment: Perspectives on Sustainable Rural Development* (Washington, D.C.: World Bank, 1998).

31. See case study for Colombian watershed in Jacqueline Ashby, Edwin Knapp, and Helle Munk Ravnborg, "Involving Local Organizations in Watershed Management," in Ernst Lutz, ed., *Agriculture and the Environment: Perspectives on Sustainable Rural Development* (Washington, D.C.: World Bank, 1998).

capital required for people to build consensus about and enforce the agreed use of resources for diverse, multiple, and often conflicting purposes.[32]

Few local organizations at the watershed scale have arisen without some intervention from outside agencies to catalyze their formation and action. At the local level, outsiders usually play a significant role in enabling stakeholders to arrive at a joint plan of action that takes into account effects not readily perceived or measured by those who are not directly affected. Another important point of interface between local organizations and external agencies in watershed management is the need for external intervention in identifying the relevant stakeholders and bringing them to the table, whether this is literally a negotiating table or participation in collective labor, monitoring, or enforcement of sanctions.

Getting local groups and organizations to become self-managing organizations can extend over several years and does not happen without investment in capacity building. Local elites often take leadership roles. Although not necessarily bad, this can result in the hijacking of resources unless transparency and accountability are somehow enforced.[33] Case studies show that women, the landless, marginal ethnic groups, and the laboring poor are unlikely to be represented in participatory resources management. Therefore, natural resources development projects should deliberately seek to overcome this bias not only for reasons of social equity but also because of productivity.

Local organizations can often be effective in generating and securing compliance with rules for the use of common property such as water, common grazing land, or forest, and the management of buffer zones around conservation areas, all of which may be important features of watershed management. Devolving responsibility to local organizations can both externalize some costs of enforcing conservation from the state to local communities and also reduce costs overall, by creating conditions in which outside agencies become more efficient and effective through their collaboration with local organizations.

National level. Even in relatively decentralized settings, sound national level policy, institutional frameworks, and enforcement of laws remain of great importance.[34] An important element of sound national level policymaking is to give fiscal as well as administrative authority to the lowest level of government that can efficiently deal with a resources issue within its jurisdiction. This includes supporting the principle of compensation for external damages caused. Where there remain resources management problems involving issues between regions, national level

32. Jacqueline Ashby, Edwin Knapp, and Helle Munk Ravnborg, "Involving Local Organizations in Watershed Management," in Ernst Lutz, ed., *Agriculture and the Environment: Perspectives on Sustainable Rural Development* (Washington, D.C.: World Bank, 1998).

33. Deepa Narayan, "Participatory Rural Development," in Ernst Lutz, ed., *Agriculture and the Environment: Perspectives on Sustainable Rural Development* (Washington, D.C.: World Bank, 1998).

34. Dan Bromley, "Property Regimes in Economic Development: Lessons and Policy Implications," in Ernst Lutz, ed., *Agriculture and the Environment: Perspectives on Sustainable Rural Development* (Washington, D.C.: World Bank, 1998).

institutions should assist by creating an atmosphere and venues for discussion between representatives. Finally, national level authorities often have an important positive or negative influence on resources management through decisions regarding the construction of new roads and maintaining existing ones. In the Amazon, for example, improved infrastructure has decreased the costs of resources extraction, thus making more areas vulnerable to exploitation.

GLOBAL LEVEL. Some local actions cause global externalities. These include, for example, loss of biodiversity from deforestation and global warming due to the carbon released in forest fires. Mechanisms have been and are being developed to provide incentives for local resources users to adopt changes. The Global Environment Facility and the World Bank's Carbon Initiative are such examples.

Conclusion: No Simple Recipes

Decentralization and natural resources management at various levels are complex processes that interact with one another in many ways. Resource and environmental problems and management issues are quite different for the array of conditions that one encounters, and this variability demands flexible institutions and actions. Sustainable resources management is not a rigid model; rather, it is a process involving widespread experimentation, learning by doing, sharing of information, innovation, group problemsolving, and an enhanced capacity to adapt to unexpected changes and emerging uncertainties.

Although many lessons can be learned and principles derived from experience, the last word on what works (and what does not work) is by no means decided. Indeed, the dynamic nature of the process of involving various levels in resources management is one of its most important characteristics and requires focusing as much on the management of the process as on defining a blueprint for how to go about it.

Decentralizing by giving new responsibilities to regional, watershed, and local government units, to communities, and to NGOs creates both opportunities and potential problems for resources management. To take advantage of the former while avoiding the latter, a cluster of arrangements must be made as a whole if natural resources management is to work well in a moderately decentralized setting. Of these, six institutional and incentive elements merit special attention:

- Local participation, especially in a way that allows local people to understand and endorse the boundaries and management plans of forests and nature reserves and that promotes clear tenure over land and other resources.
- Capacity building, especially to increase skills and accountability, among local government units and NGOs to enable them to work together to promote improved resources management, conservation, and rural development.
- Incentive structures that properly address the externality issues at the appropriate levels; this could include conditional subsidies, especially where divergent costs and benefits of conservation are experienced by local and nonlocal groups, making it necessary for global and national society to bridge the gap with livelihood investments or grants.

- Appropriate enforcement, especially against powerful local or central interests and always in the context of education and public relations activities.
- Stakeholder forums, which need decisionmaking power and fiscal authority to fulfill their three main roles of avoiding conflict through dialogue, authorizing action, and requesting help from outside organizations to meet local development priorities.
- Policies, laws, and institutions that create incentives at the local level for sound resources management and reduce the need for costly monitoring and enforcement action by the central government.

4
Potential Impacts of Decentralization

This chapter contains four notes that review the existing evidence on the impact of different forms of decentralization on equity, macroeconomic stability, economic growth, and accountability, transparency, and corruption.

Equity and Multileveled Government

Should governments redistribute to people or places? If so, which level of government should be responsible for the redistribution, and under what conditions? And how can governments attain these distributional goals while minimizing economic distortions? What has been the experience with decentralization and its impact on equity?

These questions are priority policy areas in industrial, developing, and transition economies. For example, in recent years there has been a substantial devolution in distributional responsibilities for welfare payments from the federal to the state governments in the United States. Economic integration and increased mobility in Europe raise questions about these national governments' ability to redistribute income effectively within their boundaries. Developing countries are often concerned with large variations in the relative revenues of subnational governments.

Assignment of Responsibility for Interpersonal Redistribution of Income

THE THEORY. The conventional wisdom from classic sources in the literature implies that redistribution has to be carried out by higher levels of government.[1] Factor mobility (particularly labor) will make attempts by lower jurisdictions to change the distribution of income self-defeating as the poor gravitate to areas of high redistribution, while the rich cluster in areas of low redistribution.

THE REALITY. The world does not fully correspond to this theoretical model, however. Many functions of subnational governments do, in practice, have significant distributional effects: regulatory policies on land use and rent controls have profound distributional implications, for example. Some frequently subnational functions—most notably health and public education—also affect distribution.

Infrastructure services are another area in which local government policies can have important redistributive effects, both progressive and regressive. Throughout the world, infrastructure services are one of the core areas of responsibility of local governments, an indication of the important role of this level of

1. Wallace E. Oates, *Fiscal Federalism* (New York: Harcourt Brace Jovanovich, 1972), pp. 6–8; R. A. Musgrave, *The Theory of Public Finance* (New York: McGraw-Hill, 1959).

government in attaining efficiency goals. One implication of such efficiency goals is that the appropriate method of paying for these utility and infrastructure services is by cost recovery through user fees, so that the price charged for these services reflects their value to consumers.

Departures from the user cost pricing principle are generally an unsuitable means of achieving other goals of government, such as the distributional objective of helping those with low incomes. For instance, subsidies for utility use always benefit those who are better off more than others, because utility use rises with income. Algeria's 1988 expenditure survey found that the richest 10 percent of households spent four times as much on subsidized urban transport as the poorest 10 percent. Subsidies on fuels and urban transport in Algeria were cited in the Bank's *World Development Report 1994* as an illustration of the regressive effects of infrastructure subsidies. Better targeted and more effective transfer instruments are available to help low-income groups.

There is some evidence that the formal assignment of distributional authority to a local government can work. In Switzerland, cantons have jurisdiction over health, education, and welfare services and have priority in levying taxes on personal income and wealth. In some nonfederal states such as Sweden, the constitution formally gives local governments the right to levy income taxes. In fact, many attribute the relatively large size of local governments in Scandinavian countries to their substantial responsibilities in distributional programs. In Denmark, for example, local governments account for over half of general government expenditures and about a third of gross national product, while social security and welfare payments account for more than half of these large local government budgets.[2] Local distributional functions are often substantially financed by local income tax rates that are piggybacked on broadly redistributive tax rates of the central government.

There is also plenty of evidence that subnational jurisdictions systematically incorporate their own particular distributional preferences into choices on spending decisions.[3] One study shows that monthly average benefits for Aid to Families with Dependent Children vary by a factor of five among U.S. states. Noting that such differences have persisted over long time periods, the study asserts that "decentralized redistribution is a fact of life that must be dealt with as a practical matter."

Reconciling theory and reality. Although debate on this subject continues, the traditional view that central governments have the major role to play in functions of income redistribution still prevails. Depending on how much a nation values equity, the central government will need to play a redistributive role to raise welfare for poor people in poor areas. Some of the most recent contributions to the literature, however, recognize that local preferences for redistribution do matter.

2. Giancarlo Pola, George France, and Rosella Levaggi, eds., *Developments in Local Government Finance: Theory and Policy* (Cheltenham, U.K.: Elgar, 1996), contains several essays on local governments' revenues and responsbilities in Scandinavian countries.

3. David E. Wildasin, "Income Distribution in a Common Labor Market," *American Economic Review* 81(1991):757–74.

And while the traditional idea that the central government should control or at least coordinate redistribution remains, there are some interesting new ideas for approaches which incorporate subnational levels. In particular, Wildasin argues that an optimal solution in multilevel systems of government is to provide grants that, because of differing subnational preferences for redistribution, are nonuniform by subnational jurisdiction, but lead to identical levels of transfer payments.[4] This researcher finds examples of behavior in multilevel systems of government that support the analysis and policy prescription.

Factor mobility, the largest theoretical constraint on subnational redistribution activities, may not be so large a concern in reality. First, while empirical studies broadly indicate that interregional factor flows are influenced by the potential for monetary gain, such flows are usually relatively small. Second, barriers to mobility may be significant. For example, in many of the countries in transition, labor mobility is limited because of lack of housing. Because housing is often the responsibility of local governments in these countries, local redistributional policies (or the absence thereof) acquire added importance.

A benefit of subnational redistribution. While the goal of reducing poverty is explicit in the objectives of the World Bank and much other public policy, such redistributional policies rest on value judgments that are not shared by all. Those who place greater priority on goals of individual freedoms and fear the arbitrary use of power see limits on the ability of predatory governments to carry out redistribution as important benefits of migration and federal structures of government.[5]

Interregional Transfers: An Often Overlooked Issue

Interregional redistribution has received less attention at the World Bank. A longstanding complaint in economic policy is that redistribution to poor regions may interfere with natural adjustment mechanisms such as outmigration that will otherwise rectify regional imbalances. Nevertheless, this view needs to be modified to take into account the important variation in net fiscal benefits from the fiscal activities of subnational governments.

Variation in net fiscal benefits. Variation in net fiscal benefits may arise for several reasons. Two of the most common are:

- **Residents with high per capita incomes—**Subnational governments whose residents have high per capita incomes may finance a given amount of public services with less tax effort (such as lower tax rates on income) than governments of poorer regions.

4. David E. Wildasin, "Income Distribution in a Common Labor Market," *American Economic Review* 81(1991):757–74.

5. Geoffrey Brennan and James M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (Cambridge, Mass.: Cambridge University Press, 1980); Charles E. McLure, Jr., "Tax Competition: Is What's Good for the Private Goose Good for the Public Gander?" *National Tax Journal* 39(1986):341–48.

- **Possession of or access to natural resources revenues—**The potential for income disparities from this source can be striking in some countries. The Tyumen oblast in Russia, for example, accounts for two-thirds of Russia's oil but only 2 percent of its population.

Efficiency arguments. The efficiency argument centers on the presumption of factor mobility. A classic example concerns fiscally induced migration, for example, if people relocate next to provincial oil wells simply to share in the jurisdiction's ownership rights. If such fiscally induced migration is significant, it would be in the interests of jurisdictions where such net fiscal benefits are substantial to make transfers to low-income jurisdictions so as to limit the amount of such migration. There would also be a net benefit to all in the nation because the real costs of migration would be avoided.

There is some doubt as to the significance of such efficiency losses, however. A study in Canada, for instance, calculated that there would have been a welfare gain of only $35 million from shifting billions of dollars around to equalize provincial government fiscal capacities, a proxy for net provincial benefits from subnational governments.[6] As a consequence, the equitable case for redistribution of net fiscal benefits arising from subnational government activities probably deserves more weight than that arising from their efficiency costs.

Equity arguments. The equity problem for a central government's tax and transfer system arises because of the horizontal equity goal of treating citizens alike no matter where they reside. The problem is that central government attempts to attain interpersonal equity are implemented through tax and transfer systems that deal only with the market or taxable incomes of individuals, but the net fiscal benefits from subnational government activity may lead to substantial differences in the real or comprehensive incomes of citizens in different areas. It is difficult to think of practical ways for a central government to deal with the fiscal benefits from subnational governments by adjusting its own personal taxes and transfers. It would be impractical and politically unacceptable to have different national personal income tax rates in different subnational jurisdictions, for instance, and such a policy would also override legitimate subnational redistribution policies. One practical solution is to undertake intergovernmental transfers to equalize subnational per capita fiscal capacities so as to make it financially possible to achieve horizontal equity goals.

Extent of equalization programs. This reasoning may help to explain why programs to equalize subnational per capita fiscal capacities are common throughout the world. Programs of equalizing state and provincial fiscal capacities may be more the rule than the exception in industrial countries with federal systems; they

6. William G. Watson, "An Estimate of the Welfare Gain from Fiscal Equalization," *Canadian Journal of Economics* 19(1986):298–308.

exist, for example, in Australia, Canada, Germany, and Switzerland. Programs to reduce tax-base disparities among local governments are also common in both unitary and federal systems. In developing countries, equalization is a factor in the general revenue sharing transfers to subnational governments that exist in such countries as Brazil, Chile, Colombia, India, Mexico, Morocco, Nigeria, and Pakistan. Economies in transition have also realized that revenue sharing based on the origin of revenues (the derivation principle) results in a very unequal distribution of subnational government resources. Several countries of the former Soviet Union, the largest in population (Russia) to the smallest (Estonia), as well as Hungary, Poland, and other Baltic countries, have instituted programs to reduce disparities in the per capita revenues of subnational governments.[7]

TRANSFERS BETWEEN SUBNATIONAL GOVERNMENTS. It may be inappropriate to finance such equalization transfers through central government revenues, if the revenues are raised from different sources than those received by subnational governments. The usual principles of tax assignment, whereby higher-level governments tax more mobile resources and local governments tax more immobile resources such as property, will automatically result in such differentiation of revenue sources by level of government. Another example is when subnational rather than national governments own natural resources that yield substantial revenues. This problem assumed serious proportions in Canada following oil price increases in the 1970s that raised the revenues of oil-producing provinces. The government of Canada was responsible for the equalization of provincial government fiscal capacities but did not have access to these oil revenues. In effect, redistribution of revenues to poorer provinces resulting from higher oil prices was being financed by transfers from federal taxation raised in the richer nonoil-producing provinces.

The straightforward method of dealing with this problem is for direct redistribution to take place between subnational governments, where equalization to the desired standard of fiscal capacity is financed by "have" subnational governments contributing to a revenue pool that is then redistributed to "have not" subnational governments. Two of the best-known examples are in the Federal Republic of Germany and Switzerland. There are also examples of voluntary direct transfers between local governments, as in the tax-base sharing among 201 municipalities in the Minneapolis-St. Paul area. Alternatively, some central governments require such equalization transfers to be undertaken between local governments, as in Denmark and Sweden. Chile also has a system of direct transfers from rich to poor municipalities.

Impact of Decentralization on Equity

Many nongovermental organizations (NGOs) and international donors encourage countries to decentralize because they believe it will lead to greater local participation, which will benefit communities, households, and particularly the poor.

7. For essays on equalization grants as well as other forms of transfers, see Ehtisham Ahmad, ed., *Financing Decentralized Expenditures: An International Comparison of Grants*, *Studies in Fiscal Federalism and State-Local Finance* (Cheltenham, U.K., and Lyme, N.H.: Elgar, 1997).

This is not necessarily the case. This will depend on how much emphasis the central and local governments place on redistribution, how the system of intergovernmental finance is designed, particularly transfers (see the sections on expenditure, revenue, and transfers) and the extent to which participation in local decisionmaking is truly broad-based (see the section on participation). Although evidence is scant, decentralization seems to be more "pro-poor" when undertaken at the local rather than intermediate level of government (see the section on safety nets). This permits funds to reach the poorer areas and encourages greater local accountability.

Macroeconomic Impact of Decentralization

The design of decentralization can significantly influence how the restructuring of decisionmaking and responsibility will affect a country's macroeconomic conditions. Some countries, including Brazil and China, experienced macroeconomic problems when tax bases were decentralized without a clear assignment of expenditures to the level of government that receives the revenues.[8] Others, including Argentina and Mexico, ran into problems, because subnational governments accrued unsustainable debts and had to be bailed out by the central government. Decentralization efforts in which governments solved their fiscal imbalances at the center by decentralizing expenditure responsibilities without the matching revenues left essential services unperformed and, in some cases, gave rise to unsustainable subnational deficits.

The design of intergovernmental fiscal relations needs to recognize the possibility of these negative effects. Most important, it must ensure a match between expenditure responsibilities and revenues at each level of government and create institutional mechanisms that will enforce a hard budget constraint between levels of government.

Subnational Incentives

Compared with central governments, subnational governments have less incentive to consider the macroeconomic impact of their policies. Such impacts tend to leak away to other jurisdictions, giving subnational macroeconomic stability policies public goods characteristics. Central governments are therefore usually assigned the task of maintaining stability, and they should have the tools to go with it, such as control over monetary policy and at least some control over fiscal conditions. That includes a share of revenues and expenditures sufficiently large and sufficiently flexible to influence aggregate demand in a country. However, whether intended or not, subnational policies can influence stability: even balanced-budget spending increases by subnational governments can affect macroeconomic stability, and subnational borrowing can become a major macroeconomic concern. Yet because macroeconomic shocks can hit different jurisdictions differently, some subnational influence on macroeconomic conditions is actually desirable. Finally, centralizing all expenditures and revenues with a potential macroeconomic impact may have excessive efficiency costs.

Structuring Intergovernmental Fiscal Relations to Enhance Stability

REVENUE ASSIGNMENT AND TAX SHARING. Subnational governments should have a fairly stable tax base, because highly income-elastic tax bases (such as the value-added tax (VAT) and progressive income taxes) can induce procyclical government expenditures that aggravate macroeconomic imbalances. Central governments have tended to be more responsible in this respect. Moreover, taxes such as the VAT and income tax lend themselves well for use as macroeconomic policy tools (increasing rates to cool down an overheating economy, for example).

8. William Dillinger, "Brazil's State Debt Crisis: Lessons Learned," Economic Notes 14, Country Department 1, Latin America and the Caribbean (Washington, D.C.: World Bank, 1997).

Expenditure assignments. Although its discussion of this topic is limited, the public finance literature usually recommends assigning sufficiently stable expenditures to subnational governments. For instance, many analysts argue that social security is better assigned to the national level because of its procyclical nature. See the section on expenditure assignment.

Incentives, however, may moderate this standard conclusion. For instance, while assigning unemployment compensation to central government may create an "automatic stabilizer," it also takes away the incentive for subnational governments to hold down unemployment expenditures by, for instance, following a proactive employment policy. Thus the centralization of social security may actually increase macroeconomic imbalances, while making local governments responsible for a part of these highly cyclical expenditures may reduce instability.

Grants. Macroeconomic considerations—as well as tax administration and equity considerations—are likely to give central government the larger part of revenues but not necessarily expenditures. Thus, a system of grants will be needed to fill the vertical imbalances. Although efficiency and equity considerations are likely to dominate the process of grant design, several features could be beneficial to macroeconomic stability. See the note on intergovernmental transfers and grants.

- Grants should be designed to fill the ex ante gap between subnational revenues and expenditures. Filling ex post gaps could give rise to excessive expenditures at the local level, as central government will foot part of the bill.
- The size of the grant pool should be fairly independent of macroeconomic conditions, to avoid the procyclical spending patterns noted earlier. Having a broad revenue base that feeds the grant pool is therefore to be preferred over single-tax-based grants.
- Central government needs some discretion to adjust the amount of grants transferred. Although this is often impossible for general grants mechanisms, which are usually based in law, special-purpose grants offer more flexibility. Their expenditure effects can even be leveraged, if the grants require subnational matching.

Subnational borrowing. Subnational borrowing can have a significant effect on macroeconomic conditions in a country. Countries such as Brazil and Mexico saw their restrictive central fiscal policies of the early 1990s undermined by subnational deficits (either open or hidden), resulting in the end in a bailout by the national government. However, intertemporal efficiency speaks strongly for allowing subnational governments at least some access to borrowing. Countries have therefore taken a number of approaches in allowing subnational borrowing. See the section on subnational borrowing.

Reliance on market discipline to limit borrowing requires that several strict conditions be fulfilled, among them open capital markets, adequate information, responsiveness of the borrower to market signals, and a strict no-bailout policy by the central government. Except for some federal countries (the United States and Canada, for example), few countries rely solely on market discipline.

A number of countries (Germany, Switzerland, Spain, the Republic of Korea) rely on legally binding rules to restrict borrowing. Some have used the golden rule of allowing borrowing only for investment purposes. Others use rules that restrict borrowing to some indicator of debt-servicing capacity.

Some countries directly control subnational borrowing by setting overall limits, approving individual debenture issues, or allowing borrowing only through a centrally controlled municipal bank. Local governments have ways to circumvent these regulations, including reclassifying expenditures from current to capital, running arrears, creating off-budget activities, and using state enterprises for borrowing or providing guarantees for enterprise borrowing. Thus, any rule should have sufficient incentives and controls to enforce it.

COORDINATION MECHANISMS. In recognition of the influence of subnational governments on stability, several countries have designed intergovernmental macroeconomic coordination mechanisms. Germany, which probably has the most elaborate one, coordinates expenditure and borrowing plans within the context of the Stabilitaetsgesetz (stability law). The five-year fiscal plan is discussed and coordinated with the states before submission to parliament. In Australia, the Loan Council now coordinates the borrowing requirements of the national and subnational public sector, after previously serving as a forum to limit subnational borrowing. In China, the annual planning and finance conference is used to discuss and coordinate the plans of each level of government. And many countries have informal coordination mechanisms, either through state or provincial representation in a house of parliament or through special subcommittees of parliament. Whether or not coordination without binding rules actually delivers better results is an open question.

Regulating Incentives by Design

In designing intergovernmental fiscal relations, the incentive effects on macroeconomic stability should be explicitly considered. Large vertical imbalances in favor of national governments are likely to lead to ex post gap filling by national governments, bailouts of subnational debt, or circumvention of national policies on taxes or debt. Large imbalances in favor of subnational governments, on the other hand, could lead to large national debts and to insufficient fiscal discipline at subnational levels. Little tax autonomy of subnational governments reduces the incentive to behave responsibly, because they cannot be required to increase taxes to restore balance on the budget. Thus, other things equal, a broad matching of expenditure and revenue responsibilities, together with an explicit responsibility for each level of government to live within its means and the autonomy to do so, is desirable.

Rules for budget management for subnational governments could address many of the detrimental macroeconomic effects of decentralization. As long as subnational governments are held to responsible management—including limits on deficit spending—and provided the means and incentives to actually do so, the macroeconomic impact of their actions can be limited. Having harsh measures for use by the central government in dealing with fiscal irresponsibility could help, such as bankruptcy procedures for local governments in New Zealand. Transparent fiscal accounts that are regularly published and audited can add to discipline. Also, in the end, one of the best incentives for responsible behavior is likely to be the pressure from an electorate that would suffer from a fiscal crisis.

Decentralization and Economic Growth

We know very little about the relationship between decentralization and growth. Empirical evidence for the way in which decentralization affects growth has been contradictory and has had problems with measurement, specification, and analysis. There is stronger evidence for a relationship in the other direction—from growth to decentralization—but the interpretations of this correlation between high income and decentralization have varied.

Decentralization and Growth: The Empirics

The few empirical studies that have directly examined the relationship between decentralization and growth come up with mixed results. Zhang and Zou show that decentralization has a positive and sometimes significant effect on regional economic growth in India. Their work on China and Davoodi, Xie, and Zou's unpublished work on the United States, however, find fiscal decentralization to be associated with lower growth. In a larger sample of developed and developing countries, Davoodi and Zou found that decentralization has a negative relationship to growth in developing countries and no discernible effect on growth in developed countries. Several methodological problems in these studies discount even these mixed results and much more needs to be done to ensure that the measured decentralization-growth relationship is robust.[9]

In the absence of strong, unambiguous empirical evidence, researchers have put forward three hypotheses about the relationship between decentralization and growth. In each hypothesis, growth has only a secondary relationship to decentralization, and the nature of the connection, whether growth-enhancing, growth-impeding, or growth-requiring, depends on what are considered to be the primary effects of decentralization. These primary effects, in turn, have much to do with the specific design of decentralization policy.

While other decentralization notes discuss the methods for reaching certain primary effects, ideally, more efficient, responsive delivery of services, this section outlines the ways in which the commonly discussed primary effects of decentralization can shape decentralization's effect on growth and desirability in developing countries. Three alternative hypotheses for how decentralization can indirectly affect growth are presented in the following paragraphs.

HYPOTHESIS 1—DECENTRALIZATION INCREASES ECONOMIC EFFICIENCY IN PUBLIC SPENDING; THEREFORE ITS DYNAMIC EFFECTS SHOULD BE GROWTH-ENHANCING. Local governments'

9. See Tao Zhang and Heng-fu Zou, "Fiscal Decentralization, Public Spending, and Economic Growth in China," *Journal of Public Economics* 67:2(1997):221–40; H. Davoodi, D. Xie, and H. Zou, "Fiscal Decentralization and Economic Growth in the United States," 1995 (unpublished); T. Zhang and H. Zou, "Fiscal Decentralization and Economic Growth: A Cross-Country Study," *Journal of Urban Economics* 43(1996). A critical summary of the evidence is available in J. Martinez-Vazquez and R. McNab, "Fiscal Decentralization, Economic Growth, and Democratic Governance," paper prepared for the U.S. Agency for International Development Conference on Economic Growth and Democratic Governance, Washington, D.C., October 9–10, 1997.

information advantage allows them to respond better than central governments to constituents' preferences. Central governments would have to invest far more resources to obtain the same information. Although constituents' preferences do not always serve as a guide for productive investment, they can be useful as reviews of program design and as guidelines for expenditure allocation.

Citizens in decentralized systems are able to move across jurisdictions to settle where the available package of public goods matches their preferences. High mobility may force subnational governments to be more competitive, thus more efficient and possibly innovative, in providing services.

It is an intuitive leap from these stylized effects to the dynamic effect of increasing growth. Several studies of public expenditure and growth show that certain kinds of public expenditure have more significant growth-enhancing effects than others. Decentralization might improve the quality of proven growth-enhancing inputs such as education.

HYPOTHESIS 2—DECENTRALIZATION CAN LEAD TO MACROECONOMIC INSTABILITY, WHICH CAN INHIBIT GROWTH. Three arguments underlie this hypothesis. First, decentralization reduces the tax and expenditure base that the central government can use to carry out its stabilization function. Subnational governments are incapable of taking over this national macroeconomic stabilization because the borders of their individual jurisdictions are open to migration of people and goods. The practical importance of this effect, however, depends on the extent to which the central government actually uses these bases for stabilization.

Second, poorly designed decentralization policies can create incentives for subnational governments to spend irresponsibly and unsustainably. A hard budget constraint between levels of government is essential. Loosely defined, unpredictable transfer arrangements can lead to fluctuating and unsustainable subnational government spending, particularly in cases where the fiscal gap can be filled by subnational borrowing. Policymakers should explicitly consider ways to create or reinforce institutions and incentive structures that prevent worst-case scenarios such as deficit-increasing central government bailouts.[10]

And third, decentralization of revenues and expenditures to subnational governments can take scarce resources away from national projects, such as infrastructure, that could make greater contributions to growth.

The evidence concerning decentralization's destabilizing effect is mixed, however.[11] Research in China and Russia has clearly linked subnational government

10. David Wildasin, "Externalities and Bailouts: Hard and Soft Budget Constraints in Intergovernmental Fiscal Relations," Policy Research Working Paper 1843 (Washington, D.C.: World Bank Development Research Group, 1997), discusses the incentives operating at various levels of government.

11. For further discussion of these themes and examples, see the note on macroeconomic stability; Charles McClure, "Comment on Prud'homme," *World Bank Research Observer* 10(1995):221–26; Remy Prud'homme, "On the Dangers of Decentralization," *World Bank Economic Review* 9(1995); David O. Sewell, "The Dangers of Decentralization According to Prud'homme: Some Further Aspects," *World Bank Research Observer* 11:1(1996):143–50; Vito

autonomy to growing central government deficits, but these cases may not be generalizable because of their unique system of using local governments to collect central government revenue. Other, more typical subnational governments in Argentina and Brazil have followed the destabilizing path of expanding expenditures beyond revenues and then turning to the central government for bailouts or debt relief.[12] Switzerland, on the other hand, has been both highly decentralized and highly stable in the post-war period. Research on Canada has shown that increasing subnational governments' budgets may have actually had a stabilizing effect. Subnational governments have coordinated spending and may be better able to offset region-specific business cycles.

HYPOTHESIS 3—DEVELOPING COUNTRIES HAVE SIGNIFICANTLY DIFFERENT INSTITUTIONAL AND ECONOMIC ENVIRONMENTS THAN DO INDUSTRIAL COUNTRIES AND WILL NOT REAP THE BENEFITS OR SUFFER THE CONSEQUENCES OF DECENTRALIZATION IN THE SAME WAYS.[13] Institutional arrangements in developing countries do not necessarily give subnational governments the incentive to use their information advantage in responding to their constituents. Leaders may be appointed or elected on the basis of their social standing. Further, subnational governments in developing countries may not have the economic resources to attract sufficiently trained people or the human resources to manage larger budgets. The decentralization of Peru's water supply and sanitation sector, for example, reportedly reduced the quality of service because local governments did not have the technical ability to maintain or plan infrastructure. Nevertheless, Colombia's success in decentralizing some services suggests that these ability constraints can be overcome by private-public partnerships.[14]

Conclusion: Design Matters

There is no clear, automatic relationship between decentralization and growth. Direct empirical studies have not been satisfying, and a return to the literature on decentralization's primary effects may be a more useful way to think about the relationship between growth and decentralization. From this point of view, the design of decentralization becomes the key factor in determining whether policies will lead to the efficiency linked to higher growth, exacerbate the deficits and instability connected to lower growth, or simply become mired in institutional constraints.

Tanzi, "Fiscal Federalism and Decentralization: A Review of Some Efficiency and Macroeconomic Aspects," in *Proceedings of the Annual Bank Conference on Development Economics 1995*, (Washington, D.C.: World Bank, 1995).

12. William Dillinger, "Brazil's State Debt Crisis: Lessons Learned," Economic Notes 14, Country Department 1, Latin America and the Caribbean (Washington, D.C.: World Bank, 1997).

13. This hypothesis is particularly associated with Roy Bahl and Johannes Linn, "Fiscal Decentralization and Intergovernmental Transfers in Less Developed Countries," *Publius: The Journal of Federalism* 24(Winter 1994):1–19.

14. Ariel Fiszbein, "Emergence of Local Capacity: Lessons from Colombia," *World Development* 25:7(1997):1029–43.

Accountability, Transparency, and Corruption in Decentralized Systems

Decentralization, in its democratic political aspect, has two principal components: participation and accountability. Participation is concerned chiefly with increasing the role of citizens in choosing their local leaders and in telling those leaders what to do—in other words, providing inputs into local governance. Accountability is the other side of the process; it is the degree to which local governments have to explain or justify what they have done or failed to do. Improved information about local needs and preferences is one of the theoretical advantages of decentralization, but there is no guarantee that leaders will actually act on these preferences unless they feel some sort of accountability to citizens. Local elections are the most common and powerful form of accountability, but other mechanisms such as citizen councils can have limited influence.

Accountability can be seen as the validation of participation. The test of whether increased participation is worthwhile is if people can use the participatory channels to hold a local government responsible for its actions.

Types of Accountability

Accountability comes in two dimensions: accountability of government workers to elected officials and accountability of the elected officials to the citizens who elect them.

GOVERNMENT WORKERS TO LOCAL OFFICIALS. The first type of accountability can prove difficult to achieve since civil servants, particularly professionals in such fields as health, education, and agriculture—the very sectors that are most commonly decentralized—often have considerable incentive to evade control by locally elected officials. Such people generally have university training and sophisticated lifestyle practices that are hard to maintain in small towns and villages, career ambitions that transcend the local level, and goals for their children's education that local schools cannot meet. They may also well fear that quality standards for service delivery will suffer if provision is localized. Finally, they often find opportunities for corruption are greater if they are supervised by distant managers through long chains of command than if they must report to superiors close at hand. For all these reasons, they tend to prefer strongly maintaining ties with their parent ministries in the central government and resisting decentralization initiatives. And understandably, their colleagues at the center have a parallel interest in maintaining these ties, for they are much concerned about preserving national standards in service delivery and often about avoiding opportunities for venality (many corruption schemes provide for sharing ill-gotten gains upward through bureaucratic channels to the top). See the section on the civil service for more about this subject.

Given all these reasons both good and bad for opposition, it is scarcely surprising that decentralization initiatives so often run into heavy bureaucratic resistance and that designers find themselves pressured to keep significant linkages between the field and the central ministries, especially concerning such issues as postings, promotions, and salaries. Needless to say, such ties tend to undercut the capacity of elected officials to supervise government servants who are supposedly working for them. Some decentralized governance systems (for example, Karnataka State in India) appear to have worked through these problems to establish popular control over the bureaucracy, but it has taken many years to do so.

Elected leaders to the citizenry. The second type of accountability is that of elected officials to the citizenry. Elections (provided they are free and fair) provide the most obvious accountability, but this is a rather blunt tool, exercised only at widespread intervals and offering only the broadest citizen control over government. Voters can retain or reject their governors, a decision that can certainly have salutary effects on governance, but these acts are summary judgments, generally not reactions to particular acts or omissions. And when local elections do revolve around a given issue, such as schools, they necessarily leave everything else out of the picture. Citizens need more discriminating instruments to enforce accountability. Fortunately, a number of these are available:

- Political parties can be a powerful tool for accountability when they are established and vigorous at the local level, as in many Latin American countries. They have a built-in incentive to uncover and publicize wrongdoing by the party in power and to continuously present an alternative set of public policies to the voters.
- Civil society and its precursor social capital enable citizens to articulate their reaction to local government and to lobby officials to be responsive. These representations generally come through NGOs (though spontaneous protests can also be considered civil society), which, like political parties, often have parent organizations at the provincial or national level.
- If citizens are to hold their government accountable, they must be able to find out what it is doing. At the immediate neighborhood level, word of mouth is perhaps sufficient for transmitting such information, but at any higher level some form of media becomes essential. In some countries, print media can perform this function, but generally their coverage is minimal outside larger population centers. A feasible substitute in many settings is low-wattage AM radio, which is highly local, cheap to operate, and can offer news and talk shows addressing local issues.
- Public meetings can be an effective mechanism for encouraging citizens to express their views and obliging public officials to answer them. The *cabildos abiertos* held in many Latin American countries are a good example. In some settings, such meetings may be little more than briefing sessions, but in others they can be effective in getting public officials to defend their actions. Participatory budgeting processes are also a powerful channel for communicating citizen preferences to local decisionmakers.
- Formal redress procedures have been included as an accountability mechanism in some decentralization initiatives. Bolivia probably has the most elaborate instrument along these lines with its municipal vigilance committees, which

are based on traditional local social structures, charged with monitoring elected councils, and encouraged to file actionable complaints with higher levels if needed. In other systems, formal recall procedures are available to citizens dissatisfied with their officials.

- Opinion surveys have generally been considered too complex and sophisticated to use at the local level, but usable and affordable technologies are being developed in the Philippines, enabling local NGOs through polls to assess public opinion about service provision.

A recent U.S. Agency for International Development assessment of democratic local governance in six countries found that each country employed a different mix of these mechanisms, while no country employed them all. No one instrument proved effective in all six settings, but various combinations offered considerable promise. Some of these instruments may be able to substitute at least in part for others that are weak or absent. Civil society and the media, for example, might together be able to make up for a feeble party system at the local level.

Transparency and Corruption

In theory transparency and corruption should be inversely related, such that more transparency in local governance should mean less scope for corruption, since dishonest behavior would become more easily detectable, punished, and discouraged in the future. The history of industrialized countries indicates that this tends to be true in the longer term, but recent experience shows that this relationship is not necessarily true at all in the short run. In the countries of the former Soviet Union, for example, local governance institutions have become much more open to public scrutiny in the 1990s, but at the same time there can be little doubt that corruption at all levels has increased greatly. It is to be hoped that the local mechanisms of accountability discussed here will in tandem with greater probity at the national level improve the degree of honesty at all levels, but at best this will take time. The message for the international development community is to press forward with as many of these accountability mechanisms as is feasible.

Manor notes a second type of linkage between transparency and corruption. He found that in India, greater transparency in local governance was not accompanied by increased corruption, but it did lead to popular perceptions of greater public malfeasance, simply because citizens became more aware of what was going on.[15] This pattern has surely repeated itself in many other locales. Over time, to the extent that accountability mechanisms begin to become effective and corruption begins to decline, the citizenry should appreciate the improvement.

Conclusion: Slow but Sure Progress

The democratic local governance initiatives currently underway in many countries hold much promise for developing effective systems of public accountability that

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15. James Manor, "Democratic Decentralization in Africa and Asia," *IDS Bulletin* 26:2(1995):81–88.

will ensure that government servants are responsible to elected officials, and that officials are in turn responsible to the public that elected them. In the process these systems of accountability should increase the pressure for more transparent local governance, in which corruption will be easier to bring to light and thus to curtail. But just as it took many decades for such efforts to make much headway in the industrial countries, so too quick results cannot be expected elsewhere.