Chapter 5

Decentralization: Rethinking Government

People around the world are demanding greater self-determination and influence in the decisions of their governments—a force this report has labeled *localization.* Some 95 percent of democracies now have elected subnational governments, and countries everywhere—large and small, rich and poor—are devolving political, fiscal, and administrative powers to subnational tiers of government (box 5.1).[1] But decentralization is often implemented haphazardly. Decisionmakers do not always fully control the pace or genesis of the decentralization process. Even when they do, models of decentralization are often exported from one country to another without regard for local political traditions, regulatory frameworks, or property rights.

Decentralization itself is neither good nor bad. It is a means to an end, often imposed by political reality. The issue is whether it is successful or not. Successful decentralization improves the efficiency and responsiveness of the public sector while accommodating potentially explosive political forces. Unsuccessful decentralization threatens economic and political stability and disrupts the delivery of public services.

This chapter argues that the success of decentralization depends on its design. It reviews developing countries' experience with decentralization and shows that the stakes are high. Drawing on this experience, it offers guidelines for improving the political, fiscal, and administrative institutions of decentralization. This advice is not only relevant to countries that have already decentralized. It can also help the many countries now embarking on this path avoid some of the major hurdles that have confronted their predecessors.

What is at stake?

The experience of the last 15 years shows that the devolution of powers affects political stability, public service performance, equity, and macroeconomic stability.[2]

Political stability

A primary objective of decentralization is to maintain political stability in the face of pressures for localization. When a country finds itself deeply divided, especially along geographic or ethnic lines, decentralization provides an institutional mechanism for bringing opposition groups into a formal, rule-bound

Box 5.1
Decentralization as the devolution of powers

Decentralization entails the transfer of political, fiscal, and administrative powers to subnational units of government. A government has not decentralized unless the country contains "autonomous elected subnational governments capable of taking binding decisions in at least some policy areas."[3] Decentralization may involve bringing such governments into existence. Or it may consist of expanding the resources and responsibilities of existing subnational governments. The definition encompasses many variations. India, for example, is a federal state, but the central government has considerable power over subnational governments. Political power in China is officially centralized, but subnational units have substantial de facto autonomy in what can be described as "decentralization Chinese style."

Central governments can devolve their powers in other ways. *Deconcentration* increases the autonomy of staff in regional offices, while *privatization* moves responsibility out of the public sector altogether. The policy implications differ. Deconcentration preserves the hierarchical relationship between field staff and the central government. Privatization eliminates it altogether, introducing the profit motive instead. Decentralization shifts the focus of accountability from the central government to constituents, usually through local elections.

bargaining process.[4] In South Africa and Uganda decentralization has served as a path to national unity (box 5.2). In Sri Lanka it offers a potential political solution to the civil war. It is an instrument for deflating secessionist tendencies in Ethiopia and Bosnia and Herzegovina (box 5.3). In Colombia centralized party elites relied on decentralization to gain grassroots support, particularly in areas under rebel control.[5] And Russia's transformation into a decentralized federal system can be seen as a means of conceding enough power to regional interests to forestall their departure from the republic.[6]

Public service performance

The classic argument in favor of decentralization is that it increases the efficiency and responsiveness of government.[7] Locally elected leaders know their constituents better than authorities at the national level and so should be well positioned to provide the public services local residents want and need. Physical proximity makes it easier for citizens to hold local officials accountable for their performance.[8] Finally, if the population is mobile and citizens can "vote with their feet" by moving to another jurisdiction, decentralization can create

Box 5.2
South Africa and Uganda: unifying a country through decentralization

South Africa and Uganda have adopted ambitious decentralization programs and, despite some difficulties with implementation, are emerging as two important models for devolving centralized power.[9] The models operate in different contexts: a middle-income and predominantly urban country (South Africa), and a low-income, predominately rural country (Uganda). But both have the same goal: to reunify the country.

South Africa. Apartheid fostered a dual structure of government based on race. For whites, it promoted accountability, political involvement, and effective service delivery. But blacks, spatially segregated in "homelands" and "townships" on the fringes of urban areas, had limited access to public goods and services. To reverse this racial system, the new constitution provides for a comprehensive decentralization policy, which the leadership has been implementing.

The racial jurisdictions were formally abolished along with the system of apartheid. The country was subdivided into 9 provinces, 5 metropolitan areas, and 850 municipalities, all racially mixed and with democratically elected governments. The central government retains primary fiscal responsibility for expenditures that have a major redistributive impact, such as health and education, but metropolitan governments have been restructured to implement policies at the local level. Some difficulties remain—for example, how to divide responsibility for health and education between the central government and the provinces. But decentralization has succeeded in becoming one of South Africa's main instruments of unification.

Uganda. The task President Museveni faced when he assumed power in 1985 was to reunite a country that had splintered into hostile factions during years of turmoil. The broad-based politics of "resistance councils" and committees that had been developed during the years of civil war helped pacify most parts of the country. This system—which entails giving power to the people of a village (the council) to freely choose their leaders (committees)—served as the basis for the local government policy enshrined in the 1995 constitution. The 46 districts, which are subdivided into smaller units down to the village level, have taken on substantial responsibilities for education, health, and local infrastructure. They now account for 30 percent of overall government spending.

Uganda still faces problems with implementing decentralization. Limited local capacity and resistance from central ministries have hobbled the transfer of responsibilities. The revenues local governments control (primarily user charges and local taxes) have not increased as much as expected, and grants still account for 80 percent of local resources. Despite increased participation, local services and management have not become significantly more responsive to local preferences—although this is now improving. Even with these difficulties, however, decentralization has been much more successful in maintaining national unity than the previous policies of centrally imposed controls.

Box 5.3

Bosnia and Herzegovina and Ethiopia: decentralization as a response to ethnic diversity

Ethiopia and Bosnia and Herzegovina illustrate the tension between political imperatives and economic efficiency that emerges in countries with ethnic tensions.

Bosnia and Herzegovina. The possibilities for instituting "efficient" federalism and equalization in an ethnically polarized society are limited. The Dayton Peace Agreement, which addressed the challenges of governing Yugoslavia's successor states, had the potential to solidify relations among the three ethnic groups that ratified it. But the agreements had to compromise on some key principles of fiscal federalism to reach a politically acceptable solution. The Dayton agreement limited the state's authority to international relations (including customs and trade policies, debt service, and debt management), central banking (through a currency board), and telecommunications and national transport infrastructure. The national government's only revenues are now passport fees and transfers from its two constituent entities, the Federation and the Republika Srpska. It has few spending powers and no redistributive functions. All taxing powers belong to the two entities, which are responsible for all other spending, including defense, pensions, health, and local roads. The entities are divided further into local governments that are responsible for education, housing, social transfers, and public services. There are no cross-subsidies across the two entities and very few across local governments.

The state faces challenges in carrying out even its minimal responsibilities, since it relies on transfers from the entity governments. Moreover, since economic conditions differ substantially across the country, large inequalities are likely to develop among and within the entities.

Ethiopia. Ethiopia's system of intergovernmental relations is designed to accommodate the rights of citizens to ethnic self-determination within a common political and economic community. The 1994 constitution, which establishes subnational boundaries and mechanisms for intergovernmental fiscal relations, stipulates that regions shall be formed on the basis of ethnic settlement patterns, language identity, and the consent of the people concerned. Subgroups within the member states have the right to establish their own states, and states have the right to secede from the federation.

The Ethiopian system differs from the Bosnian federalist structure in one key way: in Ethiopia the central government retains control of most tax revenues and has a strong redistributive role. Central transfers consist of block grants determined according to population, development indicators, and revenue performance. The poorer regions receive as much as 75 percent of their revenues through these grants. But the capital, Addis Ababa—which is the richest region—receives no central government support. State-level spending is kept under control by federal regulations on domestic borrowing and by a block grant formula that reduces regional transfers in proportion to external borrowing and donor grant flows. States are free to spend their block grants as they choose, subject only to federal auditing.

Ethiopia faces two challenges in its decentralization model. One is to develop stronger state revenue sources to deflect ethnic tension — especially resentment from ethnic groups in richer regions that receive less in government transfers. The second is to strengthen local governments, which are responsible for delivering most services but do not have the necessary capacity.

Source: Fox and Wallich 1997; World Bank 1999b.

competition among local governments to better satisfy citizens' needs.[10]

But evidence supporting these arguments is scanty—not because there is evidence to the contrary, but rather because the causal relationships are difficult to prove. Governments perform a variety of functions under vastly different circumstances, which complicates comparisons of performance in a country before and after decentralization, or across countries between centralized and decentralized systems. Moreover, efficiency and responsiveness can be hard to measure, and indicators are seldom readily available.[11]

How decentralization affects access to and quality of public services depends on the way it is designed and implemented. What local governments can achieve depends on the resources and responsibilities they are granted and on the power of national governments to override their decisions, as happens in India (box 5.4) and Zambia. Even within a particular sector, the mode of decentralization makes all the difference. In Central America, decentralizing management responsibilities from the central government to provincial and local levels had little effect on the primary education sector. But decentralizing management responsibility directly to the schools did improve educational performance.[12]

Decentralization can also lower the quality of public services, as it has in Latin America and Russia.[13] Conceding power to local governments is no guarantee that all local interest groups will be represented in local politics. It may simply mean that power is transferred from national to local elites. In India, for instance, local participation depends on social caste, and the poor have little influence.[14]

Equity

Whether decentralization exacerbates income differences among regions or becomes a positive force in efforts to alleviate poverty depends on two factors. The

Box 5.4
India: a decentralizing federation?

India has a federal constitution that gives its states substantial fiscal and regulatory powers. But three elements undercut those powers. First, the constitution also has strong unitary features, enabling the central government to dissolve state governments and take over their administration. Second, central planning—which until recently governed India's economy—blunted the economic powers of states. Third, national parties traditionally dominated subnational politics. Thus state budgetary outcomes were the result of centrally defined development policies and, in practice, state-level regulatory powers had little meaning.

The relative centralization of India's federalism is changing, however. The gradual weakening of central planning and the growing strength of regional parties in national coalition governments are strengthening state governments and allowing them a larger role in defining their development priorities. But most states are having difficulties growing into their new role. Many are saddled with excessive debt and unsustainable wage and pension bills and have few incentives to mobilize their own resources. A few states, including Andhra Pradesh, Uttar Pradesh, Orissa, and Haryana, are improving their financial situation and are making increasing use of the powers constitutionally granted to them.

The trend toward greater decentralization in India was reinforced in 1992 by the passage of the 73rd and 74th Amendments, which offered constitutional recognition to local governments. Until then, the constitution had made no mention of local governments, which were effectively creatures of the states. States were not under any obligation to hold regular local elections, and state-run agencies controlled most local functions, including urban planning and local infrastructure. Under the amendments states continue to define local governments' powers and resources and name their chief executive officers. They also retain the power of supersession—that is, the right to dissolve a local government and take over its powers. However, the amendments suggest a list of local responsibilities for inclusion in state constitutions and call for the creation of state-level financial commissions to oversee fiscal relations between states and local governments. Most important, states are required to hold elections within six months of superseding a local government.

Implementing the amendments has been a slow process, and some states have progressed more than others. With one exception, all states have held local elections and are observing the supersession rule. The proposed local functions are now part of most states' legislation, and a number of states have set up finance commissions that have submitted recommendations. However, state governments have been slow to implement these recommendations and to enable local bodies to execute the newly devolved functions. Recent assessments show that Gujarat, Karnataka, Kerala, Madhya Pradesh, Maharashtra, and West Bengal have made the most progress in devolving powers to local governments.

Source: Hemming, Mates, and Potter 1997; Mathur 1999; Mohan 1999; World Bank 1998i.

first is *horizontal equity*, or the extent to which subnational governments have the fiscal capacity to deliver an equivalent level of services to their population.[15] The second can be described as *within-state equity*, or the ability or willingness of subnational governments to improve income distribution within their borders. An additional complication springs from the fact that responsibilities for social services and direct income redistribution are typically shared across different tiers of government that have access to different sets of information and may have different objectives.[16]

Horizontal equity. Tax bases vary substantially from region to region and city to city, but tax rates cannot. A local government with a relatively small tax base cannot compensate by imposing much higher tax rates without losing businesses and residents to jurisdictions with lower taxes. The costs of providing public services may also vary because of regional characteristics such as population density and geographic location. To correct for such variations, most decentralized fiscal systems include equalization grants. In Vietnam the per capita tax revenues of low-income provinces are only 9 percent of those of wealthier provinces, but expenditures are 59 percent as a result of transfers from the central government.[17] In Australia, Canada, and Germany grants guarantee a minimum level of per capita expenditures for essential services in all regions. In other countries the goal is to ensure similar levels of service.[18] A difficulty with equalization grants is that subnational governments may differ in their willingness to raise taxes. Furthermore, the grants create an incentive for subnational authorities to understate their tax bases or relative wealth in order to maximize transfers.[19]

Within-state equity. In most countries income inequality is due more to differences among individuals within a state or province than to differences among the states or provinces themselves.[20] Providing poorer regions with additional resources, then, affects only one aspect of the equity problem. Evidence from India and Indonesia shows that even dramatic redistribution across regions will have limited results unless targeting is improved within regions themselves.[21] This, in turn, depends on the ability and willingness of the local government to engage in redistribution.

Recent studies have shown that local officials and community groups are better placed to identify and reach the poor than central authorities. In Albania, for example, local officials had considerable success in targeting the poor—far better than expected, given available statistical information on income and family characteristics.[22] In Uzbekistan elected neighborhood committees were able to increase both the efficiency and the cost-effectiveness of targeting.[23] Their success suggests that local officials have access to social networks that help them identify the truly needy. But this may not be the case in very large jurisdictions, such as China's provinces.

Subnational governments differ in their responsiveness to the needs of the poor. A recent review of an Argentine social program that is funded by the central government but implemented by provinces found that poverty targeting varied substantially across provinces. When reforms were introduced to improve the program's reach to the very poor, most of the improvements were due to reforms in intraprovincial targeting and better national monitoring of provincial performance.[24] Similarly, in Bolivia it was only when decentralization gave communities more power to influence their local governments that the composition of local public expenditures shifted in favor of the poor.[25]

Success in targeting the poor requires, therefore, a combination of national and subnational efforts. In general, the bulk of the funding needs to remain a central government responsibility, but the better information available to local officials can be tapped by involving local governments in the delivery and management of social services. Central government needs to retain a monitoring role, however, to ensure that redistributive goals are satisfied.

Macroeconomic stability

Decentralization, if handled poorly, can threaten macroeconomic stability.[26] Fiscal decentralization reduces the central government's control over public resources. The government of the Philippines, for example, is required to share nearly half its internal tax revenue with subnational governments, limiting its ability to adjust the budget in response to shocks. Deficit spending by local governments can also thwart central government efforts to cool the economy by restraining public expenditure.

When revenues are decentralized before expenditure responsibilities, central governments are forced to maintain spending levels with a smaller resource base. The result—seen in many Latin American countries—is large central government deficits. More generally, separating taxing and spending powers allows subnational governments to incur only a fraction of the political and financial costs of their expenditures, especially when most local resources are funded out of a common national pool of tax revenues.

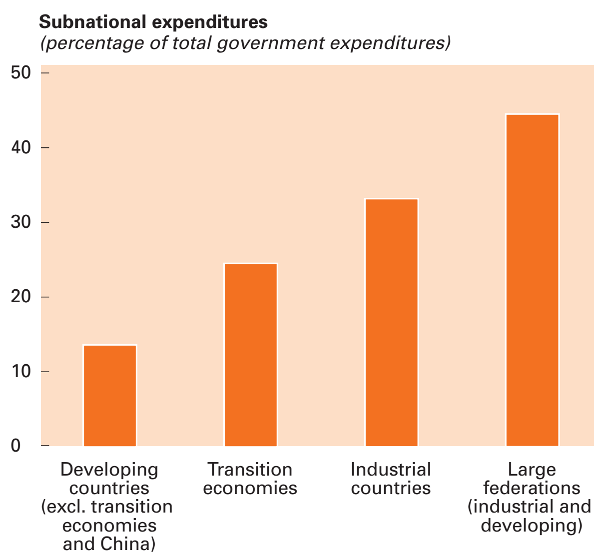
The threat of macroeconomic instability is a serious issue only in countries where subnational governments control substantial resources—usually, large federations or very decentralized wealthy countries (figures 5.1 and 5.2).[27] But even in these cases the evidence connecting decentralization and macroeconomic instability is mixed. Several studies suggest that decentralization has not undermined stability in the United States or in Western European countries. In Latin America subnational governments' contribution to the national deficit was negligible in most countries, except federal ones.[28]

From centralized to decentralized governance

A decentralization program needs to be adapted to a country's prevailing conditions. However, the experience of the past 15 years has yielded some universal

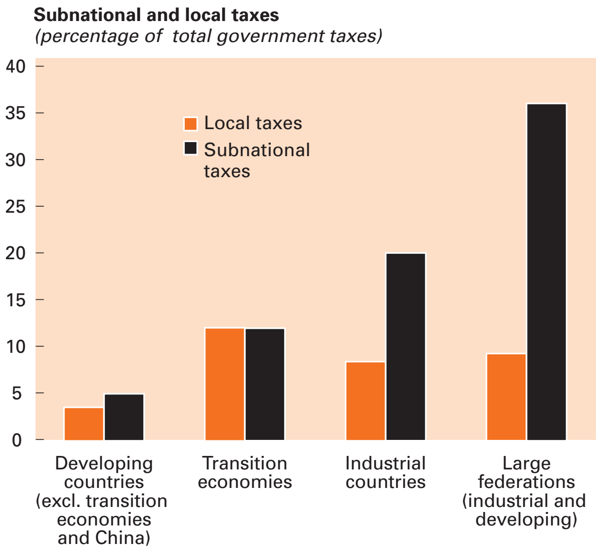
Figure 5.1

Subnational expenditures are a small share of public expenditures, except in industrial countries and large federations



Note: Graph shows median values rather than averages. *Subnational expenditures* are most recent available observations after 1990. Large federations are Argentina, Brazil, Canada, India, Mexico, the Russian Federation, and the United States.
Source: Appendix table A.1.

Figure 5.2
Local governments never control a large share of public resources



Note: Graph shows median values rather than averages. *Local taxes* and *subnational taxes* are most recent available observations after 1990. Large federations are Argentina, Brazil, Canada, India, Mexico, the Russian Federation, and the United States.
Source: Appendix table A.1.

lessons, which countries currently decentralizing can use to their advantage. One such lesson is the need for a coherent set of rules to replace the hierarchical system of governance characteristic of centralized systems.

A major challenge of decentralization is to institutionalize the balance of power between the national and local governments. This requires rules that both protect and limit the rights of subnational governments. Such rules come in a variety of forms. Some are unwritten. No law prohibits the United States government from providing relief to states in default, for example. Nor does Turkish law require the national government to bail out its defaulting municipalities. Yet in both cases these are well-established practices that influence the expectations of lenders and borrowers.

Making the rules of decentralization explicit and reasonably permanent reduces uncertainty and provides a common ground for all players in the political process. Informal, negotiation-based decentralization is difficult to manage, as illustrated by China's experience (box 5.5). Rules enable subnational governments to coordinate a defense against an overassertive central government while restricting their ability to bargain.[29] The literature on constitutionalism makes a strong case for establishing the most fundamental of these rules—choosing the heads of state and government, electing members of the legislature, distributing power among branches of government—in a form that can be altered only by exceptional majorities or complicated amendment procedures.[30] To be sustainable, such rules must be "self-enforcing"—that is, all parties must believe they have more to gain by adhering to the rules than they do by breaking them.[31]

Rules should be explicit, stable, and self-enforcing. But how should a country decide what their substance should be? The answer involves three broad areas of analysis: the division of national political power between national and subnational governments; the structure, functions, and resources assigned to subnational governments; and the electoral rules and other political institutions that bind local politicians to their constituents.

Balancing political power between central and local interests

The rules that govern relations between the central and subnational levels are almost always established at the national level, generally by the central government.[32] Even when these rules are incorporated into constitutions or treaties, they are still subject to renegotiation and to varying interpretations as to appropriate implementation.[33] The balance of powers between national and subnational governments will therefore depend on the influence of regional interests on the national government. And the stability of this balance of powers hinges upon the design of institutions that make it in the interest of national and subnational political elites to cooperate with each other.

Moderating regional influence on the national government

The influence of subnational interests on the national government depends on two factors. The first is the way regional interests are incorporated in the national legislature, which determines a subnational government's ability to pressure the national government to change rules. The second factor is the strength of the national executive, which influences the central government's ability to withstand such pressure.

Regional interests and the legislature. Seats in parliament may be allocated to give equal representation to states or provinces, thereby favoring norms of territor-

Box 5.5
Decentralization in China

China is formally constituted as a unitary state, and the dominant political party—the Chinese Communist Party—recommends candidates for the posts of governor and mayor for ratification by the People's Congress.[34] But political and economic power has dispersed markedly in recent years, particularly since the reforms of 1978. The number of posts controlled directly by the central organization of the party declined from 13,000 to 5,000, and central planning has largely been abandoned. Under such conditions, local leaders have more incentives to generate local economic prosperity than to follow some nationally determined economic goal, and they have acquired substantial autonomy in designing and implementing policy. China's central government can no longer unilaterally recapture the powers it has conceded and may not even want to. In February 1999, when a township elected its leader directly for the first time, the outcome was broadcast on national television, signaling official support for this event.

China's approach to decentralization relies on negotiations rather than rules to define relations between the central government and the four subnational tiers—provinces, prefectures/cities, counties, and towns. The allocation of responsibilities across tiers of government remains unclear except for health and education, which are controlled by the provinces. On the revenue side, until the early 1990s local governments were responsible for administering and collecting a large proportion of central government taxes, but their loyalty shifted away from the national government to the subnational level. Provincial tax officers often used the tax administration system to establish tax autonomy. They entered into direct negotiations with enterprises for payments (in lieu of the central government's enterprise income tax) and transferred tax funds that would otherwise have been shared with the central government into local extrabudgetary accounts.

In 1994 new reforms created separate tax administrations for national and local taxes, a step that increased the central government's share of tax revenues but remains highly unpopular. Five years later the principle that taxes belong to the central government unless specifically assigned to localities is still widely contested at the local level. Further, subnational governments continue to rely on extrabudgetary funds—some of them illegal—for the largest share of revenues. These funds, combined with frequent (and also illegal) provincial deficits, confer substantial fiscal independence on provincial administrations.

Decentralization Chinese-style does allow for considerable subnational autonomy. It creates incentives for local officials to work toward local prosperity and has also been an effective tool for instituting market reforms. But over time, the absence of clear rules may threaten its successes. Decentralization has accentuated a prereform tendency toward a fiefdom mentality that hampers efforts to unify the national market and periodically threatens central control over macroeconomic stability. Moreover, while administrative discretion has helped preserve the momentum for growth and reform, it has also created opportunities for rents that can be appropriated through financial corruption or political patronage. Official statistics show that by the end of 1998, 158,000 officials had been penalized by the Party's Commission for Discipline Inspection, and corruption was one of the main themes of the National People's Congress, China's parliament, in March 1999.

ial representation over norms of population (or citizen) representation. In bicameral systems the upper house commonly gives equal weight to states and thus represents regional interests in the national legislature. Senates in Argentina and Mexico award an equal number of seats to each state or province regardless of population, giving small units of government disproportional voting power. In the Argentine senatorial elections, one vote in Tierra del Fuego is worth 180 votes in Buenos Aires; in Mexico one vote in Baja California is worth 31 votes in the state of Mexico. And in Brazil, senators representing less than 13 percent of the electorate control 51 percent of the votes. In most bicameral countries, however, senates have limited powers, so the effect of territorial representation is much greater if it is applied to the lower house.[35]

When members of the upper house are chosen to represent regional interests, they can be elected directly by the people of that region, or they may be selected by the regional governments themselves, as they are in Germany, India, Pakistan, and South Africa.[36] In Russia provincial governors and prime ministers serve in the upper house on an ex officio basis. In principle, such explicit representation renders the upper house a tool of regional governments. Again, however, the impact on the national legislature depends on the powers granted to the upper house.

Finally, electoral arrangements matter. For example, electoral districts based on regional boundaries reinforce political cleavages along regional lines. For this reason, the approach is seldom used.[37] Among the large democracies, Argentina, Brazil, Colombia, Italy, and Spain are the only ones defining legislative districts solely along regional lines. Others rely on smaller subregional districts or have a number of legislators elected at large to represent the whole country, rather than a specific region.

The power of the executive. A central government's ability to withstand regional pressure depends on the strength of the chief executive and on whether a clear majority emerges in parliament. Whether the executive is chosen by parliament or by direct popular vote (that is, whether the regime is parliamentary or presidential) matters less than the powers of the executive in relation to the legislature. These powers include vetoes and the ability to control the legislative agenda or to legislate by decree. The degree to which the chief executive depends on the support of a political party is also a factor. Thus the United States is a presidential regime, but the constitutional division of powers forces presidents to rely on their party's support.[38]

The electoral system also influences the vulnerability of the executive to pressure groups. Proportional representation, which allocates seats in proportion to the share of votes received by each party, tends to produce governments that require a coalition of parties to govern.[39] Such coalition governments are inherently less stable and more vulnerable to demands by interest groups than majoritarian governments.[40] But proportional representation does allow disparate regional and ethnic interests to have a distinct voice in government. Combined with a parliamentary system of government, as in most Western European countries, proportional representation imposes the need to govern by consensus. Conventional political theory advocates such a system for new democracies precisely because it ensures a voice even for smaller groups, giving them a stake and presence in the new democracy rather than shutting them out.[41] But proportional representation combined with a presidential regime, as in Latin America, tends to produce executive-legislative deadlock.[42]

Creating incentives for national and subnational governments to cooperate

For the balance of powers to be stable, a commonality of interests must develop between national and subnational political elites.[43] Political parties play a crucial if often underestimated role in this process.[44] In the United States and Germany, national parties control the state legislatures, whereas in Canada regional parties compete with each other in subnational elections. As a result, Canada's subnational politicians are often elected on platforms explicitly framed in opposition to the national government and hardly ever move from provincial to national elected office. In contrast, in the United States and Germany opposition between national and subnational politicians is likely to be purely partisan, and often national leaders in both countries start their careers as subnational elected leaders.

Institutions can be designed to promote a commonality of interests. The electoral system and the resulting party structure determine the degree to which the political system is nationally integrated. Holding national and local elections concurrently creates incentives to nurture the meaning of party labels and to develop nationwide parties.[45] Legislative bodies that explicitly represent regions tend to promote integrated party structures.[46] The executive authority of the central government relative to the regional government matters, since it determines whether the central government needs to govern by consensus or fiat. Similarly, the strength of the chief executive's powers determines the extent to which the executive must rely on regional support.

There is no single best way to divide national political power between central and subnational governments. Nor can a single constitutional provision ensure that central and subnational political elites will find it in their interest to cooperate. But whatever system is adopted, it must not make the central government a prisoner of subnational interests.

The structure, functions, and resources of subnational governments

The second major category of rules deals with the way subnational governments are structured, what they do at each level, and how they are funded. These rules need to be determined as a system, taking into account the interactions among fiscal, political, and administrative institutions.

Structure and functions

What is the best structure for subnational governments? The traditional approach of public finance economists to decentralization, known as "fiscal federalism," calls for a subnational government structure with several tiers, with each tier delivering those services that provide benefits to those residing in the jurisdiction.[47] Experience shows that this model, while useful, has some limitations and that governments should seek instead to develop a regulatory framework that allows for the sharing of responsibilities.[48]

The fiscal federalist framework and its practical limits. The fiscal federalist model identifies three roles for the public sector: macroeconomic stabilization, income redistribution, and resource allocation (in the presence of market failure). The model assigns the stabilization role to the central government because it controls monetary policy and has more scope to use fiscal policy than subnational governments. The model also assigns income redistribution to the center, since local attempts at taxing the rich and redistributing wealth to the poor would result in inefficient population movements—high-income groups would move to areas with low taxes, and low-income groups would concentrate in areas offering high benefits.[49]

More recently the literature has recognized that while the central government should continue funding and designing redistribution efforts, local governments are often in a good position to implement and administer standardized national policies.[50] In addition, local governments usually administer services that have important redistributive implications, such as primary health care, education, child care, housing, and public transportation. In poorer countries such services are often the only vehicle for providing in-kind transfers to poor households.

The fiscal federalist approach assigns a significant role to subnational government in allocating resources. This is because when the benefits of particular services are largely confined to local jurisdictions, the appropriate levels and mix of services can be set to suit local preferences. Local consumers can express their preferences by voting or by moving to other jurisdictions.[51] In this respect, local politics can approximate the efficiencies of a market in the allocation of local public services.

This approach faces two practical obstacles, however. First, in developing countries where land and labor markets may not function well and the democratic tradition is in its infancy, it is not realistic to assume that people can move easily between jurisdictions or make their voices heard through the political process.[52] Second, establishing separate tiers of government for each service is costly and poses serious coordination problems.[53]

The structure of subnational governments. The appropriate number of tiers of government and of jurisdictions in each tier varies depending on a country's physical characteristics, its ethnic and political makeup, and possibly its income level. But all countries face the same trade-off between representation and cost. The local government of Midnapur in India may have difficulties managing local services in a way that is representative of the preferences of all its 8.3 million people. But very small local governments—like those of Armenia, the Czech Republic, Hungary, Latvia, and the Slovak Republic, which have an average population of less than 4,000—are likely to use up most of their meager resources in fixed administrative costs.[54]

Trends in mature decentralized countries suggest that costs are an important consideration. Most countries of the Organisation for Economic Co-operation and Development (OECD) have a limited number of subnational tiers and jurisdictions (table 5.1). Some countries have recently been reducing the number of subnational units, largely on grounds of efficiency and cost.[55] But in a number of developing countries, subnational governments are proliferating. In 1992 Morocco increased the number of its municipalities from 859 to 1,544 and made regions the third tier of subnational government.[56] Even among very poor countries such as Madagascar, Malawi, and Zambia, the trend is toward a constant, if gradual, increase in the number of local governments—perhaps in part because a block grant available to each local government creates an incentive to divide jurisdictions.[57]

Clarifying the allocation of functions and allowing for shared functions. Some services can be provided less expensively on a larger scale, or their benefits may spill over across districts. Providing these services centrally creates economies of scale and captures externalities, but at the cost of imposing a common policy on populations with varied preferences and priorities.[58] This trade-off, which is the basis of the fiscal federalist approach, guides some of the choices that must be made in allocating functions. The services central governments provide should benefit the entire economy or exhibit substantial economies of scale—for example, national defense, external relations, monetary policy, or the preservation of a unified national market. Correspondingly, subnational units should provide local public goods. This model, which most established democracies have adopted, is also common to most countries that have recently decentralized, with the notable exception of Bosnia and Herzegovina (see box 5.3).

Such responsibility-sharing arrangements are complex. But they work well when they are clear, when each tier's responsibilities are relatively well defined, and when the regulatory framework anticipates that local governments are sometimes agents of the central government and sometimes principals acting on their own. Without clarity and an appropriate regulatory framework, there can be no accountability. In South Africa the central government and the provinces have joint responsibilities for health and education, but the exact responsibilities of each are not defined. The result is that provinces receive transfers to fund these services but use them for other purposes, knowing full well that

Table 5.1
The structure of subnational governments in large democracies

Country	Intermediate	Local
Industrial countries		
Canada	10 provinces, 2 territories	4,507 municipalities
France	22 regions, 96 departments	36,772 communes
Germany	13 states, 3 city-states	329 counties, 115 county-free cities, 14,915 municipalities
Italy	22 regions, 93 provinces	8,100 municipalities
Japan	47 prefectures	655 cities, 2,586 towns
Spain	17 autonomous communities	50 provinces, 8,097 municipalities
United Kingdom	Counties	540 rural districts, metropolitan districts, and London boroughs
United States	50 states, F.D.	39,000 counties and municipalities, 44,000 special-purpose local authorities
Other countries		
Argentina	23 provinces	1,617 municipios
Bangladesh	—	4 city corporations, 129 pourashavas (smaller municipalities), 4,500 union parishads (which group 85,500 villages)
Brazil	27 states, F.D.	4,974 municipios
Colombia	32 departments, F.D.	1,068 municipalities
Ethiopia	9 regions, plus 2 special city administrations, 66 zones	550 woredas
India	25 states, 7 union territories	3,586 urban local bodies (95 municipal corporations, 1,436 municipal councils, 2,055 nagar panchayats), 234,078 rural local bodies
Iran, Islamic Republic of	25 provinces	720 districts and municipalities
Kenya	39 county councils	52 municipal, town, and urban councils
Korea, Rep. of	6 special cities, 9 provinces	67 cities, 137 counties
Malaysia	13 states	143 city, municipal, and district councils
Mexico	31 states, F.D.	2,412 municipios
Mozambique	10 provinces	33 municipalities
Nepal	75 districts and town panchayats	4,022 village panchayats
Pakistan	4 provinces	15 municipal corporations, 457 municipal and town committees, 40 cantonment boards, 4,683 union and district councils
Philippines	76 provinces	64 cities, 1,541 municipalities, 41,924 barangays
Poland	16 provinces, 307 poviats	2,489 gminas
Russian Federation	21 republics, 17 territories or autonomous areas, 49 provinces (oblasts), 2 cities of federal status	1,868 raions, 650 first-tier cities, 26,766 secondary cities, townships, and villages
South Africa	9 provinces	850 local authorities
Thailand	75 changwats, Bangkok	6,397 districts, 148 municipalities and cities
Turkey	74 provinces	2,074 municipalities
Uganda	45 districts, 13 municipalities	950 subcounties, 39 municipal divisions, 51 town councils
Ukraine	24 regions (oblasts), 1 autonomous republic, 2 municipalities	619 districts
Venezuela	23 states, F.D.	282 municipalities

—Not applicable.
F.D. Federal district.
Source: Appendix table A.1.

the central government will intervene to provide the needed service.

Assigning and controlling resources

The question of which tier of government controls which resources is perhaps the thorniest issue of decentralization. The ability of subnational authorities to act independently of the central government depends on whether they have access to independent tax bases and sources of credit.[59] Experience provides two lessons in this area. First, subnational governments need resources commensurate with their responsibilities. Second, subnational authorities must operate under firm budget constraints, so that they do not spend or borrow excessively in the expectation of a central government bailout.[60]

The guiding principle of revenue assignment is straightforward: finance should follow function. This is so not only because resources must be commensurate with what they fund, but also because the type of revenues used affects consumer behavior and results in different patterns of incidence. User charges, such as bus fares or water bills, affect the amounts consumed by users and are borne only by those who actually consume the service. Overall, the appropriate structure of subnational finance—the mix of user charges, taxes, and transfers—depends on the functions that have been assigned to each tier of government.

Certain forms of taxation are appropriate for financing local services with benefits that cannot be confined to individual consumers, such as local roads. Such taxes must fall on the residents of the jurisdiction and must be direct—that is they must directly target individuals or personal property so that their burden is local. Good examples are the property tax, the personal income tax, and capitation or head tax. Indirect taxes such as the value added tax (VAT) or corporate income tax, which can be built into the price of the goods and passed on to consumers outside the taxing jurisdictions, are not generally appropriate as local taxes.

But direct taxation in developing countries often yields limited revenues. The income tax is of limited use where most of the economy operates informally. In many countries the capitation tax, which was one of the main forms of taxation in colonial times, is politically unacceptable. And the property tax, which requires good information systems, is usually poorly administered.[61] To compensate, most municipalities rely on various forms of business taxation. Jordan imposes a business license fee, Brazil has taxes on services, and some Indian states rely on the octroi (a tax on goods circulating across regional or municipal boundaries). Although efficient, such taxes are politically easier to impose, since their effects are hidden in the price of goods. As a result, even mature decentralized democracies such as Germany and the United States resort to them. Overall, subnational taxes are seldom a large share of subnational revenues (see figure 5.2), although there is scope, particularly in developing countries, for improving local revenue collection.[62] For intermediate levels of government, the problem of matching taxes to the jurisdiction is even more complicated (box 5.6).

The role of transfers. Since transfers account for a large part of subnational finances everywhere, their design is a critical factor in the success of decentralization.[63] Transfers are needed to fund the services local governments provide on behalf of the central government (while local revenues should ideally cover local expenditures). And transfers are essential to ensure that decentralization does not occur at the expense of equity, particularly if the central government relies on programs administered at the subnational level to redistribute income or if there are large income differences across districts. Finally, governments can use transfers to influence the sectoral pattern of local expenditure by earmarking transfers or disbursing them in the form of matching grants.

Although transfers are almost always necessary, they should not be so large as to eliminate the need for local taxes.[64] Local taxes ensure that subnational governments face, at least to some degree, the political consequences of their spending decisions. And political necessity sometimes imposes the need for relying heavily on local taxes. Tax sharing was one of the more contentious issues in the Yugoslav federation, where wealth differed greatly across ethnic groups and redistribution issues were embroiled in ethnic tensions. Similarly, the search for a good regional tax is of paramount importance in Ethiopia, where regions are defined on the basis of ethnic identity (see box 5.3).

Transfers have three variables.[65] The first variable is the amount to be distributed. This can be fixed as a percentage of national taxes, or it can be an ad hoc decision, sometimes to reimburse preapproved expenditures. The second variable is the criteria for distributing transfers among jurisdictions. In Argentina, for example, a predetermined formula is used to allocate a fixed percentage of certain national taxes, whereas in India the central government periodically determines, on the

Box 5.6
Financing intermediate tiers of government

Intermediate tiers of government, such as states and provinces, often have substantial responsibilities that cannot be funded solely through user fees.[66] Yet direct taxes have limited yields in developing countries and tend to be allocated to local governments. Indirect taxes are generally more appropriate for the national government, since the burden of such taxes can be passed on to consumers outside the taxing jurisdiction (a problem referred to as tax exporting). No perfect solution exists for the problem of financing the intermediate tier of government, and in practice large federal countries typically use a combination of two approaches.

The first approach consists of granting exclusive rights to a broad-based tax, such as an income tax or a value added tax (VAT), to the intermediate tier. The income tax has the advantage of affecting only residents of the state or region, avoiding the tax-exporting problem, but is of limited yield in poor countries. A VAT like that used in Brazil, Russia, and Ukraine provides substantial resources but raises issues of interstate smuggling and tax exporting. In fact, subnational VATs are so complex to administer that they should only be considered in countries with efficient tax administrations. State corporate income taxes also present administrative difficulties, notably the problem of determining in which state a company has realized its profits.

The second approach is to share national taxes. This can be implemented in a variety of ways. One is to let the states set a surcharge on a nationally administered and collected tax—which does present the advantage of making state government bear at least part of the political burden of a tax. Another is pure tax sharing, in which the central government remits a part of its tax revenues to the jurisdiction in which they were collected. Mexico, for example, imposes a national VAT which it redistributes to states on the basis of what they would have received by imposing this tax themselves. Argentina uses a similar system. Pure tax sharing has no advantage over surcharges except for preserving a uniform tax rate. Revenue sharing, which relies on a formula for allocating the proceeds of a national tax across different regions, is similar, although it can be used to equalize revenues across jurisdictions regardless of their tax base.

basis of need, both the levels of the transfers and the method of distribution. The third variable concerns the conditionalities imposed on the use of transfers. Transfers can be earmarked for specific uses, such as paying teachers' salaries, or left unrestricted.

Transfers should be designed according to their objectives. Those intended to finance functions that the municipal government is performing on behalf of the central government should be earmarked. Transfers intended as substitutes for local taxes should not, but their amount needs to be equivalent to the tax base they are replacing. In practice, however, most transfers take the form of block grants. This tendency may reflect a search for administrative simplicity, or it may reflect the reluctance of subnational governments to accept any restrictions on the use of transfers. In countries where subnational interests are well represented in national parliaments—France, Germany, Japan, and the United Kingdom, for example—block grants account for the bulk of intergovernmental transfers.

Some basic principles are applicable across all countries and all types of transfers. Transfers should be determined as openly, transparently, and objectively as possible. They should be kept reasonably stable from year to year so that local governments can plan their budgets. And they should be distributed on the basis of predetermined rules, which need to be kept as simple as possible.[67] Simplicity, transparency, and predictability would help eliminate one of the worst problems of decentralization: the uncertainty and bargaining that often plague intergovernmental fiscal relations.

Controlling subnational debt. Subnational borrowing has emerged as one of the thorniest issues for decentralization. In principle, it is a private transaction between borrower and lender. But the national government is often drawn reluctantly into the transaction because of its responsibility for the stability of the financial system. As a result, subnational borrowing is almost always subject to the assumption that the central government will fund a bailout if necessary—an assumption that leads banks to lend to uncreditworthy local governments.

An alternative to the private financing of subnational borrowing is for the central government to provide long-term credit, lending either directly or through intermediaries. In most countries—particularly those with shallow financial systems—this remains the principal source of subnational credit and largely dominates private financing. But the repayment record for centrally sponsored financial intermediation is poor (see chapter 6). Loan allocation tends to become politicized, while debt collection is often lax, with national taxpayers ultimately bearing the financial burden of bad loans.

In general, however, private financing is either already the primary source of subnational credit or is meant to eventually replace central government financing. This requires developing means to protect the central government and the national financial system from exposure to excessive subnational debt. As shown in table 5.2, short of outright prohibition, four ap-

Table 5.2
Subnational borrowing controls in selected countries

	Market discipline		Cooperative control		Administrative control		Rule-based control		Borrowing prohibited	
	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic
Industrial countries										
Australia			●	●						
Austria					●	●				
Belgium			●	●						
Canada	●	●								
Denmark			●	●						
Finland	●	●								
France	●	●								
Germany							●	●		
Greece					●	●				
Ireland					●	●				
Italy							●	●		
Japan						●			●	
Netherlands							●	●		
Norway					●	●				
Portugal	●	●								
Spain					●	●				
Sweden	●	●								
Switzerland							●	●		
United Kingdom					●	●				
United States							●	●		
Developing countries										
Argentina				●	●					
Bolivia				●	●					
Brazil				●	●					
Chile				●	●					
Colombia				●	●					
Ethiopia						●			●	
India					●	●				
Indonesia					●	●				
Korea, Rep. of					●	●				
Mexico						●			●	
Peru					●	●				
South Africa			●	●						
Thailand									●	●
Transition economies										
Albania									●	●
Armenia									●	●
Azerbaijan									●	●
Belarus									●	●
Bulgaria									●	●
China									●	●
Estonia					●	●				
Georgia									●	●
Hungary					●	●				
Kazakhstan									●	●
Kyrgyz Republic									●	●
Latvia					●	●				
Lithuania					●	●				
Poland									●	●
Romania									●	●
Russian Federation	●	●								
Slovenia									●	●
Tajikistan									●	●
Ukraine									●	●
Uzbekistan									●	●

Note: Classifications attempt to capture the predominant form of control. In most countries, the approach used involves a combination of several techniques. For detailed country-by-country explanatory notes, see Ter-Minassian and Craig (1997).
Source: Ter-Minassian and Craig 1997.

proaches are used to control subnational borrowing. The first approach relies on market discipline; the second relies on cooperation between the central and subnational governments to decide what constitutes an appropriate level of indebtedness; and the other two directly regulate subnational borrowing. In practice, countries use a combination of all four approaches.

In principle, central governments can simply refuse to intervene in transactions between subnational governments and their creditors, relying on market discipline to control subnational debt. This is the most important restraint on subnational borrowing in Canada, France, and Portugal, for example. But to be effective, a laissez-faire approach requires that a number of conditions hold—the most important being the credibility of the central government's commitment not to intervene.[68] Establishing this credibility requires time, particularly where bailouts have occurred in the past. It also requires avoiding situations in which the central government would be forced to intervene—for example, where a default threatens the national banking system or the country's international credit rating. Regulation can help prevent such situations.

Some types of regulation are better than others.[69] Direct government controls, like annual limits on borrowing or administrative authorization for loans, are subject to political bargaining and are generally at odds with the trend toward decentralization. Further, they may make it even more difficult for the central government to refuse to intervene and rescue a subnational government. But administrative controls are appropriate for external borrowing because a subnational government's behavior on the international market could have contagion effects on the ratings of other national borrowers and because managing the external debt is part of the macroeconomic responsibilities of a central government.

Rule-based controls like ceilings on debt-service ratios or constraints on the type or purpose of borrowing are more transparent and less subject to political interference. They function best when they set global limits that mimic the markets—for example, by establishing ceilings on debt service as a share of revenues—and rely on a global definition of what constitutes debt. Detailed regulations are hard to monitor and will encourage behavior aimed at circumventing them.

Fundamentally, however, rules and controls will be ineffective unless accompanied by market discipline and a credible "no-bailout" pledge by the central government. Brazil has just completed the third restructuring of state debt in 10 years. Each debt crisis arose despite a blanket ceiling on subnational borrowing and a web of restrictions and controls on various forms of debt. Regulation, it seems, failed to withstand the pressure from strong regional interest groups. Even in industrial countries with sophisticated credit markets, borrowing controls are subject to slippage.[70] In the United States, for example, regulations are less important than market discipline. Bonds must be floated, and the federal government neither guarantees subnational debt nor bails out subnational governments.[71]

Central regulation of subnational governments

Rules are needed to govern relationships among tiers of government. But central governments in decentralizing countries tend to compensate for their loss of direct control by stepping up their regulation of subnational governments. This tendency can be counterproductive if central governments with only a limited knowledge of local conditions begin micromanaging local functions, or if they impose costs they are not prepared to finance.

Personnel matters are one area in which central regulation is generally undesirable. Since wages are often a very large part of local budgets, centrally mandated wage increases can cause a local fiscal crisis. The central regulation can prevent subnational governments from responding to local conditions by increasing or decreasing staff size or by keeping wages at market levels. In Turkey the central government creates the staff list for each municipality, along with the corresponding salary scale. The central government must approve any changes in a long process that involves the Ministry of the Interior, the state personnel organization, and the Council of Ministers. In Sri Lanka the central government determines the wage bill for provincial governments.

If a central government is concerned about nepotism or overstaffing at local levels, it can address them in other ways. For example, it can provide suggested hiring levels and salary scales and require subnational governments to publish their employment rolls. But central government involvement in personnel matters also reflects the power of public sector unions and their ability to organize nationally. This force has not been easy to counter, whether in developing or in industrial countries.[72]

Central government regulation remains appropriate in a wide range of other circumstances. When subnational governments act as agents of the central government, regulation and monitoring are needed to enforce national mandates and standards. Even countries that have granted substantial autonomy to subnational governments require that centrally financed welfare payments be distributed according to criteria the central government establishes. Regulation is also essential to ensure the validity of the local electoral process and to address conflicts between units of subnational government. But a free press, improved access to information, and the growth of democracy at subnational levels are decreasing the need for central regulation. Local interest groups are increasingly able to monitor the performance of local governments.

Making subnational governments accountable

The third major set of constitutional rules consists of those governing relations between local officials and their constituents. The degree to which local officials are accountable to their constituents determines whether decentralization produces the intended benefits—that is, more efficient and responsive services, and greater local self-determination. The process for electing governors, mayors, and members of the subnational legislature takes center stage in determining accountability. But elections in and of themselves are not sufficient to ensure that local governments are truly responsive to people's needs and wants. Three sets of complementary measures should be pursued. First, electoral rules need to encourage participation and representation and, at the same time, allow an effective majority to emerge. Second, civil society can be drawn upon to complement formal political processes. Finally, an effective local administration needs to develop.

Adopting effective electoral rules

Electoral rules affect whether local politics reflect the interests of the local population or are captured by local elites. Of course, rules interact with certain characteristics of civil society, such as education, access to information, and the existence of groups that have a voice in government. But making elections highly visible events, facilitating participation, and demonstrating that votes matter will affect electoral outcomes in any society.

Rules to improve visibility, participation, and expected payoffs. The size of electoral districts can influence the outcome of an election. Electing council members by ward or neighborhood rather than at large ensures that all geographically defined interest groups will have seats on the local council. This method also reduces the costs of running for office. Since candidates need to campaign only in a single ward rather than in an entire city or province, minorities and low-income candidates are more likely to run and to win seats. In turn, the presence of such candidates shows minorities and the poor that they can play a role in the political decisionmaking process and encourages them to mobilize and vote.[73]

The visibility of an election also influences participation. In general, the more local an election is, the lower the participation.[74] As voter turnout drops, the chances increase of narrowly focused special-interest groups gaining power. This problem suggests that there is a trade-off between full representation, which requires small districts, and participation, which is encouraged by the relatively high levels of visibility that come with elections in larger districts.

Two measures can help increase visibility without requiring an increase in the size of local electoral jurisdictions. One is to hold concurrent local and national elections, although this approach carries with it the risk that national issues will overshadow local concerns. Another is for the mayor or governor to be elected directly by the whole constituency, while state assembly members or municipal councilors are elected by district or neighborhood. Together, these measures help ensure higher voter participation and better representation across social or income groups.[75]

Rules that promote effective governance. Effective governance requires stable coalitions and an executive with reasonably strong and clear powers. The probability that elections will produce a stable coalition is higher with majority voting than with proportional representation, as explained earlier. Local governments composed of stable coalitions govern better than unstable partnerships—for instance, they are better able to take the measures needed to adjust to shocks.[76]

Separating the executive and the legislative branches of local government and electing the chief executive directly may also yield more effective governance.[77] Mayors elected directly are more likely than appointees to challenge the status quo. The vast majority of major municipal reforms around the world have been initiated by strong mayors. But too much authority concentrated in the executive may not be appropriate, particularly in new democracies. The mayor of Moscow had enough power to modify the city's electoral laws against the wishes of the legislative assembly.

Harnessing civil society

A multitude of actors outside the public sector—grassroots organizations, unions, universities, philanthropic foundations, user groups, nongovernmental organizations (NGOs), and neighborhood associations—influence public performance. Among other things, they can help hold local governments accountable. Such groups, known collectively as "civil society," can also complement local administration in the search for more responsive and effective governance.

Civil society and formal political participation. How can governments encourage the participation of civil society in governance? Much depends on the strength of community organizations and their ability to organize. Local officials must also be willing to tap into these groups. But examples abound of collaboration between civil society and local governments. In Colombia local governments and community associations work together to provide infrastructure for the poor. In Brazil, Chile, Mexico, and Venezuela many municipalities have adopted participatory budgeting and hold open meetings to consult the population on its priorities. Donors everywhere have initiated projects to mobilize community resources and encourage participation.[78]

The formal participation of civil society in public life has limits. Active civic organizations cannot be created in a vacuum but instead need to draw on local traditions. In Bolivia, for example, the neighborhood associations that report municipal mismanagement to the national senate are built on traditional customs.[79] Further, civic organizations are not always effective and may only reflect the views of a narrow segment of the population.[80] But where civic organizations are weak, local governments can use other mechanisms to give the public a voice, such as polling or collecting data from user groups.[81]

Civil society and political parties. Democratic revolutions are often driven by a popular upsurge and the resurrection of civil society. In Latin America's move toward greater democratization, trade unions, grassroots movements, religious groups, intellectuals, and artists supported each other's efforts, coalescing into a whole that identifies itself as "the people." [82] In a number of African societies, popular respect gave religious leaders a status and influence that autocratic regimes could not ignore. And the activities of trade unions were crucial in many countries. Strikes prompted by industrial grievances, such as late payment of wages, against the government in its role as dominant employer rapidly exploded into demands for political reform.[83]

Once democratic movements achieve their immediate goals, the civic energy that fueled them often dissipates. This was the case in the democratic revolutions of Africa, Eastern Europe, and Russia. Political parties can help maintain a continuing link between civil society and government. Parties aggregate the demands of a dispersed population, represent political interests, recruit and train new candidates for office, ensure electoral competition, and form governments. They can help organize minorities and the poor and facilitate their participation in the formal electoral process.[84] Party systems thus improve legitimacy and governability by making the democratic process more inclusive, accessible, representative, and effective.[85]

Developing an effective local administration

Improving local services requires an effective local administration. Even a well-meaning political team cannot overcome incompetent administration. In fact, lack of capacity at the local level and the need for a massive increase in skilled staff are the arguments most frequently invoked against decentralization.

Both central and local governments can take measures to improve the effectiveness of local administration.[86] First, when a central government has decentralized responsibilities, it can also devolve the appropriate staff, as the Ugandan government did. Second, local governments should be free to hire, fire, and offer appropriate incentive packages so that they can attract capable local officials. Third, privatization can reduce the number of skilled administrators needed by local governments, since the privatized services require only monitoring and regulation rather than actual management.

While problems of capacity constraints are surmountable, they deserve serious attention. Central governments need to provide technical support to local governments as part of the process of decentralization. Decentralization itself, by giving subnational governments greater responsibilities and control over resources, will then increase their incentives to invest further in their own administrative capabilities.

Policies for the transition

Decentralization typically takes place during periods of political and economic upheaval. Euphoria at the fall of an authoritarian regime, an economic crisis that precipitates a regime's collapse, the jockeying for power of new interest groups—all these conditions create an environment in which a careful, rational, and orderly process of decentralization is highly unlikely. Even when decentralization occurs in a less dramatic context, questions of strategy and timing still arise. The recent experiences of decentralizing countries can help answer them.

Synchronizing the elements of reform

The most compelling lesson of recent decentralization experiences is that all elements of reform must be synchronized. The political impetus behind decentralization prompts central governments to make concessions hastily. Granting local elections is a step that can be taken rapidly. But making decentralization a success requires taking a number of slow and difficult steps that create new regulatory relationships between central and subnational governments, transfer assets and staff to local levels, and replace annual budgetary transfers with a system of tax assignment and intergovernmental transfers. The recent history of decentralization illustrates the dangers of not sequencing appropriately.

Put expenditure and revenue rules in place before political liberalization. Russia liberalized politically while the fiscal structure of the former Soviet system was still in place (box 5.7). Subnational governments had historically acted as tax collectors for both the provinces and the central government. Once the provincial governments gained political autonomy, they began refusing to send tax revenues to the central government. Fiscal relations stabilized only after 1994, when fixed rules were established for dividing taxes among tiers of government. In contrast, Chile and Poland established fiscal rules before political liberalization and were spared a Russian-style fiscal crisis.

Decentralize a function and its corresponding revenue source simultaneously. Many African countries facing economic collapse devolved a broad range of government services to subnational governments without providing the necessary revenues. Not surprisingly, the quality of the decentralized services declined sharply. In much of Latin America the opposite occurred: governments decentralized revenues without offloading corresponding responsibilities. In Colombia central transfers to municipalities increased by 60 percent without a matching increase in responsibilities.

Decentralize the needed management controls. Governments have sometimes crippled local governments' ability to perform new functions by failing to decentralize management controls. In Colombia, for example, the central government continued to set the salaries of public school teachers even after the management of primary and secondary schools had ostensibly been decentralized to the provinces. The central government's subsequent decision to grant a major increase in salaries prompted a fiscal crisis at the provincial level that was resolved only though the creation of a special compensation fund.[87] In Poland the public housing stock was transferred to municipal governments, but the central government continues to control the rents.

The recent decentralization of education in Mexico followed a more balanced approach. The federal gov-

Box 5.7

The cart before the horse: decentralization in Russia

Under the Soviet system, subnational governments were merely extensions of the central government under the authority of the Communist Party. The central government controlled activities of national importance, such as transportation and defense. The republics were responsible for light industries. Provinces (oblasts) were responsible for health care, housing, utilities, and education. Although each tier of government was assigned a given tax base, the central government determined subnational budgets through central planning and closed-door negotiations. Revenue sharing and intergovernmental transfers were merely accounting devices used to bring each subnational budget into balance.

The party's monopoly on power was officially abolished in 1990. Following the breakup of the Soviet Union in 1991, a new constitution (adopted in 1993) declared Russia a democratic federal state. The new constitution recognized 89 subnational units (republics, autonomous regions, and oblasts) and mandated the election of governors (presidents in the republics) and legislatures in each jurisdiction.

However, Russia continued to struggle with its old system of intergovernmental fiscal relations for several years. Despite an attempt to establish a system based on separate tax assignments, subnational finances continued to depend on negotiations with Moscow. These talks soon became hostile, and the newly autonomous regional governments threatened to withhold the tax revenues they owed to the federal government or to secede from the federation entirely if their demands were not met.

Since 1994 Russia has been moving toward a rule-based system of intergovernmental fiscal relations. The 1994 reforms divided revenues from each of the major taxes among central and regional governments and established a formula-based equalization system to assist poorer regions. However, the reforms did not entirely resolve the fiscal conflicts between levels of government or settle the division of responsibilities for social expenditures. Moreover, the federal government still runs considerable risk from potential defaults on loans to subnational governments.

Source: Freinkman 1998; Le Houerou 1996; Martinez-Vasquez 1998.

ernment transferred full management responsibility for preschool, primary, and secondary education to the state governments in 1992, along with funding that equaled spending on federal facilities in the previous year. Since then, funding has been based on a formula that gradually shifts the distribution from its historic pattern to one that provides an equal amount per pupil across all states. The experience of the Philippines has been similar.[88]

Demonstrating the hard budget constraint

Central governments must demonstrate early on that they are committed to imposing a hard budget constraint on subnational governments. The mere possibility of a central government bailout can prompt excess spending and deficit financing at the subnational level. Brazil, where the federal government has assumed over $100 billion in state debt, is a clear example (see chapter 8). Argentina, in contrast, succeeded in enforcing a hard budget constraint. From the outset, the current administration has refused to provide any significant debt relief to the provincial governments. It has also minimized its potential exposure in two ways. First, provinces may not borrow directly from the federal treasury. Second, loans that provincial banks make to their governments are not eligible for central bank discounts. After the 1994 Mexican economic crisis temporarily dried up funding sources all over Latin America, Argentina's provincial governments were forced to adjust rather than rely on federal relief.

What lessons for the future?

Decentralization is a work in progress. Many experiments are under way, and only limited evidence on final outcomes is yet available.[89] Nonetheless, some lessons have emerged from recent experiences. Perhaps the most important is that a system that is based on rules produces better results than one that is not. Explicit rules setting out the division of functional responsibilities among levels of government reduce ambiguity and increase political accountability. They also provide a framework within which interest groups can compete and negotiate without resorting to violence.

Some rules work better than others. Revenues need to be decentralized at the same time as expenditures, so that finance follows function. A "hands-off" attitude when subnational governments default on their loans may be more important in controlling debt than the most comprehensive set of regulations and controls. Ward-based local politics combined with direct elections for mayors and governors, and concurrent national and local elections, improve participation and representation. Subnational governments with multiple tiers and many small units are likely to have high administrative overhead costs.

Strategies to stop decentralization are unlikely to succeed, as the pressures to decentralize are beyond government control. The emergence of modern economies, the rise of an urban, literate middle class, and the decline of both external and domestic military threats have created nearly insurmountable pressure for a broader distribution of political power in Latin America, Eastern Europe, Russia, and parts of East Asia. This same pressure is likely to affect the rapidly urbanizing economies of South Asia and parts of Africa early in the 21st century. Rather than attempt to resist it, governments should face decentralization armed with lessons from countries that have gone before them.