

BRINGING THE STATE CLOSER TO PEOPLE

And, tell me, what use is the ship-of-state if all are not on board?

—From Tijan M. Sallah, *The State* (1996)

PEOPLE ARE THE MEANS AND THE END OF DEVELOPMENT. But they have different amounts of power and resources, and different interests, all of which the state must try to represent and respond to if it is to act effectively. In nearly all societies the needs and preferences of the wealthy and powerful are well reflected in official policy goals and priorities. But this is rarely true of the poor and the marginalized, who struggle to get their voices heard in the corridors of power. As a result, these and other less vocal groups tend to be ill served by public policies and services, even those that should benefit them most.

A state that ignores the needs of large sections of the population in setting and implementing policy is not a capable state. And even with the best will in the world, government is unlikely to meet collective needs efficiently if it does not know what many of those needs are. Reinvigorating public institutions must, then, begin by bringing government closer to the people. That means bringing popular voice into policymaking: opening up ways for individual users, private sector organizations, and other groups in civil society to have their say. In the right setting, it can also mean greater decentralization of government power and resources.

This chapter discusses a wide range of mechanisms to ensure that policies and programs better reflect the full panoply of society's interests. Informing and responding to citizens will raise the state's effectiveness by improving monitoring of public goods and services and forcing greater transparency in decisionmaking. Encouraging wider participation in the design and delivery of these goods and services, through partnerships among govern-

ment, business, and civic organizations, can also enhance their supply. But effective citizen involvement does not come easily. One lesson of many such experiments is that effective participation requires enlightened government intervention, including improving the institutional environment in which social and human capital is created.

There is another important lesson: bringing government closer to some people can risk taking it even further away from others. Not all organizations of civil society are adequately accountable, either to their own members or to the public at large. And although some groups may be quite vocal, the interests they represent may not be widely shared. In reaching out to groups in civil society, government must be conscious of the interests those groups represent, but also of those they do not. Otherwise its intervention risks creating new disparities between the newly enfranchised and those whose voices remain unheard: women and ethnic groups, for example, or people whose interests have not been adopted by an active NGO.

Some of the same concerns arise with regard to decentralization. Carefully managed, decentralization can do much to improve state capability, creating pressures for better matching of government services to local preferences, strengthening local accountability, and supporting local economic development. But there are pitfalls: policymakers in central government may lose control over the macroeconomy as a result of uncoordinated local decisions, and regional disparities can widen, exacerbating economic and social tensions. Local governments can fall under the sway of particular interests, leading to abuse of state power and even less responsive and accountable

government. The message, here as elsewhere, is that bringing government closer to the people will only be effective if it is part of a larger strategy for improving the institutional capability of the state.

Greater accountability and responsiveness through participation

Throughout history nearly all societies have grappled with how to make the state reflect the needs and interests of the population. But it is an especially relevant question today, with the spread of education and information and the growing pluralism of nations creating new pressures on states to listen and respond to the voices of their citizens. A sample of public opinion around the world suggests that belief in government remains solid, but that the per-

formance of some state institutions is falling short of expectations (Box 7.1).

Electoral participation

In a democratic society elections are the primary manifestation of citizen voice. The number of democratically elected governments has increased sharply in recent decades, giving many citizens new opportunities to voice their opinions through the ballot. In 1974 only 39 countries—one in every four worldwide—were democratic. Today 117 countries—nearly two in three—use open elections to choose their national leadership, and two-thirds of the adult population in developing countries are eligible to participate in national elections (Figure 7.1). The trend is especially striking in Central and Eastern

Box 7.1 Public opinion and the state

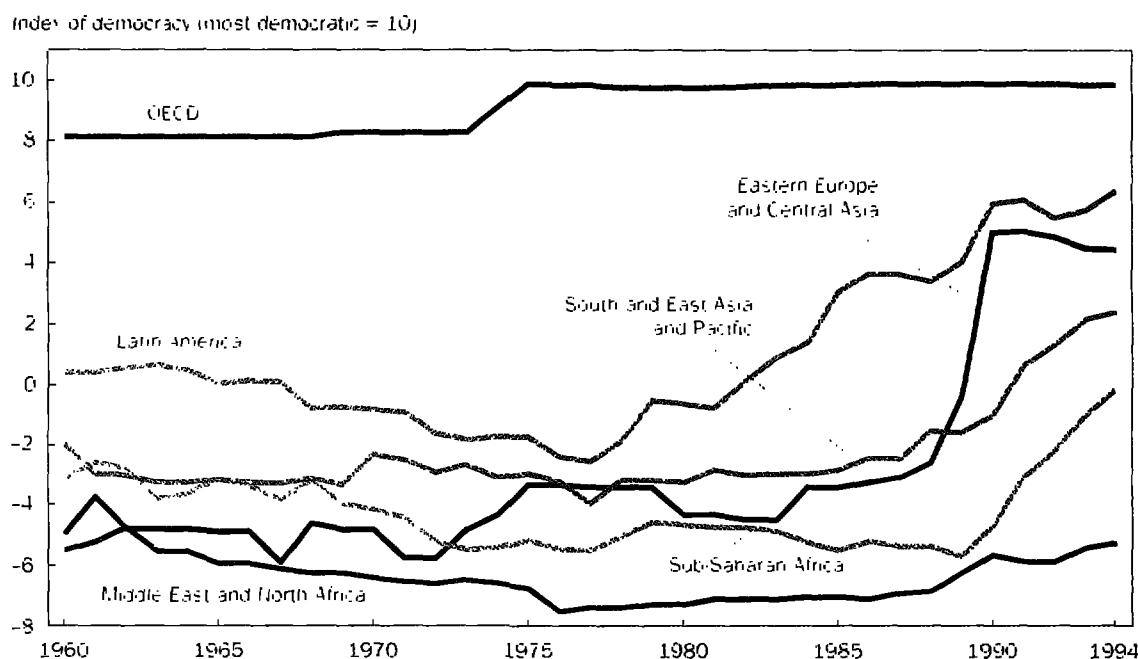
Views on the state vary widely, reflecting perceptions of wide-ranging political and economic variables. To assess these perceptions and concerns, public opinion surveys have been carried out in various countries and regions. For example, a 1991–92 survey found that 49 percent of respondents in the United Kingdom, and 44 percent in the United States, felt excluded from public decision-making that directly affected their lives. Even so, satisfaction with the way their democracies are developing is relatively high in Western Europe and North America, ranging from 54 to 64 percent of respondents. By contrast, in Latin America and the transition economies of Eastern Europe only 30 to 40 percent of respondents report being satisfied with the way their democracies are working. In Latin America this negative perception may be related to the fact that 52 percent of respondents in a twelve-nation survey felt that the administration of elections in their country was fraudulent.

In Europe public support for the state and its services has been consistently strong since the 1970s. In 1990 large majorities—more than 70 percent—in seven Western European nations still believed that the government should provide health care, services to the elderly, aid to the unemployed, and assistance to industry, as well as reduce income differences. A 1996 poll across the fifteen countries of the European Union found that 51 percent of citizens believe their governments should maintain current social benefits and protection levels, compared with 12 percent who think they should be cut considerably to enhance EU competitiveness in world markets.

In Latin America 69 percent of citizens believe that the state should intervene to reduce income differences between rich and poor. Latin American respondents also regard as critical the government's role in maintaining law and order, but 65 percent have little or no confidence in the judiciary or the police force. Only 24 percent have some confidence in these institutions. These results closely mirror the concerns voiced by the region's entrepreneurs in the survey reported in Chapter 3.

In India a 1996 survey found that, despite strong support for the democratic system, voter trust in their representatives has fallen since 1971. Trust in some public institutions was also low, particularly the police (28 percent) and the bureaucracy (37 percent). Still, the poll found strong popular participation and involvement in politics: the number of respondents who said they participated in a social organization or political party doubled between 1971 and 1996.

In contrast to Europe, Latin America, and to some extent Asia, where statist traditions remain strong, in the United States 80 percent of respondents in a recent poll said they mistrusted the government because of its perceived inefficiency and waste. In addition, public support for welfare programs, particularly targeted welfare spending, has declined. A 1993 poll found that only one-sixth of Americans thought that the welfare system was working very well or fairly well, and in 1995 two-thirds thought that too much was being spent on welfare programs.

Figure 7.1 The world has become much more democratic since 1980

Note: This particular index of democracy, as calculated for 177 countries from scores on five component indicators: competitiveness of political participation, regulation of political participation, competitiveness of executive recruitment, openness of executive recruitment, and constraints on the chief executive. The World Bank does not endorse any particular democracy index. See the Technical Note for details. Source: Jaggers and Gurr 1996.

Europe and Central Asia, where the fall of communist regimes in 1989 and 1991 sparked a series of major political changes across the region. These events had repercussions in other regions as well, particularly in Sub-Saharan Africa. In Latin America the gradual movement toward democracy started somewhat earlier. Now all but two countries in the region have democratically elected governments, and close to 13,000 units of local government are electing local leaders (such as mayors), compared with fewer than 3,000 in the late 1970s.

The principle of one person, one vote is fundamental to the representative purpose of elections. Without the necessary safeguards, however, political interference and electoral fraud can seriously affect representativeness and, thus, the legitimacy of electoral outcomes. As Box 7.1 noted, for instance, a majority of poll respondents in twelve Latin American countries felt that the administration of elections was fraudulent in their country; only 30 to 40 percent felt satisfied with the way democracy was working. Constitutional and institutional arrangements, compounded by inadequate information, also affect the ability of minority interests to gain effective representation. For example, a study of a number of European

democracies in the 1980s shows that women's parliamentary representation and voter turnout are higher in systems based on proportional representation than in winner-take-all systems. Where women are better represented in parliament, their interests are better protected, through policies relating to maternity leave, child care, and flexibility in retirement systems. This suggests caution in making simple generalizations about the representativeness of formal electoral arrangements: it is important to analyze how they play out in practice.

Diversity and representation

Concern about the effects of majoritarian rule has sometimes led to changes in electoral arrangements to ensure adequate representation of minority groups. As the number of ethnic conflicts around the world attests, the belief of certain groups that they are being left behind—in terms of income, assets, or employment—can be a powerful source of frustration. This can spill over into direct conflict if the lagging groups lack adequate means of representing their concerns. Political elites who mirror ethnic differences in competing for power and distributing patronage will add fuel to the fire. In the contemporary

world, states play a significant part in shaping ethnic relations through two related channels:

- The expansion of political authority enables states to create a competitive arena for the distribution of state resources and access to education, employment, land, and credit.
- The extension of political patronage, whether for administrative convenience or for enhanced control, lets governments favor certain ethnic groups over others.

Ethnic differences and conflicts are a part of most societies, yet some societies have managed them better than others. Techniques for alleviating such pressures have included dispersing the “points of power” (decentralization or devolution), supporting electoral arrangements that encourage cooperation among ethnic groups (electoral incentives and coalitions), and giving preferences to less privileged ethnic groups in public sector employment and other areas. Box 7.2 describes how constitutional change and preferential policies were used in Malaysia and Mauritius. By looking at some of the basic rules of the game, including elements of the political or institutional structure, both countries seem to have found a way to manage ethnic differences effectively.

Alternative strategies for voice and participation

Voting rules and electoral incentives can be reformed to make them more representative, but the simple fact that elections and referendums are held relatively infrequently (Switzerland is an exception, with an average of five local referendums each year since 1945) limits their scope for communicating timely information about societal preferences. In most societies, democratic or not, citizens seek representation of their interests beyond the ballot: as taxpayers, as users of public services, and increasingly as clients or members of NGOs and voluntary associations. Against a backdrop of competing social demands, rising expectations, and variable government performance, these expressions of voice and participation are on the rise.

The rapid growth of NGOs illustrates the trend most vividly. Since the late 1980s the number of NGOs operating in parts of Africa and Asia has almost doubled. In Central and Eastern Europe and the CIS the number of NGOs may have increased three- or fourfold from its very low base of 1989. In some countries of the OECD, operating expenditures in the voluntary or NGO sector now account for almost 4 percent of GDP.

NGOs have myriad organizational forms and functions, from labor unions to professional associations to neighborhood groups to philanthropic trusts. Among the most active NGOs today are those providing services directly to individuals and communities, from health and

Box 7.2 Managing multiethnic societies in Malaysia and Mauritius

Ethnic divisions in Malaysia have their roots in the colonial period, when large numbers of ethnic Chinese and Indians immigrated to take jobs and commercial opportunities that were not being filled by the largely agrarian native Malays (*bumiputera*). The 1957 constitution enshrined consociational principles, achieved through extensive negotiation among the major groups. In 1971, however, the new parliament passed a constitutional amendment that firmly established Malay primacy. The amendment made it illegal to “question publicly or even in Parliament the status of Malay language, the sovereignty of the Malay rulers, the special position of Malays or the citizenship rights of the immigrant communities.” This ruling changed the character of electoral campaigns, since parties could no longer gain votes by arousing ethnic antagonisms.

A second initiative, the New Economic Program (1970–90), boosted the economic position of Malays. The program had two main elements. The first was the promotion of full, productive employment of Malays and an expansion of the supply of skilled Malay labor. Preferential university admissions standards for Malays almost tripled their enrollment, to three-quarters of the total. The second was the gradual redistribution of asset ownership. The government made it clear that it would not confiscate Chinese economic wealth, but that it would promote Malay participation in a growing economy. Strong growth allowed non-Malays to continue to gain, while the New Economic Program ensured that the growth would be shared by all citizens.

Mauritius has at least three major ethnic groups: Indo-Mauritians, Creoles, and Chinese. The designers of the electoral system, anxious to avoid creating institutions that might exacerbate the country’s ethnic divisions, structured the system to force the main parties to seek support from all communities. Moreover, Mauritian governments have generally chosen broad-based growth and distribution policies over ethnic preferences. Formal preferences in employment and in education have never been used. And all governments since independence have had to form multiethnic coalitions in order to assume and maintain power. Growth with redistribution has tended to blunt the appeal of communal politics.

education to microcredit, vocational training, and professional services. In the OECD countries many NGOs operate alongside public providers. In Japan and the United Kingdom, for example, a large percentage of non-profit organizations are active in education. In the United States they figure prominently in health care. But unlike public providers, most NGOs are not obliged to cater to the general needs of the population; this makes it simpler for them to provide services of a particular type and quality to specific groups.

In most developing countries NGOs engaged in service delivery are small in scale, working in communities and settings where the reach of government or private providers is weak or nonexistent. In the West Bank and Gaza, for example, an estimated 1,200 NGOs provide 60 percent of primary health care services, up to half of secondary and tertiary health care, and most agricultural services, low-cost housing schemes, and microcredit. In Cambodia some thirty to forty NGOs provide microcredit to rural and urban entrepreneurs in the absence of alternative government programs for poverty alleviation. The numerical importance of these NGOs reflects their ability to substitute for weak public sector capacity and to mobilize funds from a range of different sources, including national and international organizations.

Yet not all NGOs are involved in the delivery of services. Many others are research and civic education groups, advocacy organizations, and professional and business associations that represent particular interests or seek to educate the public about issues in their collective interest. The Socio-Ecological Union in Belarus, for example, is actively engaged in public education about industrial pollution and its consequences. The West Africa Enterprise Network is a business-oriented network, with some 300 members from twelve nations, representing the interests of domestic entrepreneurs in dealings with government. In many countries trade unions play an important role in generating and disseminating information on labor and policy-related issues. The growth of these intermediary organizations reflects the larger movement toward democracy in many regions and, in some countries, the need to bridge the "missing middle" between citizens and the state. Unlike the electoral process, however, where all votes are counted equally, not all these organizations are equally representative, either of their clients' interests or of the public interest more broadly.

Most intermediary NGOs tend to be one step removed from ordinary citizens; by contrast, grassroots organizations, community-based groups, and people's organizations engage them directly. In Umu-Itodo, a village in Enugu State, Nigeria, for instance, the Community Development Committee formed in 1986 has been responsible for numerous development and infrastructure projects that

have had a direct impact on this isolated community. The committee has an elected executive board consisting of members from each part of the village; villagers rank it as the most relevant and effective organization in the village. Similar locally based organizations include rotating credit associations, farmers' associations, worker cooperatives, parent-teacher associations, and even religious congregations. These associations are valuable not only for their ability to meet basic needs, but also for the role they play in building trust and a sense of public connectedness among those excluded or alienated from the formal political process. But organizations such as these also face limitations, including narrowness of membership and representation, limited management capacity, and the risk of co-optation by traditional power holders or political factions.

The institutional basis of participation

The depth and intensity of popular collective activity obviously differ by social and institutional setting. One explanation for these differences lies in differing endowments of *social capital*, the informal rules, norms, and long-term relationships that facilitate coordinated action and enable people to undertake cooperative ventures for mutual advantage. The presence of rules conducive to social organization can improve the collective efficiency of a community, but the absence of such rules is not necessarily a permanent condition. They can be generated by participation itself, and here governments and other formal organizations such as labor unions can play a positive role. Government efforts to improve the management of irrigation systems in Taiwan (China) and the Philippines, for example, have yielded numerous collective responses from farmers in managing operations and maintenance and in collecting water user fees. By accepting co-management of water resources by farmers, public officials achieved a substantial improvement in irrigation management. In the state of Ceará in northeastern Brazil (see Box 5.7 in Chapter 5), community monitoring of an innovative government health program provided the basis not only for a highly successful program but also for more effective cooperation among community members on other mutually beneficial courses of action.

The debate about the contribution of social capital to economic and social development is just beginning, and the early evidence is by no means unambiguous. But some studies are already demonstrating its potential impact on local economic development, on the provision of local public goods, and on the performance of public agencies (Box 7.3).

The social mechanisms that constitute social capital and the myriad forms of more formal nongovernmental activity directly reflect the heterogeneity of needs and preferences in society. At the same time there are no guarantees that these

Box 7.3 Does social capital matter?

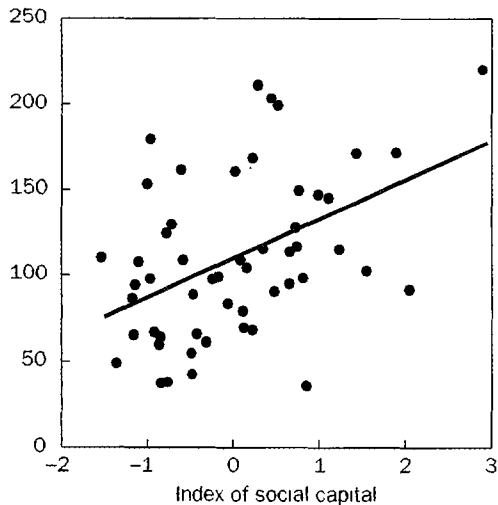
A study of regional government in Italy during the 1970s and 1980s found that although political and economic failures were widespread, some regional governments, particularly those in the north, had performed well. Northern regional governments were notable for developing innovative day care programs and job training centers, promoting investment and economic development, managing the public's business efficiently, and satisfying their constituents. Regional governments in the south, by contrast, showed much weaker responsiveness and performance. The study attributed the better performance of northern governments to the external pressures created by dense networks of civic associations and citizen involvement in local public affairs.

A recent study of villages in rural Tanzania found that households in villages with high levels of social capital (defined in terms of the degree of participation in village-level social organizations) have higher ad-

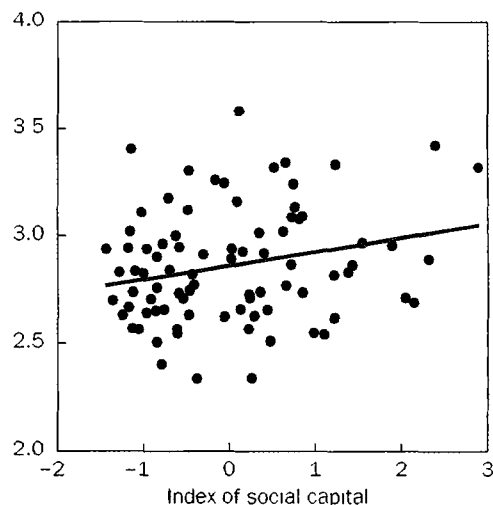
justed incomes per capita than do households in villages with low levels of social capital. When other non-social capital determinants are controlled for, there also appears to be a strong correlation between a village's well-being and its level of social capital. This result points to important spillover effects at the village level arising from individual participation in local associations and groups. Although no general conclusions could be drawn about the impact of social capital on government performance, the study points to a number of important linkages, including a positive association between social capital and the quality of local schooling (see figure). The implication is that where parents can organize to monitor and pressure local government into maintaining local schools, school quality is enhanced. Even though the direct benefits of schooling accrue mainly to individuals, the benefits of monitoring local government performance accrue to all as a public good.

Social capital, household expenditure, and school quality in Tanzania

Household expenditure per capita
(thousands of Tanzanian shillings)



Index of school quality

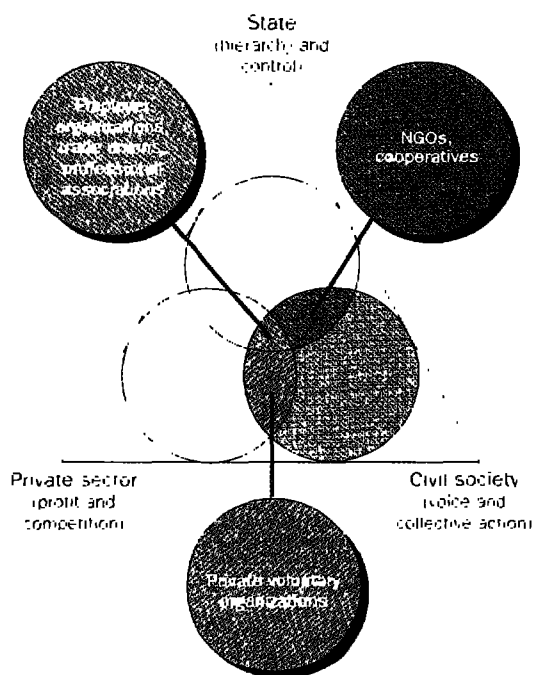


Note. Data for the social capital index are from a 1995 survey of 1,376 Tanzanian households. The social capital index measures the prevalence of residents' participation in groups and voluntary associations. The school quality index measures households' perceptions of school quality. See the Technical Note for details. Source: Narayan and Pritchett 1997.

organizations are adequately addressing citizens' needs or that they are genuinely concerned with promoting the public interest. Most NGOs provide services of high quality, but some suffer from serious problems, including poor quality of service, inadequate community participation, and weak accountability. Some NGOs are created opportunistically, to advance the interests of narrow and privileged constituencies, often at the expense of the less vocal and less powerful. And the same social rules and norms that facilitate collective action among citizens can preserve inequalities and power differences within communities.

Yet given the many obstacles facing ordinary citizens, especially the poor, in articulating and pressing their needs, these associations play a vital role in channeling their voice and in building capacity for participation in public affairs. And those organizations that genuinely seek to work in the public interest can be valuable partners in economic and social development. Working from this premise, many governments are searching for new institutional arrangements for providing public goods, which involve both the private sector and groups in civil society (Figure 7.2). The next section sets these efforts in a broader context, exploring the range of mechanisms for increasing popular participation in the design and implementation of public policy.

Figure 7.2 Organizations at the interface of state, markets, and civil society



Improving institutional capability

Increasing opportunities for voice and participation can improve state capability in three ways. First, when citizens can express their opinions, formally or informally, and press their demands publicly within the framework of the law, states acquire some of the credibility they need to govern well. Broad-based discussion of policy goals can also reduce the risk that a powerful minority will monopolize the direction of government. States that achieve credibility are then allowed more flexibility in policy implementation and have an easier time engaging citizens in the pursuit of collective goals. This does not mean that Western-style democracy is the only solution. Experience from parts of East Asia suggests that where there is widespread trust in public institutions, effective ground-level deliberation, and respect for the rule of law, the conditions for responsive state intervention can be met.

Second, where markets are absent, as is the case for most public goods, popular voice can reduce information problems and lower transactions costs. Where incentive problems and weak state capability lead to inefficient public services, user groups and citizen associations can inform public officials of the problem and pressure them for improvements. A recent user assessment of the water supply system in Baku, Azerbaijan, for example, revealed not only significant problems of water leakage and water-related health problems, but the high costs that the city's unreliable water supply imposed on low-income consumers. Perhaps most interesting, users also revealed themselves willing to pay between two and five times more than they were actually paying for a reliable and safe water supply.

Third, no matter how dedicated, hardworking, or public spirited state officials are, they cannot anticipate all the public goods and services that citizens desire. The emergence of private and NGO alternatives to public provision can help meet gaps in the supply of public goods, as well as provide those goods and services that individuals are willing to pay for out of their own pocket. NGOs can be both partners and competitors in the delivery of public services. And when backed by citizen voice, they can exert useful pressure on government to improve the delivery and quality of public services.

There is no blueprint for finding the appropriate balance of voice, participation, and bureaucratic control in the provision of public goods. The solution depends on the capabilities of the public agencies in question and other providers and on the characteristics of the public good or service being provided. As discussed below, efficiency and equity dictate some degree of centralized government control and coordination when it comes to goods and services that have jurisdictional spillovers, are subject to economies of scale, or raise distributional concerns. In the technical and often sensitive area of economic man-

agement, for example, some insulation of decisionmaking from the pressure of political lobbies is desirable. In setting standards, such as in the provision of basic education, there is also an important role for centralized decision-making. But the process by which broad policy directions and standards are set should not be insulated from public discussion. And in the management of common-property resources, the production of basic infrastructure, and the delivery of essential services, there is considerable scope for involving people directly, both in the formulation of policy and in its implementation.

Participatory mechanisms

MECHANISMS FOR INFORMING AND CONSULTING. It is generally accepted that some areas of public decisionmaking require insulation from political pressure. In others, however, public and private interests coincide to such an extent—efforts to raise agricultural production, for example, or reforming the health system—that some level of public-private deliberation is not just desirable but in fact critical to success. In East Asia, by institutionalizing public-private deliberation councils comprising representatives of labor unions, industry, and government, policymakers were able to get broad agreement on economic policy issues and the necessary commitment to intervene quickly and flexibly. Other nations with very different institutional settings, such as Botswana, Chile, Mexico, Senegal, Uganda, and the United States, have also sought to implement deliberative mechanisms on issues ranging from economic policy to institutional reform.

By embedding the voice of powerful interest groups in mutually acceptable rules, public-private deliberation councils can reduce transactions costs by reducing the scope for opportunistic behavior. But these councils do not always succeed. Systematic evaluations of performance are not available, but a number of conditions and characteristics appear to affect success. These include broad enough representation and public education for the process to have widespread support, technical support and assistance to the councils, and an emphasis on building trust and mutual monitoring among both public and private sector participants.

Deliberative mechanisms are unlikely to enable governments to be effective in the long run if their policies appear illegitimate or unresponsive to crucial societal demands. Efforts to reach out to citizens must reach all the way down. At the very least, reforms and programs must be made intelligible to the public, for example by encouraging widespread media coverage of budget debates. In Singapore the Division of Public Feedback systematically gathers citizens' comments on a variety of national policies and invites interest groups to public hearings with ministers and senior officials. As discussed in Chapter 5,

legislation can also strengthen public accountability and responsiveness by requiring agencies to announce and enforce service norms and standards, provide public information, and respond to consumer complaints.

Specific techniques and mechanisms for consulting users and intended beneficiaries can also help improve the quality of specific public services. As the cases in Box 7.4 illustrate, feedback mechanisms such as client or user surveys can provide valuable information about an agency's performance and the type and quality of services reaching consumers. Simplified surveys such as the report card used in Bangalore, India, can be particularly useful when institutional capability is limited.

Besides increasing the flow of information to public officials, techniques for citizen and client consultation can introduce more openness and transparency into the system. As more people become aware of the performance of specific agencies or officials, they are more likely to exert collective pressure on the agency to perform better. At the same time public agencies will have less opportunity for arbitrary action.

But no mechanism for consultation automatically reaches all the appropriate individuals and groups. There are costs to acquiring and providing information, and the low income or subordinate position of some groups in society makes them nearly invisible to public officials. In consulting with users or clients, every effort must be made to identify all relevant social groups and ensure that they are represented.

MECHANISMS FOR DESIGN AND IMPLEMENTATION. Improving government performance does not end with improved consultation. There is also compelling evidence that arrangements that promote participation by stakeholders in the design and implementation of public services or programs can improve both the rate of return and the sustainability of these activities.

The education sector has proved particularly fertile ground for this kind of experimentation. Weak monitoring and supervision of local schools is a perennial problem for governments. But several are finding that these problems can be addressed by increasing the involvement of parents and communities in school management. In New Zealand, elected boards of trustees that manage schools are composed of parents of children at the school. Legislation enacted in Sri Lanka in 1993 established school development boards to promote community participation in school management. Many countries have also found that communities that participate in school management are more willing to assist in school financing.

Yet effective citizen involvement in school management does not come easy, nor is it a panacea. New Zealand realized after it had embarked on its reform that newly elected trustees required intensive training.

Box 7.4 Client surveys to motivate service improvements in India, Uganda, and Nicaragua

In several countries client surveys have helped motivate better public sector performance. By tapping the experience of citizens and having them monitor and evaluate services, surveys have helped identify problems and design and implement innovative solutions.

In Bangalore, India, 'report cards' ask citizens and businesses to rate the public agencies they use to solve problems or get services. The report cards, administered by the Public Affairs Centre Bangalore, an NGO, assess the quality and cost of citizens' interactions with public agencies. In the first round of report cards the Bangalore Development Authority, responsible for housing and other services, scored the lowest in several categories, including staff behavior, quality of service, and information provided. Only 1 percent of respondents rated the authority's services as satisfactory. Rather than viewing the results as a threat, however, the authority's director took them as an opportunity, launching a citizen-government initiative to address delivery problems. Other agencies in Bangalore have also taken action inspired by the report cards. And groups in five other Indian cities,

including Mumbai (Bombay), have started using the report card approach.

Working with NGOs and communities, Uganda's government is also surveying views on service delivery. The first survey found that just 11 percent of rural households had ever been visited by an agricultural extension worker. Several districts have incorporated the survey findings into their district plans. One district has instituted further training for extension workers and is lobbying the central government for permission to spend more of its budget on extension workers.

Nicaragua's surveys, like Uganda's, were initiated by the government. The first survey, in 1995, found that 14 percent of bus riders had at some time been assaulted on a bus. It also found that 90 percent of bus drivers did not respect the official fare of 85 cordobas: they did not return the 15 cordobas in change from a 100-cordoba note to riders. Moreover, the survey revealed that people were willing to pay higher bus fares. Based on these findings, the fare was raised to one U.S. dollar. In a follow-up survey in 1996, 90 percent of users said that the official rate is respected.

Botswana found it difficult to attract qualified people to lower secondary school boards of governors, especially in rural areas. In Uganda, community training for parent-teacher associations and school management committees is being provided in two districts by an international NGO, to ensure that the quality of schooling and of school administration is enhanced.

Citizen participation may also be crucial in programs for the management of natural and common-property resources such as grazing lands, wildlife, forests, and water sources. Exclusive bureaucratic control of such resources has proved inadequate in many different institutional settings, in some cases leading to confrontation between the users of these resources and the public officials seeking to manage them. Recognizing the importance of participatory natural resource management, forestry officials, NGOs, and local communities in India are now undertaking a variety of initiatives. The National Forestry Policy embraces increased participation of local people in managing forests. In India's joint forest management programs, forest departments and local user groups share decisionmaking authority and control over forest lands and products and revenue. The result has been reduced conflict and increased productivity of the land.

Practices are also changing elsewhere. In Zimbabwe the CAMPFIRE program seeks to return the benefits of

protecting and conserving wildlife to local communities. And across Africa, Asia, and Latin America high levels of beneficiary participation in the design and management of rural water supply projects have been shown to be highly correlated with project success (Box 7.5).

However, the same study of rural water supply also revealed that, among the highly participatory projects, only half adequately involved women. The explanation was found in factors specific to women's participation, including time constraints and cultural barriers. Consequently, innovative participatory mechanisms are required that explicitly seek women's involvement in the design and implementation of projects that directly affect them. One such effort can be found in the Philippines, where a series of measures over more than two decades has gradually led to the integration of gender issues in the government's agenda, partly through greater participation of women in planning and implementing policies, and partly through specific programs for women. The expected payoff to such measures lies not just in improvements in the process of public policymaking but in the economic returns to better-designed and better-targeted public investments.

Making participation succeed will take hard work . . .

These illustrations suggest that in the provision of certain local public goods or shared services—where the people

who pay are also the direct and principal beneficiaries—using the institutional capacity closest to the client can improve the quality and effectiveness of public action. Capable states are therefore likely to be those that strengthen and increase the efficiency of local organizations and associations rather than replace them. But reaching out to citizens as co-managers or co-producers does not necessarily reduce the role of the state, nor is it costless or quick to implement. To get users or clients to become partners, public agencies often must invest considerable time and energy in building ties with communities, in building commitment among their own staff, and in ensuring that minimum standards of quality and equity are maintained.

In a pioneering case in Recife, Brazil, where the introduction of low-cost condominial sewers in low-income neighborhoods changed the relationship between the state agency and the sewer users, it took two years for public officials, working intensively and in multidisciplinary teams with residents, to figure out how to make the condominial system work. Even after the process was better understood, successful implementation took another four to six months in each neighborhood. An evaluation of the project showed that, by fostering an active and vocal constituency, the scheme not only generated considerable savings but also put in motion mechanisms for accountability that were critical for good agency performance.

Greater responsiveness means changing not only the way state agencies work with clients, but also the way those agencies are organized and reward their workers. Effective participation is more likely when opportunities for internal participation exist within the public agency. In addition, the overall incentive environment must reward higher-level staff for responsiveness to clients and must provide adequate support to street- or field-level workers in their efforts to work with clients. Without such measures, resistance to working with clients can be high, creating an atmosphere that is incompatible with a more participatory approach.

Working closely with people also often requires redefining tasks and responsibilities, reallocating staff resources, and developing new mechanisms for learning and experimentation. In Benin the Ministry of Health gave local health management committees decision-making control over resources. Committee members are elected democratically; anyone may serve, provided that at least one member is a woman. The committee is directly involved in preparing the health center's annual budget for submission to the ministry. It is responsible for collecting and accounting for funds paid to the health center for services and drugs. Representatives of local committees sit on the board of the government's new drug procurement agency, which is one way of keeping the agency accountable, and on the Health Sector Coordinat-

Box 7.5 Does participation improve project performance?

Using data from 121 diverse rural water supply projects in forty-nine countries in Africa, Asia, and Latin America, a recent study tested the relationship between participation and project performance. Participation was measured on a continuum ranging from simple information sharing through in-depth consultation with beneficiaries to shared decision-making to full control over decisionmaking. The authors found a strong correlation between high levels of beneficiary participation, especially in decisionmaking, and project success. Of the forty-nine projects with low levels of participation, only 8 percent were successful. But of the forty-two projects with high levels of beneficiary participation, 64 percent were successes.

Case studies support these conclusions. The first phase of the Aguthi Rural Water Supply Project in Kenya was conducted without community participation. The project, which involved piped water systems, was so plagued with problems that it came to a standstill and had to be redesigned. Working with project staff local leaders, organized as the Aguthi Water Committee, mobilized community support for the project. Following public conferences with stakeholders, community members began to contribute labor and funds. Phase II of the project was completed on schedule and within budget. The communities continue to pay monthly tariffs for the new water service, and operation and maintenance are handled successfully in cooperation with the relevant government agency.

ing Committee, which gives local representatives a voice in national policy.

... And a supportive environment

Government can also support participation indirectly through its influence on the enabling environment. States have great power over individuals and organizations through the information they make public and through the laws they enact and administer. The rule of law that protects both persons and personal property is important to a healthy, vibrant civil society. Governments can facilitate participation by safeguarding the right of people to organize, to gain access to information, to engage in contracts, and to own and manage assets. The constitutions of Bolivia, Brazil, Colombia, and the Philippines explicitly encourage the development and participation of NGOs at all levels of decisionmaking. In Singapore the government

helps NGOs recruit staff, allocates unused government buildings to them at nominal rents, and funds up to half the capital and operating costs of facilities run by NGOs for social welfare purposes. Without a credible legal environment that requires NGOs and public agencies to act openly and transparently, legitimate organizations are deprived of an opportunity to develop, or, perhaps worse, the door is left open for unhealthy or corrupt activities that taint the reputation of all NGOs. The aim must be to strike the right balance between regulations and reporting requirements that fosters growth of NGOs, while guarding against corruption and malpractice.

The benefits of greater consultation and partnership with civil society show up in improvements in the process of public policymaking, in the quality of service delivery, and, in some instances, in improved rates of return. They also manifest themselves in the greater flexibility afforded to public agencies and officials in the way they intervene. But without effective monitoring this flexibility can give rise to capricious or arbitrary action. Again, finding the right balance between participatory mechanisms and enlightened government control is crucial. The next section examines some of these concerns in the context of the debate over decentralization and the fostering of greater public accountability from below.

Decentralization: Matching services with local preferences

Decentralizing state power and resources seems a logical continuation of the many recent efforts to bring government closer to the people. Like the broad range of participatory mechanisms described earlier, decentralization offers the chance to match public services more closely with local demands and preferences and to build more responsive and accountable government from below. But decentralization also has its pitfalls, including the possibility of increased disparity across regions, loss of macroeconomic stability, and institutional capture by local factions, especially in highly unequal societies. This section focuses on some of the factors explaining recent trends in decentralization, and on some areas where it has been shown to have a positive impact, including bringing citizens into public affairs and stimulating local economic development. The section concludes by exploring the risks of decentralization and the implications for governments of differing capabilities starting out on the decentralization path.

The age of decentralization?

The rising demand for decentralization has come as part of the broader process of liberalization, privatization, and other market reforms in many countries. These reforms are distinct from one another, but their underlying rationale is similar to that for decentralization: that power over

the production and delivery of goods and services should be rendered to the lowest unit capable of capturing the associated costs and benefits. In many countries this will involve scaling back the power of central government, but reformers must be discriminating. Depending on the institutional environment, decentralization can improve state capability by freeing it to focus on its core functions; it can also, however, undermine that capability.

The demand for formal, political decentralization has been driven by at least three major recent developments:

- *The minimum size of self-sufficient government has declined.* New technological options and new demands from citizens, producers, and consumers mean that some of the advantages (security, for example) that kept countries, regions, and provinces working together under a central government have become less important. In Europe and North America the pressure from global markets is creating strong demand for local and regional governments that can better provide the infrastructure and skilled labor force that multinational businesses need.
- *Political changes have given voice to local demands.* Centralized authority in Czechoslovakia, the Soviet Union, and Yugoslavia collapsed once the unifying force of the Communist Party disappeared. Elsewhere, regions and subnational governments benefited from the political vacuum created before and during regime changes, as in Argentina and Brazil in the late 1980s, and South Africa in the 1990s.
- *Countries often turn to local and regional governments when the central government has persistently failed to provide essential services.* In the second half of the 1980s, Colombia embarked on a path of decentralization and political reform that reversed a long tradition of centralism. A new government changed direction, transferring social services delivery to the local level and opening up the rigid political appointment system to local electoral choice. Similarly, in Venezuela and other countries in South America, active local governments have made local administration more responsive and improved the quality of services provided, often dramatically.

Before assessing how governments can act to meet such demands, it is worth asking what decentralization really means. In fact, the term encompasses a wide range of distinct processes. The main ones are administrative deconcentration, or the transfer of state functions from higher to lower levels of government while retaining central control of budgets and policymaking; fiscal decentralization, or the ceding of influence over budgets and financial decisions from higher to lower levels; and devolution, or the transfer of resources and political authority to lower-level

authorities that are largely independent of higher levels of government. Rarely does decentralization embrace all three. This wide diversity of experience makes it difficult to compare trends across countries or draw many hard and fast conclusions.

Richer and larger countries tend to be more decentralized, in terms of the share of subnational governments in total public expenditure and revenue. In the aggregate, however, industrial countries have become slightly more centralized since 1974 (Table 7.1). This is especially true of the United Kingdom, whereas Australia, France, Spain, and the United States are continuing to decentralize central government functions. Developing countries, most of which went through a nation-building phase of development in the aftermath of colonialism in the 1950s and 1960s, have become more decentralized since the 1970s. Striking examples include Argentina, Brazil, and Colombia. In both groups of countries decentralization of expenditure has gone significantly further than that of corresponding revenue.

How to think about decentralization

As the above discussion has made clear, what constitutes the best structure of intergovernmental arrangements will be highly country-specific. The one-size-fits-all approach

is as fruitless here as in other aspects of state reform. But a number of important analytical principles are available to guide reformers. The clearest and most important principle (often referred to as subsidiarity) is that public goods and services should be provided by the lowest level of government that can fully capture the costs and benefits.

Applying this principle is no simple matter, however. Table 7.2 illustrates some of the demand and supply characteristics of goods and services that will be relevant to the decision. As already discussed, for some local goods, such as those with common-property characteristics, organizations outside of government such as forest or water user associations or NGOs may be the most appropriate institutional mechanism for delivery. More generally, where preferences or demands differ from one community to the next, local governments can better match supply to suit local tastes. Decentralized service provision can also enhance efficiency and interjurisdictional competition in supply, providing consumers (at least in theory) with the option to exit to other jurisdictions. On the other hand, where economies of scale or interjurisdictional spillovers are present on the supply side—as in the construction and maintenance of interurban highways—or where minimum standards (such as for primary schooling) and other consumption externalities apply on the demand side,

Table 7.1 Changes in subnational finance in selected countries

(percentage of expenditures or revenues for all levels of government)

Country	Subnational expenditures			Subnational revenues		
	1974	1994	Trend	1974	1994	Trend
Argentina	25	45	↗	25	37	↗
Australia	47	49		20	27	↗
Brazil	30	38	↗	23	25	
Canada	61	60		39	44	↗
Chile	2	9	↗	2	5	
Colombia	25	35	↗	16	15	
France	18	19		6	13	↗
Germany	44	40		34	30	
India	45	49		27	25	
Indonesia	11	15		3	3	
Iran, Islamic Rep. of	1	5		1	6	↗
Malaysia	18	14		13	8	↘
Romania	16	10	↘	12	6	↘
South Africa	24	41	↗	4	12	↗
Spain	10	34	↗	5	12	↗
Sweden	44	34	↘	28	32	
Thailand	17	8	↘	5	5	
United Kingdom	33	28	↘	15	8	↘
United States	45	44		33	36	
Zimbabwe	26	25		24	15	↘

Note: Data are for all levels of government other than central government. Data include transfers from central government to subnational governments. Arrows indicate changes of 5 percentage points or more. Where data for 1974 or 1994 were unavailable (indicated by italics), data for the closest available year were used. Data for Germany for 1974 refer to the preunification territory.
Source: IMF, various years (a).

Table 7.2 Demand and supply characteristics of local and national public goods

Level of public provision	Demand-side factors	Supply-side factors
Local	Variation in local taste (street lighting zoning) Common property (urban roads, waste disposal)	Potential for competition between jurisdictions (police protection, road maintenance)
National	Spatial consumption externalities (control of epidemics) Equity concerns (minimum standards for primary education)	Economies of scale (defense) Cross-jurisdictional externalities (inter-urban highways)

centralized control (whether at the national or the provincial level) is likely to be preferable.

Matching services to local preferences can lead to lower transactions costs (particularly information costs), efficiency gains, and incentives to local economic development. But even where a service might, in principle, seem a candidate for local provision, the benefits and costs of decentralization will vary by setting. And experience suggests that decentralization is unlikely to work without effective institutional arrangements to foster accountability at the local level, and fiscal restraint on the part of both local and national governments. This is best explained in terms of two separate but interrelated sets of relationships facing local governments, both of which need to be considered in gauging the scope for decentralization.

The first are horizontal relationships between local government and citizens, NGOs, and private businesses. Institutional arrangements, for example local elections or referendums, can create or influence such relationships, providing incentives for cooperation, accountability, and improved local government performance. The second set of relationships is vertical, between levels of government. Most countries have formal institutional arrangements that define the role and functions of each tier of government, particularly as they affect intergovernmental fiscal relations. Both vertical rules and horizontal incentives are essential if local governments are to perform their functions well (Figure 7.3). The next section discusses some of the ways in which horizontal relationships can encourage local governments to enhance their responsiveness, mobi-

lize resources, improve service delivery, and stimulate private sector development.

The benefits of improved local accountability and incentives
CITIZEN PARTICIPATION. In theory, decentralization can strengthen and complement the measures to broaden popular participation described earlier in this chapter. Like them, it can help guard against majoritarian tyranny by moving government closer to people and by facilitating local definition of issues and problems, especially those of minority groups. The contrasting situations of Oaxaca and Chiapas, two of the poorest states in Mexico, provide a telling example of these effects at work. The two states have similar resource endowments and development potential, and both have a high percentage of poor and indigenous populations. Yet the outcomes of antipoverty programs are generally regarded as good in Oaxaca, whereas neighboring Chiapas has a bad record. The difference seems to stem from the degree of popular participation in policy decisions and implementation. Oaxaca has a long tradition of participatory mechanisms for indigenous populations and the poor. In Chiapas, on the other hand, the denial of such options, coupled with widespread official corruption, has led to poor services and rising tensions, including armed conflict since early 1994.

Where public office is contested and people can participate in elections and decide on representatives at different levels of government, the number of political choices also increases, thus stimulating competition between levels of government. Local participation can also mean greater confidence in and acceptance of policy decisions by constituents. Decentralization can therefore increase local options for policymaking while holding local officials accountable for what they do and how they do it. Recent evidence from Latin America, particularly Colombia, suggests that once local policymakers are held accountable for their actions and made aware that their jobs depend to a large extent on citizens' assessments of their performance, they tend to be much more concerned with the quality of their staff and of the tools they have to run their offices effectively. In Porto Alegre, Brazil, an innovative process of public investment planning and management was launched in 1989, to mobilize citizen groups to take part in formulating the municipal budget. In 1995 some 14,000 people were engaged in the process through assemblies and meetings. Indirectly, an estimated 100,000 people were linked to "participatory budgeting" through local associations and popular organizations.

LOCAL SERVICE PROVISION. Many governments have responded to fiscal crises, the availability of new technologies, and citizen concerns by transferring resources and responsibility for service provision, especially in education and health, to local authorities. In many cases this has

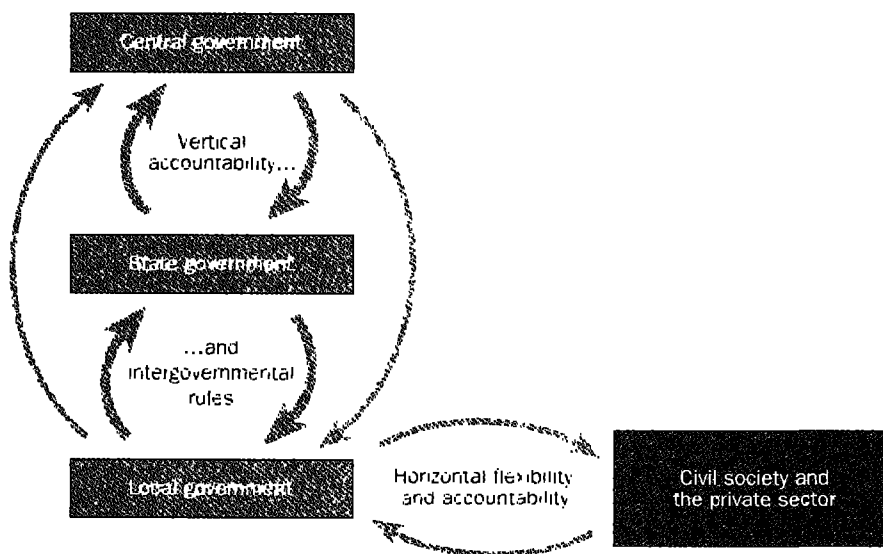
given rise to new and often creative arrangements among local governments, NGOs, and local businesses. Although relatively little comparative evidence is available with which to evaluate the relationship between decentralized government and service quality, some recent examples from Latin America are illustrative. In the 1980s the primary education system in the state of Minas Gerais, in southeastern Brazil, faced many of the problems common among education systems in developing countries: high repetition rates, low graduation rates, and low achievement scores. Contributing to these problems were overregulated and centralized management, inadequate funding, and poorly trained teachers. In the 1990s a series of measures, including the introduction of autonomy to elected boards in each local school (composed of teachers, parents, and students over 16), together with grants from central government based on enrollment and special needs, have produced some encouraging early results: achievement scores have risen by 7 percent in science, 20 percent in Portuguese language skills, and 41 percent in mathematics.

In Teocelo, a town in Mexico's state of Veracruz, decentralization has created opportunities to organize resources for health more efficiently by identifying the population's needs and designing strategies to foster participation through community organization and health education. Coverage increased for both preventive and curative care, the quality of services improved enormously, and infant mortality rates fell. In addition, users of health facilities reported that the attitudes of health personnel and the quality of services had improved greatly.

LOCAL ECONOMIC DEVELOPMENT. The participation of local businesses can also play a crucial role in decentralization, shaping incentives at the local level. Entrepreneurs have for centuries strongly influenced both the pace of development and intergovernmental relationships in industrial countries. Property-owning classes with command over local resources exerted considerable pressure on public entities. To spur expansion, private actors and public officials were encouraged to cooperate. Much of this began in local environments. Members of the business community often participated in local legislatures. Provided that rent seeking is minimized by effective competition policies—a function for higher levels of government—a strong local private sector may promote better administrative performance. And local governments that provide and maintain credible frameworks for local economic development end up promoting private investment, which over time increases local government revenues.

The world is replete with examples of local governments that have stimulated economic development in their communities, and of decentralized institutional arrangements that have contributed to growth. The cities of Greenville and Spartanburg, South Carolina, are small, inland, and far from major U.S. population centers. Yet they have the highest foreign investment per capita of any metropolitan areas in the United States. They are host to 215 companies from eighteen countries, seventy-four of which are headquartered there. Visionary decisionmakers with a strong private sector approach to local development have established a solid base of innovative small and

Figure 7.3 Vertical rules and horizontal incentives shape local government's capability



medium-size enterprises, employing a work force whose skills are regularly upgraded.

On the other side of the world, the city government of Wuhan, in central China, decided in the early 1990s to transform the old city and build a new one on a large scale. To this end it relaxed controls on foreign investment in two development zones, opened a third, passed local regulations to supply foreign investors with a legal foundation for business operation, strengthened the management of real estate and land rentals, and undertook several projects to improve the infrastructure for foreign investment. As a result, in 1992 alone the number of foreign investment projects approved for the city was more than two-and-a-half times the total for the previous eight years, producing a threefold increase in total capital invested. Not satisfied, the city government organized a huge investment promotion mission in 1993, which garnered agreements worth \$5 billion from Singapore and Hong Kong (China).

Despite such encouraging cases, experience suggests that successful decentralization may be short-lived, or difficult to replicate, without effective rules for intergovernmental collaboration. Horizontal incentives for improved performance tell only part of the story. In education, for example, involvement of higher levels of government may be needed to prevent fragmentation and to minimize differences in the quality of education in different communities. And in the health sector the appropriate allocation of responsibilities across levels of government is rarely clear-cut. Immunizations, tuberculosis surveillance, and vaccine storage all need strong, effective management from higher levels of government. In addition, localities may not provide the right framework for policy formulation and implementation. Consequently, decentralization should not become a rigid, doctrinaire exercise, pushing functions onto communities and municipalities or artificially separating levels of government. Instead it should be a practical endeavor to find the right balance between the roles of different levels of government, to ensure that high-quality services are provided in a timely manner. As the following sections describe, the quest for that balance must take place within a framework of credible rules.

The pitfalls of decentralization

In many cases decentralization is not the result of any carefully designed sequence of reforms, but has occurred in a politically volatile environment in which the level of trust is low and policymakers respond unsystematically to emerging demands from below. Such weak policy frameworks can lead to serious economic problems, including loss of macroeconomic control, regional disparities in service provision, and misallocation of resources as a result of local capture. The lesson, for all governments, is that there

must at any given time be clear rules specifying the range of responsibilities for each level of government.

MACROECONOMIC DIMENSIONS OF INTERGOVERNMENTAL FINANCE. Macroeconomic control is universally regarded as a function of central government. Centralization, or at least strong central guidance, in budget and financial matters has proved critical in ensuring sound public finances and a reliable framework for economic development in most industrial economies. Because decentralization increases the number of actors and of budgetary accounts, countries facing serious budgetary and inflationary pressures will be confronted with additional challenges and risks should they embark on decentralization.

Intergovernmental fiscal relations mainly affect the macroeconomy through three channels: the assignment and sharing of tax bases and expenditures, the match of tax and expenditure decisions, and levels of subnational borrowing.

Serious macroeconomic imbalances can occur if major tax bases are inappropriately assigned. In India, for example, important tax bases have been assigned to subnational governments. This has left the central government, despite a growing public debt and pension liabilities, with a tax base, consisting mainly of income, foreign trade, and excise taxes, that is too small to cope comfortably with its expenditure responsibility. The sharing of major tax bases also has the potential to dilute the impact of deficit reduction at the central government level. This happened in Argentina in the early 1990s, when increased tax revenues following a tax reform had to be shared with provincial governments. Provincial governments essentially took a free ride on the central government's efforts and used the extra revenue to expand their work forces.

Expenditures with national benefits and costs—national public goods—should be the responsibility of central government. These include the costs of economic stabilization and redistribution. But many local expenditures also affect income distribution, such as the provision of health and housing subsidies in transition economies and many developing countries. In addition, where the benefits of local public expenditure are concentrated within the jurisdiction doing the spending, but the costs (in the form of general taxes or negative spillovers) are spread more widely, subnational governments have an incentive to spend beyond their means. The effect on national fiscal policy can be severe.

SUBNATIONAL BORROWING. Borrowing by local governments can contribute to macroeconomic instability when the central government fails to impose hard budget constraints and there is no effective mechanism for monitoring debt obligations, particularly when there are multiple lenders. Another problem is asymmetric information on the part of borrowers (subnational governments)

and lenders (central government and international capital markets). In China, for example, provincial governments are not allowed to finance budget deficits through borrowing. But in the early 1990s all-but-uncontrolled borrowing by state enterprises at the subnational level contributed to economic overheating and imperiled macroeconomic sta-

bility (Box 7.6). The combined indebtedness of the Brazilian states exceeds \$100 billion, close to the levels of total federal and central bank debt. Unless the growth of this debt is curtailed, the federal government will have to reduce its own spending, raise taxes, or resort to inflationary financing to cover the states' debts.

Box 7.6 Pitfalls in intergovernmental relations: The experiences of Brazil and China

Democratization and constitutional revisions in the 1980s increased the amount of resources under subnational control in Brazil and the degree of local autonomy in their use. Local governments now account for half of total public spending.

Although decentralization shifted resources downward, there was no corresponding clarification or expansion of local responsibilities. Subnational governments were not prepared to assume new tasks, and were neither required to perform specific functions nor prohibited from performing functions already performed by other levels of government. As a result, local governments used much of their windfall to increase staffing and launch questionable new projects. There is scant evidence that the overall efficiency of public sector spending improved. Decentralization also increased the fiscal deficit, as large states used their improved political autonomy to extract federal resources: by the mid-1990s nearly a third of the growing federal deficit was due to subnational debt.

Brazil's experience shows that political and fiscal decentralization does not guarantee improved public sector efficiency, and may threaten macroeconomic stability. To achieve its objectives, fiscal decentralization must be accompanied by a corresponding decentralization of expenditure responsibilities; state and municipal governments' institutional capacities should be improved; and the federal government should impose hard budgets in its fiscal and financial relationships with subnational governments.

China's experience in the early 1990s demonstrates the pitfalls of decentralization that is not accompanied by parallel reforms and macroeconomic safeguards. Beginning in 1978, central authority over investment and allocation decisions was gradually decentralized to provincial governments, enterprises, financial institutions, and even households. This was a crucial element of China's economic liberalization and a key factor in the economy's impressive growth over the past two decades. At the same time, however, three consequences of decentralization undermined the central government's control over macroeconomic aggregates:

- Government revenues as a share of GDP declined precipitously. By contributing to increased industrial competition, decentralization helped lower the profits of industrial state enterprises, previously the main source of tax revenues. Increasingly autonomous local governments reduced revenues even further by granting tax exemptions to improve the after-tax earnings of the state enterprises under their control.
- The growing autonomy of local governments also made it difficult for the central government's investment planning system to control the investments of provincial governments and state enterprises under their control. Since tax revenues at the provincial level had declined and were inadequate to cover these investments, local branches of the state banks were usually prevailed on to lend for these projects.
- Local branches of the central bank were given discretionary authority over 30 percent of the central bank's annual lending to the financial system. When local branches of the state bank needed additional resources to support investments by local governments and state enterprises, they turned to the local branch of the central bank for an infusion of liquidity.

The resulting overheating of the Chinese economy in 1992–93 posed considerable risks to stability. Inflation climbed to its highest level in several decades. Real GDP growth reached an amazing 14.2 percent in 1992 and 13.5 percent in 1993. Eighty percent of this growth came from growth in investment, most of it by state enterprises under the supervision of provincial governments.

The authorities responded quickly with a combination of measures. The most important of these were administrative restrictions on investment by provincial governments and state enterprises and a reassertion of authority by the central bank over lending to state banks. These measures and others helped bring the economy to a soft landing. By 1995 inflation had fallen below 7 percent, while GDP growth had been maintained at around 9 percent.

All three channels can lead to undesirable macroeconomic outcomes. But some of the channels are quantitatively more important in some countries than in others. Whether they generate macroeconomic instability will depend on the relative importance of each channel, the relative capacity of central and local government policy-making and implementation, and the central government's commitment to overall macroeconomic objectives, such as growth and price stability.

REGIONAL DISPARITIES AND INEQUALITIES IN SERVICE PROVISION. Rough national equality in living standards and in access to public services is an overarching goal—even a constitutional mandate—in many countries. Centralization allows the national government more discretion to counter regional income disparities by managing regional differences in levels of public service provision and taxation. With decentralization, an equitable outcome can no longer be guaranteed or, at least, may be more difficult to achieve. And wealthier local governments and regions may benefit disproportionately from being given greater taxing power.

In China, for example, disparities in real income per capita between provinces have been growing in recent years. Income per capita in the richest province, Guangdong, is now four times greater than that in the poorest, Guizhou. Some provinces on the southern coast, such as Fujian, Guangdong, and Hainan, have done better than the western, interior provinces largely because of their central location for transport and communications and their proximity to Hong Kong (China). These natural advantages have been reinforced by official policies that favor coastal provinces, including tax breaks to foreign investors locating in special economic zones near the coast, large allocations of credit (relative to population) through China's government-directed banking system, and registration requirements that discourage the poor from migrating to the booming coast.

In Russia income inequality across oblasts is high. The ratio of expenditure per capita between the lowest- and the highest-spending oblast is estimated to have risen to one to seven by 1992, with better-off regions receiving disproportionately high budgetary expenditure allocations and rural areas relatively ill served. Subnational taxation or sharing of federal revenues from natural resources on the basis of their origin could create even greater fiscal disparities. Both Russia's and China's experiences highlight the need to design appropriate equalization schemes to deal with rising inequality during periods of accelerated growth or macroeconomic stabilization.

RESOURCE MISALLOCATION AS A RESULT OF LOCAL CAPTURE. Economic and financial distortions may also arise from subnational governments' ability to exploit weaknesses at the center. In the absence of agreed intergov-

ernmental rules, local governments may benefit from sources of income that have not been formally allocated to them under an appropriate fiscal decentralization scheme. In Poland, for example, the introduction of local self-government has seen many local authorities begin to act like pressure groups, eager to extract more benefits from Warsaw for local clientele. As a consequence, inequalities have risen among jurisdictions, leading to new forms of social conflict.

In Pakistan decentralization has been accompanied by a subtle recentralization of functions at the provincial level and difficult intergovernmental relationships. Provincial governments, which have expanded their role in the provision of education and other local public services since the 1960s, have increasingly adopted an intrusive, centralist attitude toward municipal governments. Instead of being encouraged to assume new tasks and responsibilities, municipal governments are being denied opportunities to succeed. Increased provincial control has not led to any noticeable improvement in service delivery, however.

Industrial countries that have decentralized began the process with a strong legal framework, which ties subnational governments to credible rules. Many of these countries also have mechanisms in place, such as fiscal transfer policies and equalization schemes (Box 7.7), hard budget constraints, and limitations on local borrowing, to counterbalance negative outcomes. Some countries have experimented with participatory mechanisms (blue-ribbon commissions, for example), which bring stakeholders together and provide options for feasible and manageable policies within a mutually agreed time frame.

Lessons for successful decentralization

Ideally, policymakers would embark on decentralization by gradually phasing in the reassignment of revenue authority and of expenditure authority and responsibilities in ways that are compatible and consistent with previously defined needs and responsibilities. At the same time, they would develop a system of intergovernmental grants to cover gaps between expenditures and revenues at the local level and to correct imbalances in efficiency and effectiveness, preferably with built-in incentives for local resource mobilization. So much for the ideal. The real-life business of designing a successful decentralization program tends to be more complex.

ASSIGNING EXPENDITURE AND REVENUE AUTHORITY. This brings a host of problems. Information on the true distribution of benefits and taxes both within and between jurisdictions is imperfect. And economies of scale in revenue collection and in the production of services may partly negate the efficiency advantages of a decentralized system. In addition, the costs of alternative options

Box 7.7 Calculating fiscal equalization grants

Fiscal equalization programs compensate provinces whose fiscal capacities are below the average. In addition to safeguarding national objectives of providing minimum levels of public services nationwide, an equalization program can foster the participation of member provinces in a federation. Thus fiscal equalization is often viewed as the glue that holds a federation together. Economists have long recognized that equalization is justified on grounds of horizontal equity, and in recent years it has become clear that under certain conditions it can promote economic efficiency as well.

In Pakistan, for example, a representative tax system has been proposed to equalize fiscal capacity across regions. Designing such a system involves, first, calculating the revenue that could be raised if a provincial government used all the standard sources of revenue at the nationwide average intensity of use. Then, using

the arithmetic mean of all provinces as a standard, the province's equalization entitlement for a given revenue source is determined by the difference (if positive) between the average potential yield at the national average rate of taxation in all provinces in the aggregate, and the potential yield obtained in the province when the national average tax rate is applied to its revenue base. In this way the fiscal capacity of below-average provinces is brought up to the median, the arithmetic mean, or some other norm. Because the data on tax bases and tax collections required to implement a representative tax system are published regularly by various levels of government in many countries, implementing such a system does not impose new data requirements and could be implemented as a federal fiscal equalization program in lieu of revenue sharing by the population.

for service production are often unknown. Some possible tax and expenditure assignments are shown in Table 7.3.

DESIGNING INTERGOVERNMENTAL GRANTS. Intergovernmental grants are important sources of revenue for many subnational governments. In Brazil between 1970 and 1992, grants from the federal government financed 64 percent of local government expenditure. In South Africa grants from the central government to newly elected provincial governments account for about 90 percent of total revenues for the latter. By their nature, intergovernmental grants tend to divorce local spending from local resources, and the benefits of providing local public services from the costs. The separation of benefits and costs and the limited ability of local governments to mobilize revenues for themselves can reduce the transparency of local budgetmaking and the accountability of local governments to local citizens, leading to inefficient and inequitable delivery of public services. Clearly, then, any system of intergovernmental grants in developing countries will need to be designed extremely carefully.

No blueprint exists for an optimal system of intergovernmental grants, but a good system should have certain characteristics. Above all, it should be predictable and transparent and embody the relevant principles set forth in Table 7.4.

AGREEING ON THE RIGHT APPROACH. Clear-cut rules are essential for imposing restraints on actors at each level of government. Equally important seems to be the process by which the rules are agreed on. Although, in principle, rules could be imposed from the top down to restrain the

arbitrary action of all participants, experience suggests that it is difficult to force agreement and that the result may not be sustainable. This is especially true of developing economies. Lessons from a variety of countries indicate that key policy decisions are more likely to be sustained when they are based on a broad consensus among stakeholders. Thus, the prospects of successful decentralization are greater with institutional settings and processes that allow for articulation of interests and consensual policymaking, as spelled out, for example, in the European Charter of Local Government of 1985.

In the absence of agreed-on guiding principles, what can governments committed to decentralization do to get the process started? Some models already exist. In the early 1990s the government of Uganda established a consultative process with different stakeholders—community groups, agricultural producers, and government representatives—to decide on the best way to proceed with decentralization. The decision was made for a staged and gradualist approach. Other countries have opted for commissions made up of informed leaders from different levels of government, academia, and sometimes unions and business associations, drawing on foreign advice where necessary. South Africa's recent experience is interesting in this respect. The new constitution calls for a fiscal commission to deal with the intergovernmental structure of the country. The president, in charge of setting up the commission, provided different representatives with a constitutionally guaranteed forum for articulating their interests. Although it is too early to judge its success, the

Table 7.3 Possible tax and expenditure assignments by level of government

Central government	State government	Local or provincial government
<i>Revenues</i>		
Value added tax	Individual income tax	Property taxes
Individual income tax	Surcharges on national taxes	Vehicle taxes
Corporate income tax	Retail sales taxes	User charges
Excise taxes	Excise taxes	Licenses and fees
Natural resource taxes	Property taxes	
Customs duties	Vehicle taxes	
Export taxes		
<i>Expenditures</i>		
Tertiary health care (control of infectious diseases, research)	Secondary health care (hospitals, curative care)	Primary health care
University education	University and secondary education	Primary and secondary education
Roads and highways (intercity)	Roads and highways (intercity)	Roads and highways (intracity)
Public transportation (intercity)	Public transportation (intercity)	Public transportation (intracity)
Natural resource management	Air and water pollution	Air and water pollution
Defense	Natural resource management	Solid waste disposal, water, sewerage, fire protection
	Police protection	Land use regulation and zoning
		Housing
		Cultural policy
		Promotion of tourism
		Police protection

process created a widespread sense of expectation and generated demands to design appropriate decentralization measures.

Commissions may serve short-term interests well. Over the longer term, however, more-durable solutions may be needed to allow for formal representation of sub-national governments' interests in national policymaking and legislation. Second-chamber institutions, such as the German Bundesrat, have often been used in this context. Such arrangements offer an institutionalized mechanism for articulating interests from below, while providing the means to develop widely accepted and credible rules for intergovernmental collaboration, which are essential for sustainable decentralization. They also help different tiers of government adjust to emerging needs over time.

ENSURING THAT THE INSTITUTIONAL GROUND IS READY. In principle, bringing policymaking and implementation closer to the communities they serve, and involving citizens in shaping policies, lead to greater accountability and improved local checks and balances. But as the above discussion of the potential for macroeconomic instability shows, government actions at the center can be undermined at the local level if there is no strong pattern of fiscal restraint and if there are no enforceable rules governing intergovernmental relations. In most federalized systems effective checks and balances between levels of government have evolved over long periods. What

history tells us, paradoxically, is that unless states have achieved a certain level of centralization and effective rules for overall macroeconomic control and sound policymaking, decentralization may be difficult to implement and may create imbalances. Decentralization, whether it occurs through gradual evolution or design (or both), can create additional momentum for development, but only if these conditions are met.

Any strategy of decentralization must begin with an assessment of institutional capability at the various levels of government (Table 7.5). Where there is weak central government capability to manage national fiscal and monetary policy, to enact and enforce credible rules for intergovernmental affairs, or to provide a framework for bringing stakeholders together, decentralization will be hard to pull off. Strongly polarized relationships between or within tiers of government and extremely weak organizational capacity at the subnational level will also be cause for concern. In these circumstances policymakers would do well to postpone decentralization, or eschew ambitious strategies in favor of a more carefully staged or sectoral approach. Decentralization might begin, for example, with certain priority areas such as education, health, or infrastructure. Strong monitoring mechanisms could provide opportunities for learning and for gradually phasing in new policies. Countries with greater capability at the central and the local levels have more options to choose

from—but their preferences will vary. What may be important in one country (say, decentralized service delivery) may not be desired (or desirable) in others.

Strategic options: Bridging the gap between state and citizen

The evidence presented in this chapter has shown that improving the capability and effectiveness of the state rests with mechanisms to increase openness and transparency, to strengthen incentives for participation in public affairs, and, where appropriate, to bring government closer to the people and communities it is meant to serve. Building capability in this way will take time and careful attention to the dangers: efforts to open up government to a broader array of needs and interests will not improve effectiveness or accountability if they shut other groups further out. But the experience of governments the world over suggests some clear starting points:

- Where appropriate, states should work to ensure broad-based public discussion and evaluation of key policy directions and priorities. At a minimum this means making available information in the public interest and establishing consultative mechanisms such as deliberation councils and citizen committees to gather the views and preferences of affected groups.
- They should encourage, where feasible, the direct participation of users and beneficiary groups in the design, implementation, and monitoring of local public goods and services. And they should enhance the capacity and efficiency of accountable local organizations and institutions rather than replace them.
- Where decentralized service delivery is considered desirable, states should adopt a carefully staged or sectoral approach, beginning in priority areas such as health, education, or infrastructure. They should introduce strong monitoring mechanisms and make sure that

Table 7.4 Principles and best practices in grant design

Grant objective	Principles of grant design	Best practices	Practices to avoid
Bridging fiscal gap	Reassignment of responsibilities between levels of government Tax abatement Tax base sharing	Tax abatement in Canada Tax base sharing in Brazil, Canada, Pakistan, and South Africa	Deficit grants Tax-by-tax sharing as in India and Pakistan
Reducing regional fiscal disparities	General nonmatching grants Fiscal capacity equalization transfers	Fiscal equalization programs in Australia, Canada, and Germany	General revenue sharing using multiple-factor formulas
Compensating for benefit spillovers	Open-ended matching transfers with matching rate consistent with estimated spillover	Transfers for teaching hospitals in South Africa	
Setting national minimum standards	Conditional nonmatching block transfers with conditions on standards of service and access	Roads and primary education grants in Indonesia Education transfers in Colombia and Chile	Conditional transfers with conditions on spending alone Ad hoc grants
Influencing local priorities in areas of high national but low local priority	Open-ended matching transfers with matching rate varying inversely with local fiscal capacity	Matching transfers for social assistance in Canada	Ad hoc grants
Stabilization	Capital grants, provided maintenance is possible	Limited use of capital grants with encouragement of private sector participation through guarantees against political and policy risk	Stabilization grants with no future upkeep requirements

Table 7.5 Matching decentralization strategy to government capacity

Local government capacity	Central government capacity	
	Low	High
Low	Cautious decentralization strategy with pilot testing	Deconcentration of some priority services
	Delegation of some functions to NGOs and communities	Delegation of some functions to NGOs and communities
High	Massive institutional strengthening at both levels, particularly in public finances (most Sub-Saharan African countries)	Targeted strengthening of local entities during transfer of responsibilities (e.g., Hungary, Mexico, Thailand)
	Separatist or secessionist tendencies	Delegation or devolution of functions according to government priorities and preferences as well as articulated needs (most industrial countries)
	Delegation or devolution according to priorities of governments (e.g., Santa Cruz Province, Bolivia; parts of former Soviet Union)	

sound intergovernmental rules are in place to restrain arbitrary action at the central and the local levels.

- At the local level, states should focus on the processes and incentives for building accountability and competition. Where local governments are weakly accountable and unresponsive, improving both horizontal accountability (to the public) and vertical accountability (to the center) will be a vital first step toward achieving greater state capability.

Certain dangers are inherent in any strategy aimed at opening and decentralizing government. Expanded opportunities for voice and participation increase the demands made on the state, which can increase the risk of

gridlock or of capture by vocal interest groups. And if no clear-cut rules impose restraints on the different tiers of government, and no incentives encourage local accountability, the crisis of governance that now afflicts many centralized governments will simply be passed down to lower levels. However, as Part Four of this Report argues, the obstacles on the path to reform of the state are not insurmountable. The first step toward bringing government closer to people will be to make the objectives of reform clearly intelligible to citizens and the business community. Efforts at communication and consensus building will have a double benefit, increasing the support for reform as well as arming the government with a better sense of how to do it right.