



Initiative *for* Policy Dialogue

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## Synoptic Guide to Decentralization

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Decentralization or the devolution of power and resources from upper level to lower level governments has become one of the hot topics of our time. It is squarely in the forefront of the development debate throughout Latin America, Africa and Asia. And under the guises of subsidiarity, devolution and federalism it is also at the center of public policy-making in Europe and North America. And yet despite real experiments in decentralization under way in scores of countries, and literally hundreds of empirical studies, the economic and political effects of decentralization are still unclear. This paper seeks to provide the policy community with a synoptic guide to the state of current knowledge on decentralization and governance. Because ideal governance is an inherently subjective notion, the analysis is focused on the effects of decentralization on largely uncontroversial aspects of governance such as the degree of corruption and other arbitrary government interventions as well as efficiency in the provision of basic public services.

Section I emphasizes several aspects of decentralization related to accountability and governance. Decentralization is thought to lead to improved governance through four main channels: (i) *Improved public oversight of government activity* makes officials more accountable to citizens and may reduce corruption and improve efficiency in the provision of public services. This effect may be enhanced if decentralization also involves taxation. In this case both citizens and public officials face even stronger incentives to ensure efficient use of public funds. Better public oversight of government activity may improve governance more generally by making public services and policies more responsive to people's needs. Finally, improved public oversight and government accountability may allow specific disadvantaged groups to be targeted for benefits or welfare improvements. (ii) *More equal power distribution between private actors and local instead of national government agencies* may reduce arbitrary government interventions and promote the efficiency of public service. (iii) *Competition among local jurisdictions* may improve governance at large by giving citizens the possibility to exit a given jurisdiction and allowing them to compare policy performances across jurisdictions. (iv) *Political competition* at the *national* level may be enhanced via the creation of new political platforms at the local level and new avenues to power within established parties. Governance may be improved by a more vigorous and competitive national politics leading to political entrepreneurship and policy innovation. On the other hand, governance may be worsened if the decentralizing reform allows local elites to capture the political process.

As the subsequent discussion will make clear, decentralization is not an easy fix for unresponsive or inefficient government. In order for decentralization to enhance welfare, a number of conditions must be met in addition to the basic decentralizing reform transferring power and resources from upper to lower levels of government. These can be divided into three categories: (i) *Information*. Politicians must have good information on what local voters want, and voters must in turn have good information on what government does. (ii) *Openness and Competition*. This refers to both the political party system and local firms and other economic actors that finance political parties and candidates. Openness and competition facilitate the role of policy entrepreneurs, who identify gaps in the policy offerings and devise new policies to fill these gaps. (iii) *Social Trust and Civic Organization*. Individuals do not participate in politics only as individual voters, but also collectively according to different cross-

cutting cleavages that change over time, grouping a given set of voters in different ways. Local government depends on the relationships that collectively comprise civil society to elicit information necessary to the policy-making process, judge the efficacy of previous interventions, and plan for the future. It will be argued that complementary institutions and organizations can contribute powerfully to information, openness and competition, and social trust and civic organization.

As will be made clear below, successful decentralization also requires good governance at the center, as well as a working relationships between central and local governments. In section II the focus is on such intergovernmental relations, and to their connection with the structure of central government itself.

Section II begins with an argument why it is that any discussion of decentralization has to take intergovernmental relations into account. The next subsections describe the fiscal and political aspects of intergovernmental relations, highlighting their potential to affect the impact of decentralization. The section closes with a brief discussion of the mechanisms by which accountability (emphasized in section I) and intergovernmental relations (emphasized section II) are intertwined. The paper begins with the question of decentralization and governance, and then moves on to intergovernmental fiscal and political relations.

## I. Decentralization and Governance

This section discusses the notion that decentralization can be used to promote good governance. The first subsection discusses the meaning of good governance. The next subsection focuses on the channels through which decentralization is thought to affect governance as well as available empirical evidence to that effect. The third part discusses how certain complementary institutions and organizations can contribute powerfully to information, openness and competition, and social trust and civic organization.

### **Good Governance**

The rhetoric of decentralization is often associated with generalized claims about the need to improve the way a country is governed. To make sense of this idea requires a notion of idealized governance. While there is much debate about what exactly constitutes good governance, in general the debate revolves around the positive and negative functions of government.

A government should know when and how to intervene effectively, and also when to keep out. Thus there seem to be two main theses about good governance that are prevalent in policy debates.

**Positive Governance:** Good governance performs key positive functions as an effective provider of public goods, a fixer of market failures and engages in such pro-poor redistribution as can be justified.

**Negative Governance:** Good governance is about the exercise of restraint -- judiciously allowing for private actions either in markets or voluntary organizations.

While the weight to be placed on the positive and negative aspects may vary, most positions on the political spectrum accept some role of the negative and positive thesis. Even the most committed interventionist recognizes that government can be overbearing, slowing the process of wealth creation by blunting investment incentives, for example, or stifling civil society by taking decisions about community institutions out of local people's hands. Similarly, even the most liberal perspectives recognize some role of the state in providing public goods and supporting a legal framework for exchange.

It is quite possible for a given government to care about both of these objectives at the same time – improving the operation of public services such as schools (in the positive sphere) and reducing the arbitrary regulatory power of the state which inhibits a business-friendly investment climate.

Path dependency is also important. The starting point and history of the country in question may also reflect which concern in improving government performance is uppermost in policy-makers minds. Countries with histories of weak and ineffective states may be keen to enhance the positive role of government, while those in transit away from dictatorship may eagerly seek its restraint.

In practice, the institutional framework in which government operates can make a huge difference to how given ideas of good governance are pursued in different countries. And these institutional structures are themselves often a product – at least in part – of views regarding which of positive or negative government is more important in a particular context. Nonetheless, the general direction of attempts to strengthen government’s positive or negative role will be similar regardless of institutional context or historical/ideological starting-point.

Promotion of the positive function of government requires that government be better informed and more accountable to its citizens in order to facilitate specific interventions (e.g. public investments, taxes and transfers). Promotion of its negative functions requires government to provide a framework in which private interventions can flourish, and resist making arbitrary interventions of its own. At the most general level this requires government to respect its commitments and to avoid arbitrary taxation.

It is not entirely straightforward to define the ends of good governance. The world is populated by many different individuals, with heterogeneous and conflicting objectives. It is almost never possible to speak of ends that are good for every member of a society. Thus, good governance requires some value judgment about whose gains and losses are to be valued most highly.

There are, however, a small number of government activities that most citizens will readily agree ought to be improved. Chief among these are the efficiency of certain basic public services and reductions in corruption and other forms of arbitrary government interventions. These are the most uncontroversial areas of government intervention, and hence constitute a weak definition of good governance.

**Weak Definition of Good Governance:** Promoting good governance involves reducing corruption and other forms of arbitrary government interventions and promoting efficiency in the provision of basic public services.

Good governance can also be defined as targeting the fruits of state intervention towards particular deserving groups, especially disadvantaged groups. This notion of good governance is inherently redistributive and hence requires a stronger value judgment than the weaker.

**Strong Definition of Good Governance:** In addition to reducing arbitrary interventions and promoting efficient provision of public services, good governance involves targeting the benefits of government intervention towards particular “deserving groups”.

The deserving can include socioeconomic groups, ethnic groups, or the inhabitants of particular regions. There are clearly many societies that believe such actions are important. For example, the Indian government has repeatedly looked for means to help its traditionally disadvantaged lower castes. The American government has numerous programs to help disadvantaged “minorities”. The Bolivian government has directed significant public

investments toward its rural and indigenous poor. And the European Union has “structural” programs aimed at boosting growth in its poorest regions.

Even if targeting particular beneficiaries is not the express aim of decentralization, it is important to keep track of the pattern of winners and losers. Whether it is politicians or advocacy groups that are monitoring the impact of decentralization, the perception of success or failure often hinges on which groups gain and lose.

Having defined the notion of good governance, the next subsection will discuss the underlying mechanisms through which decentralization is thought to achieve an improvement in governance.

#### **Four mechanisms for improving governance**

(i) Decentralization may lead to **improved public oversight of government activity**, which makes officials more accountable to citizens and may reduce corruption and improve efficiency in the provision of public services. Decentralization can improve governance at large by tailoring public services and policy more closely to citizen’s needs and preferences.

A number of agents are involved in the political process, some of which may have different objectives. The main groups of agents are:

**Citizens:** These groups may have the power to vote, to stand as candidates and to participate in meetings. They may also have explicit legal rights, and recourse to a judicial system which protects them.

**Higher-Tier Governments:** Governments which lie above the unit to which authority has been decentralized may still exercise considerable power. For example, central governments may retain the power to dictate the spending patterns of lower tier governments, or to lay down the rules according to which spending is undertaken. This point will be taken up specifically in Part II.

**Lobby Groups:** Some groups have the power to influence government behavior through channels outside the electoral process. This kind of activity varies enormously in its scope and nature, from activities that skirt the border with bribery to those mainly concerned with providing information or promoting particular perspectives on a policy issue in question.

**Civil Society:** Beyond political lobby groups is a large variety of civic organizations that affect the ways in which government and society interact. These include non-governmental organizations that both complement and substitute for government; newspapers and think tanks that inform the policy process; as well as civic organizations that inform government about popular demands, provide feedback on policy effectiveness, and mobilize grass-roots contributions to particular projects.

One of the key consequences of decentralizing authority is to change the structure of accountability. This structure describes the relationship of authority between those

who make social decisions and those citizens who experience the consequences of such decisions first hand.

At the heart of the accountability structure are the *incentives* faced by those who make social decisions. Incentives refer to the carrots and sticks that citizens use to influence policy-makers' decisions, and discipline them when social decisions are not in line with their wishes. **Decentralization matters because it facilitates the exercise of mechanisms for disciplining policy-makers.** Following Albert Hirschman such disciplining mechanisms are called voice and exit.

**Voice:** This refers to the variety of ways in which citizens are granted the right to express their approval or disapproval with those who govern them. The most obvious forms of voice are straightforward and direct: public meetings, speaking or writing to elected officials, and holding demonstrations, marches and rallies. Other, indirect mechanisms of voice are also important – voice can be exercised through the press and media, opinion polls, focus groups and a host of other forms of *political participation*. A particularly important form of voice is lobbying, in which favors may be granted in some bargain between those who make social decisions and those represented by lobbyists.

Decentralization facilitates the exercise of voice which leads to improved public oversight and accountability and thus enhances governance. Where taxation is also decentralized, local governments will have an even stronger incentive to tailor local policies and services to the priorities of those who pay. Similarly, citizens have a greater incentive to monitor the use of funds.

A defining feature of many forms of governmental incentives is their implicit nature. Citizens cannot lay down performance targets for government as a basis for rewarding them as easily as shareholders can for a firm's managers. This can lead to all manner of distortions in the way in which incentives operate. For example, political competition might result in a small but intense minority obtaining policies that are opposed by the majority if the election is finely balanced and their votes are required for a politician or coalition to win power. Such distortions may be counterbalanced through other forms of voice such as the direct democratic institutions of initiative and referendum. An *initiative* is a legislative proposal which enables citizens to shape the political agenda. A *referendum* is an instrument which allows citizens to check parliament's legislation. Such institutions make it much harder for politicians to favour their pet constituencies because any policy may be subject to general popular approval.

**Exit:** This refers to the possibility of expressing displeasure with those who are making decisions by leaving (a) the electoral coalition, or (b) the jurisdiction in question. In the first case exit occurs through the electoral mechanism, when voters who formed part of a winning majority desert their candidate/party out of dissatisfaction with their performance. The threat of non-reelection is a powerful incentive for disciplining politicians. In practice it serves largely as a threat which gives power to the opinions expressed through voice. Exit can also be physical, and complete when residents migrate to another jurisdiction; or incomplete when they shop or hold savings in another jurisdiction. This type of exit constitutes another

mechanism for improving governance and will be discussed more thoroughly in the third section.

The following provides examples of improved basic public service provision through greater public oversight of government activity:

In Bolivia before decentralization, a highly centralized government was physically concentrated in the capital city, with little or no government presence in the overwhelming majority of municipalities. Bolivians living in these districts had almost no access to public officials, and thus little opportunity to oversee those who governed them. Not surprisingly, government was insensitive to local demand, failing to invest anything at all in fully one-half of municipalities in the years leading up to reform. And corruption was endemic, with Bolivia placing amongst the few most corrupt countries in the world according to Transparency International. Decentralization led to a huge shift in the use of public resources in favor of the primary education, health and water & sanitation services favored by the poor majority. Local governments invested more where need was greater, and the number of municipalities receiving investment increased substantially. Popular participation in government also increased substantially, and in a number of highly publicized cases corrupt local officials were ejected from office via elections and demonstrations.<sup>1</sup> The facts are similar for Chile, which also stands out for its successful decentralization.<sup>2</sup> The striking similarity between these cases is that both took the related issues of revenue devolution, institutional capacity building and creation of democratic local institutions seriously, whereas less successful cases did not.

Evidence on corruption is quite broad, but mixed. Some researchers have found that fiscal decentralization is consistently associated with lower measured corruption across a sample of countries.<sup>3</sup> But others have found that federal states tend to score worse on measures of corruption.<sup>4</sup> This might be explained by the fact that federalism and decentralization are not the same thing<sup>5</sup> – a point discussed in Part II. Other aggregative cross-country evidence (for 80 countries) shows that the effect of decentralization on corruption depends on how sub-national expenditures are financed. It is reasonable to presume that local people are much more vigilant of official malfeasance with their own tax money than with fiscal grants coming from central government.<sup>6</sup>

In this area, China appears to be notable by contrast. Despite decentralization in the economic spheres, China's central government has maintained its power over the appointment and dismissal of local government officials. In particular, the central government, through the Party, selects top provincial officials. This combination of increased fiscal incentives for local governments and continued central control of the appointment of local leaders is a salient feature underlying China's central-local relationship during the reform period. Nonetheless, scholars such as Lin (2001) and

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<sup>1</sup> See Faguet (2001) and Faguet (2002) for detailed treatments of the Bolivian case.

<sup>2</sup> See O'Neill (2001).

<sup>3</sup> See Fisman and Gatti (2000).

<sup>4</sup> See Treisman (1999).

<sup>5</sup> See Rodden (2002) and Chhibber, P. and E. Somathan (2002).

<sup>6</sup> This point is crucial, and is examined further in Part II.

Qian (2001) have argued that local actors are able to exert pressure and oversight on local officials despite this through other, non-electoral means, leading government responsiveness to increase after decentralization.

Improved public oversight and government accountability may allow specific disadvantaged groups to be targeted for benefits or welfare improvements. This can happen when sub-national districts are created where such groups are in electoral majority, giving them control over devolved resources and decision-making power. In such a situation the political oversight described above can lead to greater government responsiveness to the special needs of disadvantaged groups. It can also happen through central mandates setting aside legislative seats for particular groups. In this way, and paradoxically, decentralization operates hand-in-hand with central requirements to ensure certain groups are empowered.

That disadvantaged groups have reaped benefits from decentralization is well illustrated by the Indian reforms of 1993, which mandated that every Indian state institute Panchayati Raj institutions (PRI), and defined several mandatory and discretionary items to be devolved to PRIs. Broadly speaking, political decentralization was made mandatory, but the extent of administrative and fiscal decentralization left to individual state's discretion. The main features of the reform were:

- Introduction of a three-tiered Panchayat structure, with the constitution of a local participatory forum at the village level called the Gram Sabha, with five-year terms.
- Seats reserved in all PRIs for Scheduled Castes and Scheduled Tribes in proportion to their population, and one-third of all seats reserved for women.
- Functions and responsibility for 29 areas of rural local government were to be delegated by states to PRIs.

It is clear that mandated political representation for women and disadvantaged minorities has significantly increased their presence in local elected bodies. Recent evidence<sup>7</sup> suggests that this has affected policy outcomes – women and men favor different public goods, and hence increasing female representation in panchayats has altered the mix of public good provided.

In China, decentralization has gone hand-in-hand with positive discrimination towards disadvantaged groups. Whereas most regions must share a significant portion of their revenues with the center, the five minority autonomous regions (Xizan, Xinjiang, Ningxia, Inner Mongolia, and Guangxi) and three poor and remote provinces with large numbers of minority people (Qinghai, Yunnan, and Guizhou) receive subsidies from the rest of the system.<sup>8</sup> In Latin America as well, researchers have found that decentralization some times seems to have provided an entry point into the political arena for ethnic groups and opposition parties.<sup>9</sup>

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<sup>7</sup> See Chattopadhyay and Duflo (2001).

<sup>8</sup> This is as much an issue of fiscal federalism as of decentralization. We return to it in Part II.

<sup>9</sup> See Dahl (1971) and Diamond (1999).

In countries where revenue generation and devolution by the center, as well as local institutional capacity, are insufficient, however, decentralization has led to the abandonment of the social protection function by central government. Abandonment is often driven by fiscal crisis which makes funding of social protection systems untenable. When budget deficits are sufficiently large that central government can no longer afford social protection programs, it may devolve responsibility for funding and providing social protection to lower levels of government. This has been the case in a number of transition countries, including Russia<sup>10</sup>, Kyrgyzstan, Kazakhstan, Uzbekistan and Tajikistan,<sup>11</sup> as well as sub-Saharan African countries such as Tanzania, Uganda, Zambia and Senegal,<sup>12</sup> and in Argentina<sup>13</sup> and Indonesia.<sup>14</sup> It carries a multitude of problems. Local tax bases are typically inadequate to maintain social expenditures, and as a result these systems are either severely scaled back or dismantled altogether. Though various laws and decrees may be passed which vest responsibility for social protection in the hands of municipalities, these are typically not heeded as there is no financial or other incentive for local governments to comply. Localities differ in their capacity to raise revenue and this tends to lead to the emergence of dramatic regional inequalities in levels of social sector spending. Funding bases tend to be weakest where social protection needs are greatest so that there is mismatch between local demand for these measures and funding capability. And because labor is relatively immobile, migration often does not represent a viable means for improving the matching between demand and supply. In addition, local governments often do not have much experience administering such programs, and do so badly. Limited institutional capacity is thus a major constraint on this form of decentralization.

(ii) Decentralization induces a **more equal power distribution between private actors and local instead of national government agencies** which may reduce arbitrary government interference with productive or other private activities and promote the efficiency of public service.

Decentralization can enhance good governance through a weakening of government with respect to private firms and actors. The effect operates through two related channels: (i) decentralization transfers authority and responsibilities to lower layers of government, whose power compared to private actors is less than central government's was; as a result of which (ii) the central state leviathan is itself weakened. Examples of this include regional governments making business regulations more business-friendly, and local government investments becoming more attuned to local business needs.

The intuition behind this mechanism is a simple one: decentralization reduces the scale of relevant government agencies to one which more closely approximates that of local businesses and civic groups. By encouraging negotiation and dialogue amongst actors that are more approximately equal, decentralization significantly reduces government's power to interfere in the affairs of the latter. This leads both to fewer

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<sup>10</sup> See Grafe and Richter (1998).

<sup>11</sup> See Falkingham et. al, (1997).

<sup>12</sup> See Graham (1994) and Subbarao et. al., (1997).

<sup>13</sup> See Tommasi (2002).

<sup>14</sup> See Yusuf and Beier (1997).

distortions in private activity, and to a greater sensitivity of policy to these actors' needs.

A good example is the case of China. The fiscal system in China was highly centralized before the transition from a planned to a market system in the late 1970s. Financial relations between the central and provincial governments were labeled *tongshou tongzhi* (unified revenue collection and budget appropriation). No sub-national government had a separate budget: the central government collected all revenues and prepared a consolidated budget for governments at all administrative levels. This financial arrangement was extended to state-owned enterprises (SOEs): they were required to remit all profits or financial surpluses to the state, and the state would cover all their expenditures by fiscal appropriation. Local budgets could be altered by the center as it saw fit, and often were. This resulted in large swings in total budget size, as well as in the policies they were instructed to pursue, in many localities. With the fiscal decentralization reforms of the 1980s, central government relinquished fiscal controls to sub-national governments. Local officials now raise their own taxes, sharing some with the center, and allocate funds as they see fit. Budget levels are now more stable than before, and policy priorities are no longer subject to the whims of a distant center. As local governments in China control the majority of the country's enterprises, decentralization may also have hardened the budget constraints of local enterprises and improved their efficiency, leading to higher and more sustainable economic growth.

In Bolivia, centralized government had, by its own admission, traditionally "tried to resolve problems from the central, national or departmental level, committing enormous mistakes and stupidities; without mechanisms for social participation, control and evaluation, public projects were the products of charity, and their implementation a fertile breeding ground for corruption."<sup>15</sup> Decentralization changed this, freeing local budgets from central whim by placing resources in the hands of locally elected officials. The reform program was designed to increase the level of transparency in the transfer and allocation of resources, thus decreasing opportunities for corruption systematically across the country. It brought more stability in the size and use of local investment, and forced municipal governments to listen to the demands of local civic groups and businesses. Faguet (2002) shows how government-business alliances were formed to provide much-needed public infrastructure in return for increased local tax compliance.

An important feature in both cases is idiosyncrasy and inconsistency in central government policy toward the regions. The motives for this are not clear, as there seem no good *ex ante* reasons to expect the center to be unsystematic across space and/or time. Nonetheless, where such behavior is present in a country it is not surprising that decentralization improves matters. It is most unlikely that a large number of local governments will all act idiosyncratically, and much more likely that some will act idiosyncratically and others rationally, leading to an improvement in policy nation-wide.

India, on the other hand, provides an example where decentralization has increased confusion about government responsibility without pushing meaningful authority

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<sup>15</sup> Molina (1994).

further down the government hierarchy. Ambiguity in the delineation of functions between the three tiers of panchayats (local and regional governments) has generated uncertainty about the rules of the game, and so opportunities for graft. More often than not state bureaucracies keep control over key decisions involving resource allocation. In most cases these are under the jurisdiction of senior bureaucrats, with locally elected panchayat members having little control.

(iii) Decentralization creates **competition among local jurisdictions**, which may improve governance at large by giving citizens the possibility to exit a given jurisdiction and allowing them to compare policy performances across jurisdictions.

Decentralization creates multiple jurisdictions allowing citizens to express their displeasure with those who are making decisions by leaving the jurisdiction in question. This physical type of exit can be complete when residents migrate to another jurisdiction; or incomplete when they shop or hold savings in another jurisdiction. This kind of multi-jurisdictional competition is central to decentralized political authority. Clearly the efficacy of this mechanism depends on the costs of mobility of those who exit, and the incentives the jurisdictional government has to retain its resource base. Unlike competition between firms, which is universally acknowledged as welfare improving, the literature on competition between governments is more equivocal. Certainly if governments act benevolently, then there is no good reason to believe that competition will serve a valuable function.

In the context of accountability, it is clear that competition can enhance the power of exit – a dissatisfied citizen might be able to move to another jurisdiction. However, the power of mobility as a disciplining device is widely debated. Even in the U.S., where there is both a long tradition of strong local government and a high level of demographic mobility, evidence that mobility affects government policies is weak.

Competition may also be important when it is used to benchmark government performance. This is referred to as yardstick competition. The idea is that citizens in one jurisdiction can see how well their government is performing relative to those in surrounding jurisdictions and thereby have a better basis for disciplining incumbents. This has been shown to be empirically important in a number of developed countries. Of course, a certain amount of cross-jurisdictional information that facilitates comparisons must be present in order for this mechanism to be relevant. This speaks to the importance of having well-developed complementary institutions, such as the media to provide information, and political movements that raise awareness and mobilize voters. It is also important to note that this device works well only if there are good measurable bases for performance comparisons.

(iv) Decentralization may enhance **Political competition** at the **national** level through the creation of new political platforms at the local level and new avenues to power within established parties. Governance may be improved by a more vigorous and competitive national politics leading to political entrepreneurship and policy innovation. On the other hand, governance may be worsened if the decentralizing reform allows local elites to capture the political process.

Decentralization may facilitate the rise of “outsider” politicians, and politicians with untraditional backgrounds. Where independents can achieve power in a sub-national contest and use their performance in that position to launch a presidential bid for power, traditional parties lose their ability to control access to the national electoral arena. More importantly, where popular party members can use sub-national elective positions to leverage their possibility of winning nominations within parties, traditional party elite lose their influence over political succession and, perhaps, over party coherence. Thus where traditional political elites are concerned, the idea of decentralization carries with it strong anti-capture tendencies at the most basic level, via the creation of new political platforms and new avenues to power.

Local elites often play a key role in the link between decentralization and government accountability. Elites are defined here to be traditionally powerful groups such as landowners, religious leaders and tribal elders. It may be against their interests to develop strong, representative local government which they may see as a threat to their power. Indeed in some societies, the argument for centralized power holding may be to short-circuit these groups in the policy process – to drop locally big fish into a much bigger pond, where their influence is diluted. Decentralization can lead them to re-assert their power. Where elite capture occurs, its extent depends upon 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. Of course, central governments are also subject to capture, but the elites are usually more divided at that 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 in 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.

Bolivia illustrates some of the risks of resurgent elites. After decentralization, dozens of nascent municipalities were immediately captured by local businessmen and landowners who had the resources and prestige to manipulate local politics. Mexico, too, is littered by what one observer calls “authoritarian enclaves”. “During the present phase of the country’s political evolution, the sub-national political arena will be the principal source of inertia and resistance to democratization, rather than the prime breeding ground for democratic advances.”<sup>16</sup> In India, the fact that Gram Panchayats are multi-village institutions makes the resolution of competing village demands difficult. Existing evidence suggests that many of these Gram Panchayats are effectively “captured” by the villages where their leaders live, and are accordingly favored in resource allocation.<sup>17</sup> Consequently, even in areas where rural

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<sup>16</sup> Cornelius, W. (1999), p. 11. Similar “brown areas” of weak local democracy are found in the Argentine case (O’Donnell, 1997).

<sup>17</sup> See Chattopadhyay and Duflo (2001).

participation in local politics and development is high, attendance at Gram Sabhas is a mere 7%. Additionally, it appears that despite mandated political representation, males, well informed citizens, and educated people are the most likely to be active in the panchayats, while landless people, tribals and women are less active.<sup>18</sup> And where there is ongoing civil conflict, the relevant local “elite” may be an armed group. In Colombia, decentralization has facilitated the indirect or direct control of a number of municipalities by armed guerrillas, paramilitary forces or drug traffickers.

The theme of elite influence relates to the larger issue of having a viable system of competition for political office at the local level. Effective political competition requires that incumbents who hold power may face a real chance of being ejected from office. If elites have a monopoly on power, then this may be close to impossible. For accountability to obtain, it must equally be the case that local issues and not national party profiles dictate the outcomes of local elections.

With a formally federal government structure but a highly vertical political culture, Mexico provides an interesting example of decentralization in the absence of real political competition. Non-competition has traditionally occurred in Mexico for two reasons: (a) the PRI which ruled Mexico continuously for 7 decades has a highly centralized structure; local politicians who owed their careers to superiors in the party sought to please them, and not voters, via the policies they implemented locally; and (b) re-election is constitutionally forbidden in Mexico throughout government, eliminating politicians’ main incentive to please their constituents. Hence Mexico’s federal, decentralized legal framework was undermined by its political system, resulting in policy outputs much more characteristic of highly centralized countries.<sup>19</sup>

### **Complementary Institutions**

As the previous discussion has made clear, decentralization is not an easy fix for unresponsive or inefficient government. In order for decentralization to enhance governance, a number of conditions must be met in addition to the basic decentralizing reform transferring power and resources from upper to lower levels of government. These conditions can be divided into three categories:

**Information.** Politicians must have good information on what local voters want, and voters must in turn have good information on what government does. Free and fair elections are essential to the former, although lobbying, town meetings, and other more informal mechanisms also play important roles. And a free and lively press are crucial for the latter, although government openness and regular reporting are also important.

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<sup>18</sup> See Alsop et. al. (2000).

<sup>19</sup> See Edmonds Elías, E. (1998). These comments are valid up to the early 1990s. With the gradual demise of the PRI and consequent opening of the political system since the mid-1990s, these comments are becoming increasingly less true. Also, the dynamics of Mexican democratization might have related to the process of decentralization. See for instance Díaz-Cayeros, Magaloni and Weingast (2000). That paper also makes an argument relating the maintenance of non-competitive politics to the nature of intergovernmental transfers, a point we discuss in Part II.

**Openness and Competition.** This refers to both the political party system, and local firms and other economic actors that finance political parties and candidates. A vigorous and competitive local politics leads to political entrepreneurship and policy innovation. Where a few parties manage to dominate elections and stifle innovation, on the other hand, politics will tend to grow unrepresentative of an electorate which will in turn lose interest in politics and its possibilities to effect change. Hegemony in the local economy, or monopoly in the supply of finance to the local political system, reduces competition amongst political parties, and hence impairs political oversight of local government's actions. Economic openness and competition, by contrast, promote competition in politics and increase the diversity of ideas and policies that compete for public favor. This facilitates the role of policy entrepreneurs, who identify gaps in the policy offerings and represented constituencies of established parties, and devise new policies to fill these gaps.

**Social Trust and Civic Organization.** Individuals do not participate in politics only as individual voters, but also collectively according to different cross-cutting cleavages that change over time, grouping a given set of voters in different ways. These cleavages arise spontaneously within society, according to economic and political interests, ethnicity, language, and many other criteria. In some cases they may appear as semi-permanent organizations, such as neighborhood groups, and in other cases ephemerally as political movements organized around a particular theme. They are important because they help to define the relationships that citizens have with the institutions of government. Civic organizations perform important functions, including aggregating preferences and representing communities' needs, mediating community participation in the production of certain services, facilitating social expression and the assertion of local identity, and enforcing political accountability. These social organizations often develop their own norms of behavior and responsibility organically, and over time may build up stores of trust and credibility that enhance capacity. Local government depends on the relationships that collectively comprise civil society to elicit information necessary to the policy-making process, judge the efficacy of previous interventions, and plan for the future. Politicians also depend on these relationships to gauge public satisfaction with their performance between elections. The organizational dynamic of civil society is thus intrinsic to the process of local government.

Where information, openness and competition, and social trust and civic organization obtain, local government will have a strong tendency to work better than it would otherwise. And where local government works well, decentralization will tend to make government more effective and responsive to their voters, as we have argued above. Certain complementary institutions and organizations can contribute powerfully to information, openness and civic organization.

A good example of how the decentralization experience depends on the availability of complementary organizations is the case of the "oversight committees" or "public accounts committees" that serve as watchdogs, scrutinizing the activities of local governments. Bolivia's oversight committees are based on the pre-existing, spontaneous forms of social organization (*e.g. allyus, mallkus*, neighborhood councils, peasant unions) that occur at the community level throughout the country. These represent traditional forms of community self-government; committees based on them accordingly benefit from high levels of legitimacy and familiarity amongst local

citizens and beneficiaries. By incorporating oversight committees into the local government system, the Bolivian decentralization effectively mobilized widespread but under-utilized social capital in the interests of improving government decision-making.

Similarly, it has been observed in both Kerala and West Bengal that theft and corruption at the local level are more effectively resisted if regular local elections to select representatives to 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 village council meetings or 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 (i.e. "jobs for the boys" or *lottizzazione*), which sometimes consolidates 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.

Comparisons across the various states of India make 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 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. And in Kerala, near-universal literacy has helped sustain widespread newspaper readership, which has encouraged a vigilant press on issues like corruption in local governments.

#### **A List of Complementary Institutions/Organizations**

1. A lively, independent press and other media
2. A vigorous opposition
3. Impartial electoral authorities to run elections and monitor campaigns
4. Campaign finance laws that encourage fairness and competition
5. Impartial courts
6. Active civic organizations, such as village councils, peasants' unions, and neighborhood groups
7. Active NGOs
8. Independent professional guilds (e.g. doctors, lawyers, engineers)
9. Effective interest groups and other political lobbies
10. Minimum levels of education amongst the population that allow civic leaders to emerge spontaneously
11. Non-interference (non-favoritism) in local politics by higher-level government institutions
12. Adequate arenas for intergovernmental relations

## **II. Intergovernmental Relations**

Decentralization is more likely to lead to quality local governance in the presence of complementary institutions. But, as was made clear above, successful decentralization also imposes requirements on the quality of governance at the center, as well as on the quality of relationships between central and local governments.

The decisions taken by central and by local government officials depend on their incentives. Those incentives relate to the structure of the central government, to the structure of local governments, and to the nature of intergovernmental relations. Section I emphasized several aspects related to local governance. In section II the focus is on intergovernmental relations, and to their connection with the structure of central government itself.

Section II begins with an explanation of why it is that any discussion of decentralization needs to take intergovernmental relations into account. The next subsections describe the fiscal and political aspects of intergovernmental relations, highlighting their potential to affect the impact of decentralization. The section closes with a brief discussion of the mechanisms by which accountability (emphasized in section I) and intergovernmental relations (emphasized in section II) are intertwined.

### **The Importance of Intergovernmental Relations**

Decentralization typically does not eliminate central government responsibility, but it does change it; for instance from direct provision of some public services, to cost sharing, regulation, monitoring, and related tasks. For many “decentralized” public services, there are patterns of overlapping responsibilities shared among two or more levels of government.

Consider the case of education. Provision and regulation of education may be organized locally but financed centrally, with national standards being laid down for pricing and provision. This requires that local and central governments find a *modus operandi* for those interactions. How they do this is at the heart of the problem of intergovernmental relations (IGR).

In practice, reforms described as education decentralization can imply a variety of changes in the organization of public provision of education. The following table shows the role played by different tiers in a few Latin American countries which recently “decentralized education.”

**TABLE 1: The Locus of Key Educational Decisions and Responsibilities<sup>20</sup>**

GROUP	DECISIONS	ARG	CHILE	EL SAL	MEX	NIC
Organization	Level of decentralization	R	L	S	R	S
	Choose textbooks	S	S	S	N	S
Personnel	Determine teaching methods	S	S	S	S	S
	Hire / fire school director	R	L	S	R	S
	Recruit / hire teachers	R	L	S	R	S
Planning	Set or argument teacher pay	R	L	N	N	S
	Set performance exams	N	N	N	N	N
Resources	Determine expenditures	R	N, L	N	R	N, S
	Allocate personnel budget	R	L	N	R	S
	Allocate non-personnel budget	R	L	S	R	S

N = national, R = regional, L = local, S = school.

The table, based on statutory definitions, understates the actual involvement of national governments, which in some cases goes beyond the formal allocation of responsibilities. The extent of national government “overinvolvement” might relate to broader issues of intergovernmental relations, especially on the fiscal side. Also, international organizations (such as the World Bank) tend to operate with central ministries, and these ministries sometimes make the access of subnational governments to international funding conditional on the acceptance of some practices favored by the ministry in question.<sup>21</sup>

More generally than just the case of education, there are a large variety of alternative arrangements for “decentralized” public services. There may be:

- (a) “parallel” units servicing different parts of the “market” (e.g., national hospitals and local primary health care units),
- (b) a service supplied by one level of government, but with joint funding through grants,
- (c) the local government providing the service but subject to some supervision and regulation by a senior government,
- (d) a senior government monitoring and providing information about the performance of local government services,

and many other possible variations, including additional layers of government, and even special-purpose governments (such as school districts). There are even cases in which even though not *de jure*, the senior government is still involved *de facto* in local affairs. The upshot is that in practice and for most “decentralized” public services, interactions among different governments always take place. The effectiveness of any given vertical allocation of responsibilities will depend on the quality of these intergovernmental relations.

Another reason why IGR tend to be crucial in decentralized settings relates to one of the core issues in the decentralization debate. One of the stronger arguments for the role of the central government in the first place, is the presence of *externalities*. An

<sup>20</sup> Source: Winkler and Gershberg (1999).

<sup>21</sup> Fiszbein and Tommasi (2003) describe such instances in the case of the health sector in Argentina.

externality is present whenever the well-being of a consumer or the production possibilities of a firm are directly affected by the actions of another agent in the economy. Externalities between citizens in different locations can be positive or negative. An example of positive externalities is that of flood defenses constructed in one location, which are beneficial to citizens in other locations. Negative externalities arise, for instance, when pollution travels over space.

In the presence of such externalities, cooperation across different locations is necessary, in order to achieve the collectively adequate level of the activities generating those externalities. A key role of governments is to facilitate such cooperative actions and, if necessary, to use coercive power to achieve social benefits. As was discussed in Section I, a balance must be struck between these benefits and the possible abuse of power that can ensue.

In decentralized settings, with multiple governments, each one caring for a given community (subject to the accountability considerations of Section I), externalities can arise between the different decision-making authorities.

A broad principle of government design is the so-called *encompassing principle*: that the assignment of governmental responsibility should *encompass* the externalities in question. Loosely speaking this says that national externalities and public goods are best dealt with by national governments and local externalities and public goods by local governments.

Put into practice, this would say that having catalogued the policy externalities, the tasks of government would then be assigned so as make sure that the policy authority best able to internalize that externality is given responsibility.

Perhaps the most famous manifestation of the encompassing principle in economics is *Oates' decentralization theorem*.<sup>22</sup> Oates suggested that local government should be responsible for all forms of spending which do not inflict an externality on other jurisdictions. The advantage of such arrangements is that the level and type of such spending can be tailored to the desires of the local residents. There are natural applications of this logic to services such as trash collection and fire services, which are typically organized at the local level. Arguably these are forms of spending that have few externalities across jurisdictions.

There are considerations other than externalities that influence the “ideal” allocation of public service provision across levels of government. Among the most important ones are *scale economies*: some kinds of government activities might be organized at lower cost if they are undertaken on a larger scale.

Different public services have different “territorial” properties, in terms of the exact reach of the externalities or of the scale economies involved. Yet, with the exception of some cases such as school districts in some countries, most subnational governments are multipurpose organizations which provide a variety of different public goods and services.<sup>23</sup> This implies that the actual political jurisdictions of any

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<sup>22</sup> Oates (1972).

<sup>23</sup> This is further complicated by the fact that in many countries the subnational political units are the product of historical accident, and not of public finance optimization. This seems to be even more the

country will never adequately encompass all the relevant externalities, and hence there will always be the need for intergovernmental cooperation.

For these reasons, IGR are a crucial component of the structure and workings of government, independently of the exact level of decentralization in each case. Interactions among different governments always take place, and the effectiveness of any given vertical allocation of responsibilities will also depend on the quality of these interactions. This is likely to be even more important during the process of decentralization.

But even beyond the nowadays publicized decentralization processes, the assignment of policy responsibilities is never unambiguous or frozen. Decentralization is a dynamic process. No country ever gets it right on its first try. Circumstances change, and the nature and design of intergovernmental fiscal relations should change also. An important aspect of establishing an adequate institutional framework for decentralization is thus to build in some “error-correction” mechanism, that is, to permit and encourage the adaptive development and evolution of the system in response to changes in needs and capacities across levels of government.<sup>24</sup> Given the dynamism of the very process, IGR play an important role as the “broader governance” within which actual reallocations take place.

### **Fiscal Aspects of Intergovernmental Relations**

As stated before, the incentives of central and local governmental actors depend on the rules of the political and governmental game. Those rules include the structure of the central government (in a broad sense, including electoral rules, political parties, regime, etc.), the structure of local government, and the structure of IGR. We focus here on the structure of IGR. One of its key components, analyzed in this subsection, is the fiscal arrangement of the country. Political aspects of these relations are examined in the next subsection.

The literature on Fiscal Federalism structures itself around three questions: (1) which functions are allocated to what level of government? (2) how is revenue-raising allocated (i.e., who charges what taxes?) and (for most possible answers of the first two questions) (3) how are the resulting fiscal gaps taken care of? Question (1) has been addressed earlier in this section. The following will address the other two questions.

Effective government requires that spending and tax needs be brought into line with one another. Three major sources of funds are possible: own revenues, debt, and transfers from other governments.

#### *Own Revenues*

Standard public finance sees the design of tax systems as balancing equity and efficiency arguments. For efficiency purposes, taxes are best levied on goods and

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case for intermediate tier governments, which have been the main focus of decentralization in some countries (for instance Argentina, Brazil and Peru).

<sup>24</sup> Bird (not dated); Saiegh and Tommasi (2000).

services that are inelastically demanded; but distributional concerns must also be weighted up.

These same concerns are present in discussions of decentralized tax assignment. The main additional concern is the role of mobility across jurisdictions. From the point of view of local governments, this makes demands for goods more elastic and hence can increase the efficiency cost of taxation to the local government. However, from the point of view of the economy as a whole, there need not be any change in the elasticity. Hence, local governments will charge inefficiently high taxes on immobile goods and services, with too low a level of tax on mobile goods. The same reasoning applies to factors of production, such as labor, capital and land. This may give a presumption of the superiority of more centralized tax setting based on the encompassing principle. This may also explain why taxation of immobile structures such as land and real estate tends to be the preserve of local governments.

Those considerations have to be weighted against the benefits from greater local accountability stemming from decentralized taxation as discussed in Section I. Also, the overall incentives of the system have to be taken into consideration. As discussed in the last subsection there are reasons of *fiscal responsibility* by which it is desirable that local governments have significant taxing powers.<sup>25</sup> This might lead to cases in which it is best to leave taxation powers at the local level, even in the presence of some externalities due to mobility of tax basis.

Most countries in the world assign own sources of revenue to each level of government, with various types of intergovernmental transfers to bridge any resulting gap between revenue and expenditure assignment. Some countries espouse a principle of complete separation of the tax bases for different levels of government. Others allow different levels to tap the same tax base.

Intergovernmental considerations are even more important when there is co-occupancy of tax bases. For example, if both local and central government are able to tax labor income, then there is common-pool problem which leads to governments over-exploiting the revenue source. Avoiding this problem requires cooperation between tiers of government. The same logic holds in the case of mobility across jurisdictions.

One solution for tax coordination issues, alternative to organizing taxation at the central level, is to rely on agreements negotiated among local governments. The effectiveness of such mechanisms depends heavily on the quality of the institutional environment for organizing cooperation.

### *Debt*

Deficits and debt are a potential source of finance for subnational governments. Debt finance is appealing for financing infrastructure, a type of expenditure for which local governments tend to have important responsibilities.

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<sup>25</sup> Bahl (1999).

Viable local government debt requires a developed capital market in which rating agencies can provide information about the quality and reliability of the financial institutions. Evidence from the United States suggests that risk premia on state and local debt depend upon the budgetary institutions in place.

It is important to distinguish between operating and capital outlays and between regional and local governments. The case seems more clear-cut at the local level, where deficits in operating accounts should not be permitted and debt only allowed for the finance of capital outlays. In practice there are ways to mask irresponsible operating accounts as capital spending. The problem is a lot worse at the intermediate (region, province) level, where there might be some arguments for a role in stabilization, and where historical and constitutional factors might give some latitude in debt finance.

One key issue is whether the central government will be willing to bail out or monetize any debt issued by local government. This depends on the credibility of the monetary institutions in the economy. The fact that non-central government debt has systemic effects requires that central governments have a role in supervising the terms on which non-central governments have access to capital markets.

Whenever senior governments get involved in supervision, this ends up creating an implicit obligation to bailout the junior government in case of financial difficulties. Sub-national budget constraints are often soft. This leads to a situation of moral hazard in which sub-national governments might over-spend, under-tax, over-borrow, under-provide services, and accumulate arrears, in the hope that local public expenditures will ultimately be subsidized by taxpayers in other jurisdictions. This problem is magnified in the cases of large vertical fiscal imbalances.<sup>26</sup>

Not only the federal fiscal structure, but also the structure of political institutions affects the likelihood of moral hazard problems. In all federal countries (and many unitary ones) the structure of the central government includes representation of sub-national units. Depending on the details of such representation, and on other aspects of the country's political institutions, this can give rise to logrolling by which a central government would opt to provide bailouts to certain states, even though the policy is inefficient for the federation as a whole.

### *Intergovernmental Transfers*

The fact that taxing and spending is carried out at different levels of government implies that there are likely to be significant fiscal imbalances. Intergovernmental transfers are the vehicle by which funds flow across tiers of government.

There are two main considerations in the design of transfers:

*Vertical imbalances:* As discussed above, decentralizing expenditures might lead to more efficient service delivery, but it is not clear that there are equivalent fiscal efficiency advantages of decentralizing revenue-raising. Fiscal responsibility and accountability arguments have to be weighed against efficiency gains from applying

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<sup>26</sup> Eichengreen and von Hagen (1996).

the encompassing principle. In practice, public spending tends to be decentralized and taxation centralized leading to vertical imbalances and resource transfers to sub-national governments.

*Horizontal imbalances:* These arise due to redistribution / “equalization” across subnational jurisdictions and due to inter-jurisdictional spillovers.

It is commonly stated that an effective transfer system should satisfy several criteria:

*Revenue adequacy:* the subnational authorities should have sufficient resources, with transfers, to undertake the designated responsibilities.

*Local tax effort and expenditure control:* ensuring sufficient tax efforts by local authorities. The transfer system should not encourage fiscal deficits.

*Equity:* transfers should vary directly with local fiscal needs and inversely with local fiscal capacity.

*Transparency and stability:* the formula should be announced and each locality should be able to forecast its own total revenue in order to prepare its budget; and the formulae should be sufficiently stable to allow long-term planning at the local level.

Intergovernmental transfer systems in many countries, for instance in Latin America, are quite far from satisfying such criteria. There are often open channels for “moving money around” in ways that create negative incentives for fiscal responsibility, as well as adding uncertainty and reducing stability.<sup>27</sup> That constitutes a complicating factor for decentralization processes.

### **Political Aspects of Intergovernmental Relations**

In describing fiscal relations across government levels, it became already apparent that such relations, in practice, are often guided by political considerations. In this subsection we briefly address some of those considerations. In any given country, especially in federal ones (which contain most of the world’s population), intergovernmental relations take place in two interconnected arenas: the central government itself (mostly through subnational representation in the federal legislature), and in specifically intergovernmental exchange arenas.

#### *Central government decision-making and intergovernmental relations*

Conventional treatments of fiscal federalism (partly summarized above) tend to treat the central government as a unified actor, mostly benevolent, and at most subject to informational problems and time inconsistency temptations. It turns out that IGR, important and complex as they are, are further complicated by the fact that the central government is not a unified actor (neither a benevolent one).

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<sup>27</sup> Saiegh and Tommasi (2000).

One can think of the central government as an arena in which there are some “purely national” interests, as well as representation of subnational interests. The details of political institutions and political cleavages in each country are very important for understanding the exact incentives and exact configuration of each of these two components, as well as of their interactions.

The “purely national” interests stem in part from the more encompassing interest that national authorities (especially the national executive) tend to have, as a consequence of their broader electoral base. But they are also related to the more individualistic (or national pressure-group driven) political incentives of national actors. For instance, national government officials like to take political credit for delivering popular public goods, and dislike taking the blame for politically costly events, such as teacher strikes due to unpaid wages.

The exact way in which subnational interests are represented at the center, varies from country to country, depending on the rules by which the different chambers of parliament are configured, on the role of each chamber in the legislative process, as well as on the partisan connections across levels of government. One could imagine a continuum from a case in which the national government is totally free from “the infiltration of subnational interests,” to a case in which there is not such a thing as a national interest, and the national government is just an arena of subnational political exchanges. Clearly, no country in the world (certainly no federal country) fits either extreme, but we can find important variations in that dimension. China’s central government is less dependent on subnational political actors than Argentina’s.<sup>28</sup>

These political connections are important, since they are one of the determinants of whether the central government will behave opportunistically and also asymmetrically in its assistance to subnational governments. These factors tend to weight heavily throughout decentralization processes, impinging upon the incentives of local actors, in ways that might be more or less conducive for decentralization to improve governance.

In some countries, subnational governments do not perform well their services, and even promote street demonstrations, in order to pressure the central government for financial assistance. This is more likely to be the case, the more local governments rely on central transfers as opposed to their own tax revenues. (This is also connected to the workings of local democracy, a point treated in Section I, to which we return below).

Also, it is not uncommon for coalitions of subnational governments to utilize the central government as a mechanism of interregional redistribution. Instances of such behavior are reported in Argentina, Brazil, India, Nigeria, and other countries.<sup>29</sup>

### *Intergovernmental Arenas*

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<sup>28</sup> Although, according to Shah (1998, p.7) even in China “regional communist party bosses-governors exercise a moderating influence on an otherwise monolithic state council at the federal level.” For accounts of the dependence of national politics on subnational political forces in Argentina, see Jones et al (2002), and Spiller and Tommasi (2003).

<sup>29</sup> Asadurian et al (2003), Rodden et al (2002), Tommasi (2002).

Other than the central government as an arena of political exchange among the different local governments in each country, several countries have developed informal and often formal arenas of intergovernmental exchange. In many cases (Canada, Australia, Germany, India, Malaysia) this takes the form of “executive federalism,” that is meetings of the national and subnational governments.<sup>30</sup>

As noted above, given the changing nature of fiscal and economic technologies, and of underlying social problems, it is impossible (or at least, quite undesirable) to freeze over time allocations of specific powers, including funding, across governments. These intergovernmental arenas are often used for carrying out cooperative error-correction mechanisms.

In several federations, a variety of intergovernmental councils, commissions and committees have been developed to facilitate adaptation of the financial arrangements to changing circumstances. Australia has gone furthest in developing such institutions with three IG institutions playing different roles in the deliberations about adjusting transfers to changed circumstances: the Premiers council (although it is not a body established by the constitution, plays the top political role); the Loans council (established by constitutional amendment in 1927, coordinates federal and state borrowing, and can make decisions binding for both levels of government); and the Commonwealth Grants Commission (a standing body since 1933 which provides the technical advice supporting political decisions.) The Finance Commission in India, plays a similar role to the CGC in Australia. The presence of these technical bodies, if it becomes institutionalized; could be very important in bringing transparency and technical standards on what otherwise has the tendency to degenerate into a fight for the fiscal loot.<sup>31</sup>

### **Intergovernmental Relations and Accountability**

Section I emphasized the mechanisms by which decentralization is supposed to improve the accountability of government officials to the citizenry. Section II has emphasized the relations across different layers of government. This subsection highlights the interactions between those two dimensions. For brevity, the focus is on one core aspect of IGR, the degree to which subnational governments rely mostly on local sources of revenue as opposed to depending on different forms of redistribution from taxes collected by the central government. There are several channels by which the presence of vertical fiscal imbalances that characterize many “decentralized” fiscal systems might weaken local accountability. The following is a review of some of them.

It has been argued (and buttressed by some empirical evidence) that tax-sharing systems in which the link between local spending and local taxation is weak, increase

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<sup>30</sup> Watts (1999).

<sup>31</sup> Srinivasan and Wallack (2003), in a summary chapter for a cross national study on federal countries, suggest that those countries that have vigorous IG institutions, are more likely to find their way out of impasses, and hence more likely to instrument some necessary reforms, for instance, to the tax system.

the importance of corruption relative to provision of public goods.<sup>32</sup> The reason may be that local people are much more vigilant of official malfeasance with their own tax money than with fiscal grants coming from central government. Consequently, local governments will have a stronger incentive to tailor local policies and services to the priorities of those who pay.

A complementary channel is the blame-the-center strategy of local governments. When local governments are heavily dependent on central funds, they can always blame the poor quality of services on insufficient central funding. (This has happened repeatedly in the case of Education in Argentina). The fact that citizens might have a hard time disentangling lack of (central) funds from local incompetence or mischief, reduces local accountability.<sup>33</sup>

Furthermore, a decentralized government needs to be accountable to two major groups: the beneficiaries of its services and those who pay for them. In general, if the local government receives a large fraction of its revenue from the center, those financing its services will include many residents from other jurisdictions, represented by the central government,<sup>34</sup> which further complicates the agency problem. The following provides an illustration.

If the resources that go to each jurisdiction are determined by mechanisms that are not fully automatic, the local political process might be biased towards rewarding those capable of extracting more money from the center, not necessarily the more competent and/or honest local administrators. Some evidence of this channel can be found by comparing the results on the effects of fiscal variables on subnational elections in countries where subnational governments are more or less financially autonomous from the center. It seems that voters penalize increases in spending in the USA (a case where states rely mostly on their own sources of revenue), while they reward increases in spending in Argentina (a case characterized by large fiscal imbalances and frequent bailouts from the center.)<sup>35</sup>

## **Conclusion**

This paper provides a quick guide to some of the main issues in the debate on the pros and cons of decentralization. It has been emphasized that complementary institutions make decentralization more likely to lead to greater local accountability and improved governance. It has also been argued that intergovernmental relations exhibiting appropriate incentive structures for local and central government officials are important for successful decentralization.

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<sup>32</sup> Careaga and Weingast (2002) formalize these ideas and provide some evidence from Mexico. Bardhan and Mookherjee (2000) also stress the connection between mode of financing and local accountability. Fisman and Gatti (2000) provide cross-country evidence to that effect.

<sup>33</sup> Tommasi (2002).

<sup>34</sup> This role needs not be in the hands of the central government, but it might be in the hands of some explicitly multilateral interjurisdictional governance structure, as mentioned before.

<sup>35</sup> See Peltzman (1992) and Lowry et al (1998) for the case of the U.S., and Jones, Sanguinetti and Tommasi (2003) for the case of Argentina.

Decentralization is a complex matter. Whether a particular component of the bundle of policy decisions better pertains to a certain decision-making level depends on a variety of circumstances, likely to vary from country to country. Furthermore, those circumstances are also likely to change over time, as technologies and preferences change. Future research should also focus on the broader mechanisms by which governments decide and instrument these processes.

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## **Appendix – Background Papers**

### **Table of Contents**

#### **I. Conceptual Issues (theoretical and empirical)**

1. Notes on Different Forms of Decentralisation  
*Timothy Besley*
2. Notes on Decentralization: Elite Capture and Lobbying  
*Pranab Bardhan*
3. Notes on Fiscal Federalism  
*Mariano Tommasi*
4. Decentralization: Micro Incentives vs Macro Stability  
*Yingyi Qian*
5. Notes on Decentralization and Service Delivery  
*Francisco H.G. Ferreira*
6. A Political Approach to the Assignment of Powers in a Federal System  
*Barry R. Weingast*
7. The Role of Civil Society in the Local Government Process  
*Jean-Paul Faguet*
8. Notes on Empirical Evidence on the Impact of Decentralization  
*Robin Burgess*

#### **II. Experiences**

9. Fiscal Decentralization in China  
*Justin Yifu Lin*
10. An Overview of Decentralization in India  
*Rohini Pande*
11. Decentralization: The Latin American Experience  
*Kathleen O'Neill*