

# **Decentralization of Governance and Development<sup>1</sup>**

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<sup>1</sup> I am grateful to Brad de Long, Timothy Taylor and Michael Waldman for editorial suggestions and to Dilip Mookherjee for substantive discussion (and joint research) on issues relating to this paper.

## **Abstract**

In this paper we note that the institutional context (and therefore the structure of incentives and organization) in developing and transition economies is quite different from those in advanced industrial economies, and this necessitates the literature on decentralization in the context of development to go beyond the traditional fiscal federalism literature. We review some of the existing theoretical work and empirical case studies of decentralization from the point of view of delivery of public services and of conditions for local business development, and point to ways of going forward in research.

All around the world in matters of governance decentralization is the rage. Even apart from the widely debated issues of subsidiarity and devolution in the European Union and states' rights in the U.S., it has been at the center stage of policy experiments in the last two decades in a large number of developing and transition economies in Latin America, Africa and Asia. The World Bank, for example, has embraced it as one of the major governance reforms on its agenda (many of the World Development Reports of recent years as well as other Bank documents<sup>2</sup> give the matter a great deal of prominence). If one takes just the two largest countries of the world, China and India, decentralization has been regarded as the major institutional framework for the phenomenal industrial growth in the last two decades in China (taking place largely in the non-state non-private sector); and India ushered in a fundamental constitutional reform in favor of decentralization around the same time it launched a major program of economic reform.

On account of its many failures, the centralized state everywhere has lost a great deal of legitimacy and decentralization is widely believed to promise a range of benefits. It is often suggested as a way of reducing the role of the state in general, by fragmenting central authority and introducing more inter-governmental competition and checks and balances. It is viewed as a way to make government more responsive and efficient. Technological changes have also made it somewhat easier than before to provide public services (like electricity and water supply) relatively efficiently in smaller market areas, and the lower levels of government have now a greater ability to handle certain tasks. In a world of rampant ethnic conflicts and separatist movements, decentralization is also regarded as a way of diffusing social and political tensions and ensuring local cultural and political autonomy.

These potential benefits of decentralization have attracted a very diverse range of supporters. For example, free-market economists tend to emphasize the benefits of reducing the power of the

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<sup>2</sup> See for example, World Bank (1999), World Bank (2000).

overextended or predatory state. In some international organizations pushing structural adjustment and transitional reform decentralization has sometimes been used almost as a synonym for privatization; similarly, in the literature on mechanism design an informationally decentralized system of individual decisions coordinated by a price mechanism is pitted against a system of central commands and plans. Even those who are still convinced of the pervasiveness of market failures are increasingly turning for their resolution to the government at the local level, where the transaction costs are relatively low and the information problems that can contribute to central government failures are less acute. They are joined by a diverse array of social thinkers: post-modernists, multicultural advocates, grassroots environmental activists and supporters of the cause of indigenous peoples and technologies. In the absence of a better unifying name, I would describe this latter group as “anarcho-communitarians”. They are usually both anti-market and anti-centralized state, and they energetically support assignment of control to local self-governing communities.

As is usually the case when a subject draws advocates from sharply different viewpoints, different people mean different things by decentralization. But in this paper, we shall focus on a particular kind of decentralization in developing (and transition) economies, the devolution of political decision-making power to local-level small-scale entities. In countries with a long history of centralized control (as in the old empire-states of Russia, China or India) public administrators often mean by decentralization the dispersion of some responsibilities to regional branch offices at the local level of implementation on a particular project. For the purpose of discussion in this paper we shall distinguish decentralization in the sense of devolution of political decision-making power from such mere administrative delegation of functions of the central government to their local branches. We should also separate the political and administrative aspects of decentralization from those of fiscal decentralization, and in the latter, the more

numerous cases of decentralization of public expenditure from those involving decentralization of both tax and expenditure assignments. We shall include cases where local community organizations get formally involved in the implementation of some centrally directed or funded projects. Not all these aspects of decentralization operate simultaneously in any particular case and it is quite possible that a given economy may be de-centralized in some respects, not in others. It should also be clear that the effects of a policy of deliberate decentralization--which is our concern here--can be qualitatively different from those following from an anarchic erosion of central control (either due to the collapse of the state, as has happened in some countries in Africa, or lack of administrative or fiscal capacity on the part of the central authority leading to abandonment of social protection functions, as has happened in some transition economies).

The territorial domain of sub-national governments, of course, varies enormously from country to country. A typical province in India or China is larger (in size of population) than most countries in the world, and so federalism in the sense of devolution of power to the provincial state governments may still keep power over people pretty centralized. Unfortunately, data below the provincial government level are often very scarce, and most quantitative studies of decentralization (for example, those based on share of the central government in total expenditure or revenues) do not pertain to the issues at the local community level (even apart from the fact that the share of expenditure or revenues is not a good index of decision-making authority). Even at the latter level the units are diverse (ranging from megacities to small villages) and the boundaries are often determined by accidents of history and geography, not by concerns of decentralization of administration. In this paper we shall in general confine the analytical focus of decentralization to the governing authority at the local community level (say, village, municipality or county levels of administration).

Our discussion in the rest of the paper begins with a description of why decentralization poses some different issues in the institutional context of developing (and transition) countries, and thus why it may sometimes be hazardous to draw lessons for them from, say, the experiences of U.S. states and city governments. We try to give the flavor of some new theoretical models that extend the discussion to political agency problems that may resonate more in the context of developing and transition economies. We then refer to some of the ongoing empirical work in evaluating the impact of decentralization on delivery of public services and local business development.

Decentralization has undoubted merits and strengths. However, the idea of decentralization may need some protection against its own enthusiasts, both from free-market advocates who see it as an opportunity to cripple the state and from those anarcho-communitarians who ignore the “community failures” that may be as serious as the market failures or government failures that economists commonly analyze.

### **Departures from the Fiscal Federalism Literature**

There is a large literature on decentralization, often referred to as “fiscal federalism,” mostly relating to the case of the United States.<sup>3</sup> The principles discussed in this literature have been fruitfully applied to the national-provincial relations in developing countries like Argentina, Brazil, Colombia, South Africa, India or China, but in this paper we shall go beyond this and stress the special issues that arise in decentralization in developing (and transition) economies primarily because the institutional context (and

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<sup>3</sup> Many of the issues have been well surveyed in the *JEP* “Symposium on Fiscal Federalism” in the Fall 1997 issue.

therefore the structure of incentives and organization) are in some respects qualitatively different from that in the classical US case (or the recent case of the European Union).

Much of the fiscal federalism literature focuses on the economic efficiency of inter-governmental competition, which often starts with a market metaphor that is rationalized by the well-worn Tiebout (1956) model. In this approach, different local governments offer different public tax-expenditure bundles and mobile individuals are supposed to allocate themselves according to their preferences. The assumptions required for the Tiebout model are, however, much too stringent, particularly for poor countries.<sup>4</sup> The crucial assumption of population mobility (fully informed citizens 'voting with their feet' in response to differential public performance) that enables governments in the Tiebout framework to overcome the well-known problem of inducing citizens to reveal their preferences for public goods largely fails in poor countries. In any case many of the public goods in question are community--and site--specific and it is often possible to exclude non-residents. Rural communities of poor countries, in particular, are often face-to-face, and social norms sharply distinguish 'outsiders' from 'insiders', especially with respect to entitlement to community services.

Secondly, the information and accounting systems and mechanisms of monitoring public bureaucrats are much weaker in low-income countries. In the standard literature on decentralization and "fiscal federalism," the focus is on allocation of funds and it is implicitly assumed that allocated funds automatically reach their intended beneficiaries. This assumption needs to be drastically qualified in developing countries, where attention must be paid to special incentives and devices to check

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<sup>4</sup> There are doubts about just how the Tiebout mechanism operates even in relatively mobile societies like that of the United States. For instance, very few poor people move from state to state in search of higher welfare benefits (Hanson and Hartman, 1994).

bureaucratic corruption--and thus the differential efficacy of such mechanisms under centralization and decentralization.

Third, even in the relatively few democratic developing countries the institutions of local democracy and mechanisms of political accountability are often weak. Thus, any discussion of delivery of public services has to grapple with issues of capture of governments at different tiers by elite groups more seriously than is the custom in the traditional decentralization literature.

Fourth, the traditional literature on decentralization, even though not impervious to issues of distribution, is usually preoccupied with those of efficiency in public provision. When a major goal of decentralization in developing countries is to effectively reach out to the poor (or to diffuse unrest among disadvantaged minority groups), often in remote backward areas, targeting success in poverty alleviation programs is a more important performance criterion than the efficiency of inter-regional resource allocation. In the traditional discussion of decentralization and federalism, the focus is on checks and balances, on how to restrain the central government's power, whereas in many situations in developing countries the poor and the minorities, oppressed by the local power groups, may be looking to the central state for protection and relief. Stepan (forthcoming) has made a useful distinction between "coming-together federalism" like the United States, where previously sovereign polities gave up part of their sovereignty for to efficiency gains from resource pooling and a common market, and "holding-together federalism" like the multi-national democracies of India, Belgium and Spain, where the emphasis is on redistributive or compensating transfers to keep the contending polities together. In heterogeneous societies, such redistributive pressures sometimes lead fiscal decentralization to allow for state and local borrowing that may be large enough to cause problems of macroeconomic stabilization, as has happened



in South Africa, Brazil and Argentina.<sup>5</sup> Not all state-mandated redistribution, however, is inflationary or unproductive rent-creation, as is usually presumed in the traditional literature. Some redistribution to disadvantaged groups or regions (say in the form of decentralized delivery of health, education or infrastructural services) need not be at the expense of efficiency, and may even improve the potential for productive investment, innovation, and human resource development on the part of communities long bypassed by the elite or the mainstream.

Fifth, the fiscal federalism literature typically assumes that lower levels of government both collect taxes and spend funds, so localities can be classified as low-tax/low-service or high tax/high-service. This connection between local revenues and spending is rather tenuous. In most countries, much of the more elastic (and progressive) sources of tax revenue lie with the central government, and there is a built-in tendency toward vertical fiscal imbalance. Income is often geographically concentrated, both because of agglomeration economies and initial endowments of natural resources and infrastructural facilities. Thus, certain local areas will find it much easier to raise significant tax revenue than others. In addition, there are limits to interregional tax competition. In many low-income countries, the decentralization issues discussed there are primarily about providing centrally collected tax revenue to lower levels of government, rather than seeking to empower lower levels of government to collect taxes. The focus is on public expenditure assignments, unaccompanied by any significant financial devolution.

Sixth, the decentralization literature typically assumes that different levels of government all have similar levels of technical and administrative capacity. This assumption is questionable for all countries. On

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<sup>5</sup> This paper will not have much to say on the impact of decentralization on macroeconomic stabilization. For a game-theoretic model of how decentralization or local democratization may increase the level of central redistribution to prevent spirals of regional revolt and how the macroeconomic consequences depend on the initial levels of cultural division and decentralization, see Treisman (1999).

account of agglomeration economies in attracting qualified people, in most countries central bureaucracies attract better talent. But the problem is especially severe in many developing countries, where the quality of staff in local bureaucracies--including basic tasks like accounting and record keeping--is very low. Even their more professional and technical people suffer from the disadvantages of isolation, poor training and low interaction with other professionals. As Bird (1995) puts it, information asymmetry thus works both ways: the central government may not know *what* to do, the local government may not know *how* to do it.<sup>6</sup> Of course, this problem is of differential importance in different services. Providing for street cleaning or garbage collection may not require sophisticated expertise, but power production and transmission, bulk supply of clean water and public sanitation do. Decentralization to the local level will often work better in the former kind of services than the latter.

In our subsequent discussion we shall consider the issues of decentralization in developing countries, keeping in mind these points of difference with the traditional literature.

### **Adapting the Theory of Decentralization for Developing Countries**

The conventional wisdom in the fiscal federalism literature, as in Oates (1972), is that decentralization is to be preferred when tastes are heterogeneous and there are no spillovers across jurisdictions. With spillovers and no heterogeneity a central government providing a common level of public goods and services for all localities is more efficient; with spillovers decentralization leads to underprovision of local public goods, as local decision-makers do not take into account benefits going to other districts. The

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<sup>6</sup> Occasionally, however, the local people come up with ingenious low-cost solutions, whereas centralized systems use unnecessarily expensive services of specialized technicians. For some of the basic needs for poor people, local youths with some minimum training as primary health workers or primary school teachers can be adequate. In other, more technical, projects there is a lot of scope for improving access to engineering, project design and skills. Organizations like

issue of spillovers is relevant to investment in highway transport and communication, public research and extension, controlling pollution or epidemics, etc.

It is less relevant when the public goods are more local, as in local roads or minor irrigation, village health clinics and sanitation, identification of beneficiaries of public transfer programs, etc.

Centralization can also exploit economies of scale better in the construction of overhead facilities, but these economies of scale are less important in local management and maintenance. In a canal irrigation system, for example the one in South Korea described by Wade (1997), construction was in the hands of central authority, but maintenance was devolved to local communities. Similarly, in primary education while the local government may run the day-to-day functioning of schools, the upper-tier government can have the economies of scale in designing curricula and prescribing and enforcing minimum quality standards. In the public delivery of electricity economies of scale in generation and transmission may be the responsibility of centralized power plants and grids, while the distribution may be decentralized to local governments.

The traditional theory of fiscal federalism is now being extended to a political economy setting, with the introduction of transaction costs in the political markets, or political agency problems between the ruler and the ruled, between the politicians/bureaucrats and the electorate, and for reasons mentioned above these transaction and agency costs may be much more serious in the context of developing countries. It is usually argued that the local government has an information advantage over the upper-tier governments. But it may be asked why a central government cannot procure for itself the same information advantage of proximity through local agents. In some countries the central government uses such representatives at

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AGETIP in Africa or the Brazil-based IBAM have in recent years been helpful in developing

the local level (like the *préfets* in France and Italy or the *intendentes* in Chile) for this purpose. It may even be argued that the central government can have economies of scope in the collection of information. But the main reason why in practice the local government still retains the informational advantage has to do with political accountability. In democratic countries the local politicians may have more incentive to use local information than national or provincial politicians, since the former are answerable to the local electorate while the latter have wider constituencies (where the local issues may get diluted).

Focusing on accountability, rather than information per se, leads to thinking about how the public can monitor and affect elected officials at different levels of government. Seabright (1996) discusses the problem of political accountability theoretically in terms of allocation of control rights in the context of incomplete contracts, where breaches of contract are observable -- though not verifiable in administrative or judicial review -- and are subject to periodic electoral review. His model has both central and local elected officials. In his framework, centralization allows benefits from policy coordination, which is especially important if there are spillovers across jurisdictions. However, centralization has costs in terms of diminished accountability, in the sense of reduced probability that the welfare of a given locality can determine the re-election of the government. Elections are, of course, extremely blunt instruments of political accountability, and other institutional devices and unelected community organizations (like NGO's) may be deployed to strengthen local accountability.

The mechanism of accountability may also be strengthened by “yardstick competition,” where jurisdictions are compared to each other.<sup>7</sup> The effort or competence of public officials is not directly observable by citizens, and if poor results occur, public officials can always plead that they did the best

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local technical capacity.

<sup>7</sup> See, for example, Besley and Case (1995)

that was possible under the circumstances. However, if the shocks that create a wedge between effort and outcomes are correlated across jurisdictions, then yardstick competition can act as an indicator of relative effort on the part of agents. As Seabright (1996) points out, this argument of yardstick competition under decentralization, which may help voters to know whether they should seek to replace their governments, is to be distinguished from his own argument that decentralization may increase their ability to do so.

The combination of decentralization and yardstick competition allows the possibility of experimentation in the way a given public service is provided, and then demonstration and learning from others jurisdictions. In China in the early years of its market reforms, decentralization with jurisdictional competition allowed some coastal areas to experiment with institutional reform, the success of which showed the way for the rest of the country. Economic historians have pointed to the fragmentation and decentralization in early modern Europe – sometimes called “parcellized sovereignty”<sup>8</sup> -- as a source of strength, in enabling experimentation and competition, leading to technological and institutional innovations that helped Europe to ultimately overtake the more centralized empire-states of Asia.

Tommasi and Weinschelbaum (1999) pose the political agency problem in terms of the number of principals (relative to agents) in comparing centralization and decentralization. Citizens are viewed as principals and their elected representatives as agents. The local government has better means (in the form of information) to be responsive, also better (electoral) incentives. In the case of centralization the number of principals is very large while the number of agents are few, whereas in the case of decentralization there is one agent per locality. The larger the number of principals, the more serious is the problem of lack of coordination in contracting with agents. Decentralization is preferable to

centralization when the problem of interjurisdictional externality is less important than the coordination effect.<sup>9</sup>

Besley and Coate (2000) focus on the importance of political aggregation mechanisms in the trade-off between centralized and decentralized provision of local public goods. Under decentralization public goods are selected by locally elected representatives, while under a centralized system policy choices are determined by a legislature consisting of elected representatives from each district (so that conflicts of interest between citizens of different jurisdictions play out in the legislature). They then reconsider the traditional questions of the fiscal federalism literature in terms of alternative models of legislative behavior (one in which the decisions are taken by a minimum winning coalition of representatives and the other where legislators reach a bargaining solution). They show that the familiar presumption that larger spillovers across jurisdictions help the case for centralization is not so clear under such political economy considerations.

Political accountability in poor countries is particularly affected by the likelihood of corruption or capture by interest groups. While local governments may have better local information and accountability pressure, they may be more vulnerable to capture by local elites, who will then receive a disproportionate share of spending on public goods.<sup>10</sup> (this is in contrast to the Seabright (1996) model

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<sup>8</sup> See, for example, the discussion in North and Thomas (1973).

<sup>9</sup> The idea of fewer principals in smaller jurisdictions having more political control clearly resembles the relationship between group size and free riding in the voluntary provision of a public good first discussed by Olson (1965). As is well known, this relationship can be ambiguous.

<sup>10</sup> In the *Federalist Papers* (no. 10) James Madison comments on the notion that local governments are more prone to capture by elites and special interests:

“The smaller the society, the fewer probably will be the distinct parties and interests composing it; the fewer the distinct parties and interests, the more frequently will a majority be found of the same party; and the smaller the number of individuals composing a majority, and the smaller the compass within which they are placed, the more easily will they concert and execute their plans of oppression. Extend the sphere and you take in a greater variety of parties and interests; you make it less probable that a majority of the whole will have a common motive to

where political accountability is always greater at the local level). On the other hand, the central bureaucrat who is in charge of the delivery of, say, an infrastructural service like electricity, telecommunication, or canal irrigation may be corrupt in a way that leads to cost-padding, targeting failures and generally an inefficiently low and inequitable service delivery. The problem for the central government that employs the bureaucrat is that it has very little information on the local needs, delivery costs and the amount actually delivered. Many programs in developing countries have thus a large gap between a commitment of resources at the central level and delivery of services at the local level. For a particularly egregious example, see Reinikka and Svensson (2001) where they study the leakage in the flow of educational funds from the central government to schools in Uganda in the period 1991-95. They found that only 13 percent of the total grant transferred from the central government for non-wage expenditures in schools (on items like textbooks, instructional materials, and other costs) actually reached the schools. The majority of schools actually received no money at all from the central transfers for non-wage expenditures. Bardhan and Mookherjee (2000a) develop a simple analytical framework that formalizes the trade-off between these conflicting aspects of centralized and decentralized delivery systems. Decentralization, by shifting control rights from the central bureaucrat (who otherwise acts like an unregulated monopolist) to a local government, typically tends to expand service deliveries as authority goes to those more responsive to user needs. But with capture of the local government (in the sense of elites receiving a larger weight in the local government's maximand of a weighted sum of welfare), there is a tendency for the service to be overprovided to local elites at the expense of the non-elite. The extent of such inefficient and inequitable cross-subsidization will depend on the extent of local

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invade the rights of other citizens; or if such a common motive exists, it will be more difficult for all who feel it to discover their own strength and to act in unison with each other.”

capture and on the degree of fiscal autonomy of the local government. On the latter question three different financing mechanisms for local governments are considered: local taxes, user fees, and central grants. With local tax financing there is the risk that the captured local government may resort to a regressive financing pattern whereby the non-elite bear the tax burden of providing services to the elite. Restrictions on the ability of local governments to levy taxes may then be desirable, even at the cost of reducing flexibility of service provision to local need.

User charges may be a useful compromise between the need for matching provision to local needs and avoiding an unduly heavy burden on the local poor. Since no user is compelled to use the service this imposes a limit on the extent of cross-subsidization foisted on the poor. So with user fee financing decentralization unambiguously welfare-dominates centralization as well as local tax financed decentralization, irrespective of the extent of local capture. Central grant financing, on the other hand, may encourage local governments to claim higher local need or cost, leading to a restriction of the level of service delivery; the welfare implications are ambiguous, depending on a range of relevant political and financing parameters.

User charges cannot, however, be used to finance anti-poverty programs (like targeted public distribution of food, education or health services) that by their very nature are targeted at groups that do not have the ability to pay for the service (or pay bribes to the central bureaucrats). In such cases, as is shown in Bardhan and Mookherjee (2000b), the extent of capture of local governments relative to that of the central government is a critical determinant of the welfare impact of decentralization. If local governments are equally or less vulnerable to capture than the central government, decentralization is then likely to improve both efficiency and equity. But the opposite may be the case when capture at the local level is much greater than at the central level.



Even though the extent of relative capture of governments at different levels is crucial in understanding the likely impact of decentralization initiatives, there has been very little work on the subject, either theoretical<sup>11</sup> or empirical. The extent of capture of local governments by local elites depends on levels of social and economic inequality within communities, traditions of political participation and voter awareness, fairness and regularity of elections, transparency in local decision-making processes and government accounts, media attention, etc. These vary widely across communities and countries, as documented in numerous case studies.<sup>12</sup> Of course, central governments are also subject to capture, and it may be more than at the local level on account of the larger importance of campaign funds in national elections and better information about candidates and issues in local elections based on informal sources. On the other hand, particularly in large heterogeneous societies, the elites are usually more divided at the national level, with more competing and heterogeneous groups neutralizing one another. At the local level in situations of high inequality collusion may be easier to organize and enforce in small proximate groups (involving officials, politicians, contractors and interest groups); risks of being caught and reported are easier to manage, and the multiplex interlocking social and economic relationships among the local influential people may act as formidable barriers to entry into these cozy rental havens. At the central level in democratic countries more institutional mechanisms for checks and balances are usually at place: these include various constitutional forms of separation of powers and adjudicatory systems in some countries, more regular auditing of public accounts, more vigilance by national media, etc., much of which are often absent or highly ineffective at the local level.

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<sup>11</sup> For a theoretical analysis of the problem see Bardhan and Mookherjee (2000c). We argue that the overall comparison of capture at central and local levels in a democracy would depend on the interplay of a large number of underlying institutional factors, such as relative degrees of voter awareness and cohesiveness of special interest groups, the extent of heterogeneity across districts, and the nature of the national electoral system, and so the issue is ultimately context- and system-specific.

<sup>12</sup> See, for example, Crook and Manor (1998) and Conning and Kevane (2000).

Even in undemocratic but largely egalitarian societies the problem of local capture may be less acute. It is generally overlooked in the widely noted success story of decentralized rural-industrial development of China over the last two decades that the decollectivization of agriculture since 1978 represented one of the world's most egalitarian distributions of land cultivation rights (with the size of land cultivated by a household assigned almost always strictly in terms of its demographic size), and this may have substantially mitigated the problem of capture of local governments and other institutions by the oligarchic owners of immobile factors of production (like land), which afflicts other rural economies (for example, India).

When the potential for capture of local governments is serious, decentralization programs have to focus a great deal of attention to strengthening local accountability mechanisms. In fact in policy debates when we consider the costs and benefits of redistributive policies (like land reforms, public health campaigns or literacy movements), we often ignore their substantial positive spillover effects in terms of enlarging the stake of large numbers of the poor in the system and strengthening the institutions of local democracy. Comparing across the various states in India, it is clear that local democracy and institutions of decentralization are more effective in the states (like Kerala and West Bengal) where land reforms and mass movements for raising political awareness have been more active. The 1996 National Election Survey data in India suggest<sup>13</sup> that in West Bengal 51 per cent of the respondent voters expressed a high level of trust in their local government, whereas in the adjoining state of Bihar (where both land reforms and local democracy institutions have been very weak) the corresponding figure is 30 per cent. Near-

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<sup>13</sup> See Mitra and Singh (1999).

universal literacy in Kerala has helped sustain widespread newspaper readership, which has encouraged a vigilant press on issues like corruption in local governments.

In both Kerala and West Bengal it has also been observed that theft and corruption at the local level are more effectively resisted if regular local elections to select representatives in the local bodies are supplemented by an institutionalized system of periodic public hearings on items of major public expenditure. But even that is inadequate if the complaints made in public are not acted upon by the ruling party. There is evidence that sometimes the opposition parties or minority factions stop attending the village council meetings or the public hearings, as they perceive that they cannot do much about the ruling party's spending of public funds that takes the form of widespread distribution of patronage (like 'jobs for the boys' or what Italians call *lottizzazione*) which sometimes consolidate its electoral advantage. It is important to install public accounts committees at the local legislative level with their leading members taken from the opposition party (as is the case at the central parliamentary committees in India or Britain). In general the auditing process at the local level is extremely deficient, not always by design, but by the sheer dearth in the villages of technical capacity for accounting, record-keeping and auditing.

In sum, in considering the theory of decentralization in developing countries, it is important to move beyond the traditional tradeoff of how centralization is better for dealing with spillovers and decentralization is better for dealing with heterogeneity. It is necessary to delve into political economy issues of institutional process and accountability at both the local and central level.

## **Empirical Evaluation of Decentralized Delivery of Public Services**

In this section we shall briefly indicate some of the attempts that have been made to empirically evaluate the impact of decentralization on the delivery of social services in developing countries. Even though decentralization experiments are going on in many of these countries, hard quantitative evidence on their impact is rather scarce. There are a number of scattered studies that we will try to arrange in terms of the nature of empirical methodology followed.

In two successful cases of decentralization in Latin America there is some evidence available on the 'before-after' comparison of service delivery outcomes. One is the widely noted case of participatory budgeting in municipal government in the city of Porto Alegre in Brazil, and the other is the less well-known but quite dramatic success of the post-1994 decentralization initiative in Bolivia. In Porto Alegre, where assembly meetings of local citizens and neighborhood associations in different regions discuss investment priorities, review accounts and elect representatives to a citywide council (COP) that allocates available resources across wards, impressive results have followed: between 1989 and 1996 access to basic sanitation (water and sewage) as well as enrolment in elementary or secondary schools nearly doubled, while increasing revenue collection by 48 per cent; see Santos (1998). Although it is difficult from this study to isolate the impact of participatory budgeting reforms from those of other on-going changes, it seems likely that there has been a substantial impact on the pattern of resource allocation across localities, particularly to poor ones, and in the lessening of the misappropriation of resources compared to the past and to other areas in Brazil.

In Bolivia in 1994 the number of municipalities as well as the share of national tax revenue allocated to municipalities doubled, along with devolution to the municipalities of administrative authority,

investment responsibility and title to local infrastructural facilities. This has been associated with a massive shift of public resources in favor of the smaller and poorer municipalities and from large-scale production to social sectors. Faguet (2001) finds that public investment in education, water and sanitation rose significantly in three-quarters of all municipalities, and investments responded to measures of local need (for example, the expansion in public education spending was larger on average in municipalities with a lower literacy rate or with fewer private schools). Faguet's analysis is in terms of levels of public spending rather than outcome variables like school enrolments or school performance or access to water and sanitation services. In the studies of Porto Alegre or Bolivia there is not much information available on the allocation of resources within a community across households in different socio-economic classes. This means that issues like cost-effectiveness of programs, targeting performance or the extent of capture of local governments cannot be addressed. Without household level data on access to public services these crucial aspects of the impact of decentralization cannot be properly assessed.

There is hardly any household-level analysis in the literature of the comparative effects of centralized versus decentralized delivery. One detailed study of targeting performance of a decentralized program using household level information in a developing country is that of Galasso and Ravallion (2001) studying a decentralized food-for-education program in Bangladesh. In this central government program, in which two million children participated in 1995-96, the identification of beneficiary households within a selected community was made typically by a local school management committee (consisting of parents, teachers, education specialists and school donors). Galasso and Ravallion use data from a 1995-96 Household Expenditure Survey to assess the targeting performance of the program. They find that the program was mildly pro-poor (i.e. taking all villages, a somewhat larger fraction of the poor received

benefits from the program than the non-poor). But they also find some evidence of local capture. For example, within the set of participating villages targeting performance was worse in communities with larger land inequality or in remote locations. But the targeting improved as the program expanded, suggesting that the program shifted the balance of power in favor of the poor. It is also clearly the case that the level of targeting *within* communities was superior to that achieved *across* communities by central allocation, thus offering little support for the view that the central government is more accountable to the poor than local communities. This is in some contrast to the experience of the widely acclaimed anti-poverty transfer program of *Progresa* in Mexico. The program follows a two-stage targeting process. Coady (2001) finds that most of *Progresa's* targeting effectiveness is achieved at the first stage when poor localities are selected, rather than in the second stage when households are selected within localities, not on the basis of identification of beneficiaries by local communities as in the food-for-education program in Bangladesh, but on the basis of information collected from a census undertaken for this purpose.

Alderman (1998) examines, on the basis of a household survey conducted in 1996, a targeted social assistance program (*Ndihme Ekonomika*) in Albania that was decentralized in 1995. He finds that there have been modest gains in targeting efficiency and cost-effectiveness following decentralization, that local authorities use some additional information in allocating program benefits among households, and that the central allocation of social assistance funds to local authorities is ad hoc and not strongly correlated with the level of poverty in the local communities. He does not find evidence that the decentralization initiative caused the benefits of the program to be captured by the well-off members of the community.

There is some quantitative evidence on the impact of mandated representations of historically disadvantaged groups like women in leadership positions in local governance in India. Since 1998 one-third of all positions of chief of the village councils in India have been reserved for women: only women may be candidates for the position of chief in a reserved village council and the latter is selected randomly. Taking advantage of this random assignment (thus avoiding an econometric problem in usual cross-section studies on this question that communities which are more likely to take women's needs into account may also be more willing to let them be in leadership positions), Chattopadhyay and Duflo (2001) have measured the impact of this political reservation policy on outcomes of decentralization with data collected from a survey of all investments in local public goods made by village councils in one district in West Bengal. They find that the women leaders of village councils invest more in infrastructure that is directly relevant to the needs of rural women (drinking water, fuel and roads), and that village women are more likely to participate in the policy-making process if the leader of their village council is a woman. However, without direct evidence on the nature of women's preferences relative to men's and since women's reservation in the leadership positions in local government was not linked to the distribution of women in the village, this study does not quite address how local democracy affects the ability of under-represented groups in the village to implement their desired outcomes.

Foster and Rosenzweig (2001) use a panel dataset of villages across India to examine the consequences of democratization and fiscal decentralization. They find that an increase in the demographic weight of the landless households in a village under democratic decentralization has a positive effect on allocation of public resources to road construction (which, according to them, primarily benefits the landless workers) and a negative effect on that to irrigation facilities (which are to primarily benefit the landed). But their dataset does not contain the many severe institutional lapses in the implementation of decentralization

across India (particularly in manipulations of the local electoral process and in the range of authority and finances devolved to local governments, making democratic decentralization not yet a reality in most parts of India). It is not clear, for example, how much of a leeway elected local village councils have in matters of allocation to projects like road construction (which are often centrally sponsored and quite bureaucratically controlled from above and at most the local government gets involved only in the decision where to locate the road and to identify the beneficiary workers).

There also exist some case studies on the effects of decentralization in different parts of the world that provide some descriptive and suggestive correlations, but not enough to clinch any hypothesis. Azfar *et al* (2000) survey households and government officials at municipal and provincial levels in the Philippines with respect to the stated public investment priorities in a given locality. Stated priorities of officials at the municipal level turned out to weakly match those of local residents, while those of officials at the provincial level did not, suggesting that decentralization may improve the quality of information used in public investment decisions. There is also some evidence in the survey of more perceived corruption at the central level than at the local level. A similar survey was carried out by Azfar *et al* (2000) in Uganda with qualitatively similar results. They also find in Uganda a greater reliance on community leaders for news concerning local corruption and local elections than for national news, which they interpret as evidence of greater potential for local capture.

In the 1990's Nicaragua started a program of transferring key management tasks in public schools from central authorities to local councils involving parents. An evaluation of this program by King and Ozler (1998) on the basis of school and household surveys and student achievement tests suggests that de



facto autonomy has not yet been given to many of the councils, but where it has been there is a significant positive effect on student performance.

The World Development Report 1994 on Infrastructure cited several cases of quality improvement and cost savings in infrastructure projects after local communities were given part of the responsibility in management. A review of World Bank data for 42 developing countries found that where road maintenance was decentralized backlogs were lower and the condition of roads better. Data for a group of developing countries revealed that per capita costs of water in World Bank-funded water projects were four times higher in centralized than in fully decentralized systems. A study of 121 completed rural water supply projects, financed by various agencies, showed that projects with high participation in project selection and design were much more likely to have the water supply maintained in good condition than would be the case with more centralized decision-making.

Wade's (1997) contrasting account of the operations of irrigation bureaucracy in South Korea and in South India brings out the importance of local accountability in delivery of infrastructural services. The Indian canal systems are large, centralized hierarchies in charge of all functions (operations and maintenance as well as design and construction). Their ways of operation (including the promotion and transfer rules for officials, rules designed to minimize identification between the irrigation patrollers and the local farmers, and the frequent use of low-trust management and supervision methods) and source of finance (most of the irrigation department's budget comes in the form of a grant from the state treasury) are insensitive to the need for developing local trust and cooperation. In Korea, on the other hand, there are, according to this account, functionally separate organizations in the canal systems. The implementation and routine maintenance tasks (as opposed to policy-making and technical design work)

are delegated to the Farmland Improvement Associations, one per catchment area, which are staffed by local part-time farmers (selected by the village chiefs), knowledgeable about changing local conditions, dependent for their salary and operational budget largely on the user fees paid by the farmers, and continually drawing upon local trust relationships. Korea at the time of the study did not have a democratic political regime or a free press, but farmers were better informed about and had better access to the local irrigation organization. This is an example that there is no one-to-one relationship between the strength of democracy at the national political level and that of institutions of accountability at the local level.

A similar story on accountability can be told in the field of education and health, comparing North India with some authoritarian countries. Institutions of local accountability are rather weak in large parts of North India, and it is common to observe, for example, the serious problem of absenteeism of salaried teachers in village public schools and of doctors in rural public health clinics.<sup>14</sup> The villagers are usually aware of the problem but do not have the institutional means of correcting it, as the state-funded teachers and doctors are not answerable to the villagers in the insufficiently decentralized system. On the other hand, in non-democratic China the local Communist Party officials have sometimes been quite responsive to local needs (at least as long they are not conflicting with the Party's program), as the comparative study of two villages in China and India by DrPze and Saran (1993) show in the context of China's far better performance in the provision of primary education at the local level. (Similar accounts are available of more effective public pressure in rural basic education and health services in Cuba compared to some of the more democratic regimes in Latin America). There are, of course, many

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<sup>14</sup> See, for example, PROBE (1999), on the basis of an intensive survey of 234 randomly selected villages in North India carried out in 1996.

authoritarian countries where local accountability is completely absent and the situation is much worse than in North India.

Taken as a group, these studies suggest generally positive effects of decentralization, but it is hard to draw conclusive lessons. Many of the studies are largely descriptive, not analytical, and often suggest correlations rather than causal processes. Most of them are not based on household survey data, making the comparative impact of centralized versus decentralized programs on different socio-economic groups of households difficult to assess.

### **Decentralization and Local Business Development**

Most of the cases of decentralization in developing countries examined in the theoretical and empirical literature relate to delivery of social services. But in recent years there has been an extension of the traditional literature on federalism to the case of the role of local government in promoting local business development, particularly in the context of transition economies, especially China, and this has potential implications for developing countries where so far public delivery issues have been more prominent. In Qian and Weingast (1997) and Qian and Roland (1998), for example, decentralization of information and authority and interjurisdictional competition have been considered as commitment devices on the part of the central or provincial government to provide market incentives, both the 'positive' incentive rewarding economic success at the local level and the 'negative' incentive in terms of punishing economic failure. The local government-run township and village enterprises (TVE's), which served as the engine of growth in China in the last two decades, have been cited as a major example of the outcome of a successful 'market-preserving federalism'. In terms of 'positive' market incentives the TVE's had full control over their assets and they were largely left alone (as a residual claimant) to 'get rich gloriously',

and the limited knowledge of the upper-tier governments about the ‘extra-budget’ and ‘off-budget’ accounts of local governments acted as check on the formers’ interventionism. In contrast, as we can see from an econometric study of the fiscal relations between local and regional governments in Russia by Zhuravskaya (2001) on the basis of a panel dataset for 35 large cities, local governments could retain only about 10% of their revenues at the margin, thus providing only weak incentives to foster local business development and thus to increase their tax base. In terms of the ‘negative’ incentive, Chinese upper-tier governments by denying bailout to many failing TVE’s enforced a dynamic commitment. Having no access to state banks and facing mobility of capital across jurisdictions raised the opportunity costs of local governments for rescuing inefficient firms, thus leading to the endogenous emergence of a hard budget constraint.

Without denying the importance of these market incentives, it is possible to argue, however, that the case of market-preserving federalism is institutionally underspecified in these studies. Depending on the political-institutional complex in different countries the same market incentives may have different efficacy. As Rodden and Rose-Ackerman (1997) have pointed out in a critique of market-preserving federalism, whether political leaders of a local government respond to highly mobile investors or instead pay more attention to the demands of strong distributive coalitions dominated by owners of less mobile factors depends on the institutional milieu. Owners of capital vary widely in the specificity of their assets and institutional incentives facing political leaders may vary even for the same jurisdictional competitive pressure. Even in a democracy, not to speak of authoritarian systems, electoral competition does not necessarily punish local leaders who fail to respond to exit threats of mobile asset owners and are instead more responsive to coalition building and the ‘voice’ of well-organized lobbies. We have pointed out earlier the problem of local capture by the oligarchic owners of immobile factors of

production like land in rural India, and how in the Chinese case the lack of such strong rural lobbies (owing largely to the egalitarian land distribution) may have made a difference in the local governments' vigorous pursuit of rural industrialization.<sup>15</sup> In Russia many have pointed out that over much of the 1990's local governments have shown features of being captured by erstwhile rent-holders and old firms which sometimes blocked the rise of new firms that could compete away their rents.<sup>16</sup> Of course, even in China by some accounts, for example that by Shirk (1993), local officials have often used their financial authority under decentralization to build political machines, collecting rents in exchange of selective benefits and patronage distribution, and federalism may not always have been that market-preserving.

It seems jurisdictional competition is not enough to explain the emergence of endogenous hard budget constraints for local governments without a lot more specification of the local political process. Even ignoring the lobbies of land oligarchies, in some countries (democratic or otherwise) if a local business fails threatening the livelihood of thousands of poor people it is difficult for the local government (or if the latter is bankrupt, upper-tier governments) to ignore the political pressure that will be generated in favor of bailing them out. Wildasin (1997) has rightly pointed out that federal grants to local governments may be less 'soft' in the small jurisdictions as opposed to the large (which are "too big to fail"), but even small jurisdictions may have key politicians representing (or lobbying for) them and in any case it is cheaper to come to their rescue.

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<sup>15</sup> Even in India, in areas where land distribution is relatively egalitarian and local democracy is more solidaristic, as in Kerala, there are now some instances of municipal governments taking a leading role, in collaboration with bankers and social groups, in local business development. For some examples, see Das (2000).

<sup>16</sup> The explanation of China's relative success attributed to political centralization in Blanchard and Shleifer (2000) does not seem very plausible. A strong central political authority can punish

## Conclusion

It is quite plausible to argue that in the matter of service deliveries as well as in local business development control rights in governance structures should be assigned to people who have the requisite information and incentives, and at the same time will bear responsibility for the (political and economic) consequences of their decisions. In many situations this calls for more devolution of power to local authorities and communities. But at the same time it is important to keep in mind that structures of local accountability are not in place in many developing countries, and local governments are often at the mercy of local power elites, who may frustrate the goal of achieving public delivery to the general populace of social services, infrastructural facilities and conditions conducive to local business development. This means that decentralization to be really effective has to be accompanied by serious attempts to change the existing structures of power within communities and to improve the opportunities for participation and voice, and engaging the hitherto disadvantaged or disenfranchised in the political process. After all, the logic behind decentralization is not just about weakening the central authority, nor about preferring local elites to central authority, but it is fundamentally about making governance at the local level more responsive to the felt needs of the large majority of the population. To facilitate this the state, far from retreating into the minimalist role of classical liberalism, may sometimes have to play an activist role in enabling (if only as a 'catalyst') mobilization of people in local participatory development, in neutralizing the power of local oligarchs, in providing supra-local support in the form of pump-priming local finance, supplying technical and professional services toward building local capacity, acting as a watchdog for service quality standards, evaluation and auditing, investing in larger infrastructure and providing some coordination in the face of externalities across localities.

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local governments (reducing the risk of their capture and the scope of their rent-seeking), but

The literature on decentralization in the context of development is still in its infancy. On the theoretical side, perhaps the key challenge is to find better ways to model the complex organizational and incentive problems that are involved, in a situation with pervasive problems of monitoring and enforcement. On the empirical side, there is a great deal of scope for rigorous work in evaluating the impact of on-going decentralization initiatives, using detailed household and community surveys, comparing it with the experience with centralization or some other counterfactual. In such empirical work, one has to be particularly wary of several econometric problems. One issue is that some of the data involved in evaluating community participation and project performance may be subjective. For instance, some investigators start with the prior belief that participation is good, which creates a “halo effect” in their observations. A second problem is one of simultaneity: better beneficiary participation may cause improved project performance, but improved project performance often also encourages higher participation.<sup>17</sup> Finally, there is the commonly encountered endogeneity problem. Before being too quick to claim that decentralization brought about certain outcomes, it is worth considering that decentralization may have resulted from on-going political and economic changes that also affected these same outcomes. Separating decentralization from its political and economic causes, so that decentralization is not just a proxy for an ill-defined broad package of social and economic reforms, is a delicate problem.

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one needs a plausible story of a benevolent non-rentier central authority to go with it.

<sup>17</sup> For an attempt to take this latter set of econometric problems into account in an evaluation of 121 rural water projects, see Isham, Narayan and Pritchett (1995).

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