

Decentralised Development*

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ABSTRACT

In this paper we start with an evaluation of the various advantages and disadvantages of decentralisation (in the sense of devolution of power to local agencies and communities), and also of the conditions that predispose towards success or failure in beneficial decentralised development. In particular we have focussed on the argument that in governance structures control rights should be assigned to people who have the requisite information and incentives, and at the same time will bear responsibility for the (political and economic) consequences of their decisions. We try to provide a balanced assessment of the efficiency and equity effects of such assignments of control rights and how they operate differently under different initial conditions.

JEL Classification: O0, O1, P0, P5

1. INTRODUCTION

V. K. Ramaswamy was one of the very best bureaucrat-economists India has ever produced. He was also a good personal friend. It is a cherished honour for me to be invited to give this lecture. I have chosen a topic for this occasion which is not merely of some importance to public policy discussion, but which belongs to the general area of internal organization of government that economic theorists in this country have sadly neglected and left largely for the students of public administration to analyze.

The idea of decentralisation enjoys easy popularity, and its popularity has increased in recent years. On account of its many failures, the centralised state has lost a great deal of legitimacy. Decentralisation is often suggested and implemented as a way of reducing the role of the state in general. On the other hand, those who are still convinced of the importance of market failures sometimes turn for their resolution to the government at the local level, where the transactions costs are relatively low and the information problems (that cause government failures) less acute. They are joined by an increasing and diverse array of social thinkers (from post-modernist cultural anthropologists to grassroots environmental activists and supporters of the cause of indigenous peoples and technologies) who are both anti-market and anti-(centralised) state - in

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the absence of a better unifying name, I would describe this latter group as ‘anarcho-communitarians’. Decentralisation thus provides a way out of the impasse of the bipolar state-versus-market debates.

It is also the case that different people mean different things by decentralisation and support it for diverse reasons. To the liberal economist decentralisation is a way of getting rid of the interventionist and over-extended regulatory or predatory state. In the literature on structural adjustment and transitional reform, decentralisation is sometimes used almost as a synonym for privatisation. On the other hand, the anarcho-communitarians use it to imply control by local self-governing communities. In countries with a long history of centralised control public administrators often mean by centralisation the dispersion of some responsibilities to regional branch offices at the local level of implementation on a particular project. For the purpose of discussion in this paper we shall distinguish decentralisation in the sense of devolution of political decision-making power from mere administrative delegation of functions of the central government to local agencies. We shall also separate our discussion of the political and administrative aspects of decentralisation from that of the issues of fiscal decentralisation. Not all these aspects of decentralisation operate simultaneously in any particular case and it is quite possible that a given economy may be decentralised in some respects, not in others. It should also be clear that the effects of a policy of deliberate decentralisation can be qualitatively different from those following from anarchic erosion of central control (either due to incompetence or lack of capacity or resistance on the part of the central authority).

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

2. ECONOMIC CASE FOR DECENTRALISATION

Let us start with enumerating the advantages of decentralisation in the sense of devolution. In a closely interactive local community such devolution places decision-making in the hands of those who have information which outsiders lack, an incentive advantage qualitatively similar to that enjoyed by the market mechanism over the state. Local information can often identify cheaper and more appropriate ways of providing public services, apart from getting a better fit for locally diverse preferences (or getting rid of uniformity constraints in service delivery that a centralised

supplier is sometimes compelled to adopt). In remote regions of poor countries decentralisation also provides a more effective channel of transmitting (and acting upon) early warnings about problems which might develop into disasters (droughts, epidemics, etc.).

While sharing with the market mechanism the same informational advantage, a self-governing local community can sometimes be superior to the market in coordination and enforcement. Markets may fail as a coordination mechanism when private information renders individual market contracts incomplete or unenforceable (as in the situation of moral hazard and adverse selection in credit and insurance markets). In such cases a local community, if it has a stable membership and well-developed structures of transmission of private information and norms among the members, and if it has the power of sanctions of the local government, has the potential of providing a more efficient coordination device.

It may, of course, be asked why a central government cannot procure for itself the information advantage of proximity through local agents. In some countries the central government uses such representatives at the local level (like the “*préfets*” in France and Italy or the “*intendentes*” in Chile) for this purpose. It may even be argued that the central government can have economies of scope in the collection of information. But the main reason why in practice the local government still retains the informational advantage has to do with political accountability. In democratic countries the local politicians may have more incentive to use local information than national or provincial politicians, since the former are answerable to the local electorate while the latter have wider constituencies (where the local issues may get diluted). Seabright (1996) discusses the problem theoretically as one of allocation of control rights in the context of incomplete contracts where breaches are observable (though not verifiable in administrative or judicial review), but subject to periodic electoral review, which creates appropriate incentives for local politicians.

In some otherwise democratic countries if the institutions of local democracy and local accountability are weak (as in large parts of North India), it is common to observe, for example, the serious problem of absenteeism of salaried teachers in village public schools and of doctors in rural public health clinics. The villagers are usually aware of the problem but do not have the institutional means of correcting it, as the state-funded teachers and doctors are not answerable to the villagers in the insufficiently decentralised system. On the other hand, in non-democratic China the local Communist Party officials have sometimes been quite responsive to local needs (at least as long as they are not conflicting with the Party’s programme), as the comparative study of two villages in China and India by Drèze and Saran (1993) show in the context of China’s far better performance in the provision of primary education at the local level. (Similarly accounts are available of more effective public pressure in rural basic education and health services in Cuba compared to some of the more democratic regimes in Latin America). There are, of course, many authoritarian countries where local accountability is completely absent and the situation is much worse than in North India.

In part of India (like the South Indian state of Karnataka), a relatively effective decentralisation has significantly improved the attendance of school teachers in recent years, and in general, the speed and quality of official response to popular pressure and appeals in other services as well - as Crook and Manor (1994) point out in their comparative study of the performance of decentralised

governments in Karnataka, Bangladesh, Cote d'Ivoire and Ghana. Of these four cases they find the responsiveness to be the best in Karnataka, and they explain it not so much in terms of popular participation levels (in their Bangladesh case the participation levels were slightly better), but in terms of effective systems of democratic accountability, a good administrative and financial resource situation, and a well-established party system and free press - one or more of which was lacking in the other three cases.

Accountability usually brings responsibility in decision-making and in implementation, which helps in improving quality and cost-efficiency. There is some scattered evidence of such quality improvement and cost savings. WDR 1994 on Infrastructure reports several cases. In Mexico under the municipal fund project, introduced in 1990, community committees (*Comités de Solidaridad*) manage rural investment in simple infrastructures such as small water supply systems, rural roads and bridges, and school buildings. Studies have found that these projects often cost one-half to two-thirds as much as similar projects managed by state or federal agencies. A review of World Bank data for forty-two developing countries found that where road maintenance was decentralized backlogs were lower and the condition of roads better. Data for a group of developing countries reveal that per capita costs of water in World Bank-funded water projects are four times higher in centralised than in fully decentralised systems. A study of one hundred and twenty-one complete rural water supply projects, financed by various agencies, showed that projects with high participation in project selection and design were much more likely to have the water supply maintained in good condition than would be the case with more centralised decision-making.

In most of the examples above decentralisation with local accountability improves service in publicly supplied facilities. But such decentralisation may also help in resolving collective action problems in the management of common property resources and avoiding the so-called tragedy of the commons. The daily livelihood of the poor, particularly in rural areas, depends vitally on the local environmental resources like forestry, grazing, irrigation, fisheries and so on. The local commons also provide some elementary insurance function for poor peasants, for example as a fallback food and fodder source in bad crop years. With the erosion of the local commons –decimation of forests and grazing lands, silting and increasing toxicity of rivers and tanks, depletion of aquifers and soil erosion and desertification– life of the rural poor in many parts of the world have become in some ways more insecure and impoverished. Many of these countries have actually a long history of balanced resource management under highly informal local community arrangements. The erosion of the local commons set in only with major demographic and institutional changes in recent years, often accelerated by private commercialisation or bureaucratic appropriation of the traditional historical rights of local communities over these resources.

It is commonly suggested in economics that these problems of overuse and degradation of environmental resources reflect primarily the lack of well-defined private property rights in these local common-pool resources. Private property rights can certainly go a long way in reducing uncertainty in interaction among agents and in inducing them to conserve resources and to internalise externalities. But privatisation of these common resources often implies disenfranchisement of the poor: from the enclosure movement in English history to the current

appropriations of forests and grazing lands in developing countries by timber merchants and cattle ranchers, it has been the same sad story.

Although privatisation has its problems, nationalisation of the local commons and their management by a distant bureaucracy is rarely any better, and in some cases actually much worse. It leads to insufficient utilisation of local information and initiative. As ineffective or corrupt government supervision replaces traditional control structures, a common property resource can become a hunting ground for overexploitation and malfeasance by influential interest groups and an object of predation by even formerly responsible, now dispossessed, local users. The widespread depletion and degradation of the commons in many poor countries where they were taken over by the colonial and post-colonial governments bear testimony to the ravages of this system.

Contrary to the popular belief of many economists of the property rights school and that of many patronising bureaucrats eager to protect tribals and other illiterate villagers from their own irresponsibilities, there are several documented examples of successful and autonomous local community-level cooperation in management of common property resources - see Ostrom (1990) for examples from different parts of the world. There are, of course, more numerous cases of failure of such cooperation in poor countries, leading to an anarchical regime in the scramble for common resources. In recent years there have been a number of studies - Bardhan (1984, chapter 16), Wade (1987), Ostrom (1990), Bardhan (1993) and Baland and Platteau (1995) - trying to understand the conditions working for and against sustainability of local cooperation on the commons. It is generally agreed that cooperation works better in small groups with similarity of needs and clear boundaries, and shared norms and patterns of reciprocity. In such communities monitoring is easier, the "common knowledge" assumption of strategic cooperation (in models of repeated games) is likely to be more valid, and social sanctions are easier to implement through reputation mechanisms and multiplex relationships of face-to-face communities. It is clear that decentralisation in the sense of devolution of power to such local communities may succeed in regulating, conserving and maintaining these common resources in areas where centralised bureaucratic systems have clearly failed.

Even limited decentralisation in the sense of delegation of implementation tasks to local-level agencies can make a difference. Wade (forthcoming) points to interesting contrasts between the mode of operation of Korean irrigation bureaucracy (under an authoritarian regime in the recent past) and that of the Indian, and the clearly more effective performance of the former. The Indian canal systems are large, centralised hierarchies in charge of all functions (operations and maintenance as well as design and construction). Their ways of operation (including the promotion and transfer rules for officials, rules designed to minimise identification between the irrigation patrollers and the local farmers, and the frequent use of low-trust management and supervision methods) and source of finance (most of the irrigation department's budget comes in the form of a grant from the state treasury) are totally insensitive to the need for developing and drawing upon what Putnam (1993) and others have called local 'social capital'.

In Korea there are functionally separate organisations in the canal systems. The implementation and routine maintenance tasks (as opposed to policy-making and technical design work) are

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

In the public economics literature there is extensive discussion on decentralisation around the Tiebout (1956) model of local government. In this model intergovernmental competition across local jurisdictions, competing for mobile residents, ensure the efficient supply of local public goods. The assumptions required for the Tiebout result are, however, much too stringent, particularly for poor countries. The crucial assumption of population mobility (full informed citizens 'voting with their feet') that enables governments in the Tiebout framework to overcome the well-known problem of inducing citizens to reveal their preferences for public goods largely fails in poor countries. In any case many of the public goods in question are site-specific and it is possible to exclude non-residents, making the revelation problem somewhat irrelevant. The introduction of any realistic political process (instead of the assumption of an efficiency-driven profit-maximising government, unencumbered by political-institutional obstacles) or oligopolistic competition and externalities across jurisdictions will violate the free market-like efficiency properties of the Tiebout framework in most countries. Yet one should not deny that jurisdictional competition does bring some choices in the public sector and provide yardsticks for performance comparison that help monitoring, and can allow important experimentations in the way a given public service is provided. On a more general level, the sequence of recent market reform in China shows that decentralisation with jurisdictional competition allowed some coastal provinces to carry out major experimentations with institutional reform the success of which showed the way for the rest of the country.

3. THE CASE FOR SUPRA-LOCAL CONTROL

We have discussed above some of the common arguments in favour of decentralisation. But there are many reasons why it often does not work and some form of central control becomes necessary, even in case of goods or services whose spatial characteristics do not encompass the whole country (like national defence or money supply). The major trade-off is between the need for policy coordination at some central level when there are economies of scale and of scope and interjurisdictional externalities on the one hand, and that for local information and accountability on the other. The importance of the two sides in this trade-off varies from case to case, and it is difficult to pass generic judgment on the appropriate extent of decentralisation without looking into the empirical details of each case.

There are very few studies of scale economies in the supply of local public services. For many local public goods it is unlikely that the optimum scale in production exceeds a reasonably sized local jurisdiction, and so one may not require a national or provincial administration to utilise the scale economies. On the other hand, a proliferation of agencies in multiple jurisdictions sometimes

unnecessarily increase overhead and administrative costs. A decentralised administration of education, for example, may make it difficult to reap scale economies in curriculum development, textbook production, examinations, teacher training, etc. A related point is that some degree of centralisation is necessarily involved in setting national standards defining minimum requirements in areas like education and health. (In Kenya, for example, the privately-run Harambee local schools are of very low quality; most of them are below the minimum standards which are satisfied by the overwhelming majority of central government schools). Local consumers should definitely have some say, but they are not always the best judge of quality, particularly when merit goods are involved, and local public providers of these goods may have no incentive to hide their low standards. There are large fixed costs in setting up organisations that serve as quality watchdogs, which often only the central government can afford. Centrally-supported but locally-controlled projects should, therefore, have built-in provisions for periodic renewals contingent on independent evaluation of performance quality.

Similarly, there are agglomeration economies in attracting qualified people in bureaucracies. In most countries central bureaucracies attract better talent (sometimes with better reward structure, career paths and diversity of tasks), and a pool of talent draws others through the usual self-reinforcing mechanisms of human capital externalities emphasised in recent growth theory. In many developing countries the quality of staff in local bureaucracies (including accounting and record-keeping) is very low, hampering their technical and institutional capacity; even their more professional and technical people suffer from the disadvantages of isolation, poor training and low interaction with other professionals. As Bird (1995) puts it simply, information asymmetry thus works both ways: the central government may not know *what* to do, the local government may not know *how* to do it.

Of course, this problem is of differential importance in different services. Providing for street cleaning or garbage collection may not require sophisticated expertise, but power production and transmission, bulk supply of clean water and public sanitation do. Decentralisation will often work better in the former kind of services than the latter. It has also been pointed out that sometimes centralised systems use unnecessarily expensive services of specialised technicians. For some of the basic needs for poor people, local youths with some minimum training as primary health workers or primary school teachers can be adequate. In other, more technical, projects there is a lot of scope for improving access to engineering, project design and administrative skills. Organisations like AGETIP in Africa or the Brazil-based IBAM have in recent years been helpful in developing local technical capacity.

Supra-local coordination may also be necessary in the case of interjurisdiction externalities, which the local authorities may be unable and sometimes even unwilling to cope with. In cases of positive externalities across localities there may, for example, be underinvestment in infrastructural facilities (say, in road-building or labour training) the benefits of which spill over to other communities. In cases of negative externalities local control mechanisms may be inadequate as, for example, upstream deforestation causes flooding and soil erosion in downstream communities. The standard Coasean bargaining solutions in case of such externalities do not work on account of the inevitable information, negotiation and enforcement costs.

Supra-local intervention and involvement are also necessary for credit and insurance. In an agricultural community, for example, risks are often covariate, requiring pooling of risks with other geographically distinct communities for insurance purposes. Covariate risks coupled with seasonal synchronicity in demands for credit make the development of locally-based rural deposit banking or credit cooperatives difficult. Without territorial diversification and supralocal coordination in credit and insurance functions local community organisations can remain desperately vulnerable. Traditional community riskcoping strategies (like kinship networks, gift exchange, seasonal migration and private remittances) are highly imperfect substitutes and requisite adjustments can be costly for efficiency and innovations.

It has often been observed that the problem of corruption afflicts local governments more than national governments in developing countries. And we know from the recent literature on corruption (see, for example, Shleifer and Vishny (1993) that decentralised corruption is more costly in terms of efficiency than centralised corruption, as the former system fails to internalise the (negative) externalities of one bribe transaction on another. The concept of decentralisation used in this literature is somewhat wider in terms of economic agency than that used in the literature on political and administrative decentralisation, but the logic can be applied to this context. Applying the same logic to the general case of rent-seeking, one can say that decentralisation may lead to larger subsidies for the economy as a whole, as the lobby for subsidy in each locality does not take into account the effects of the lobbies of other localities (this is an example of what in the theoretical literature in political economy is called a common agency problem). It is likely, for instance, that the massive government subsidy in the form of electricity or water underpricing in India would have been somewhat less if it were centrally rather than regionally determined.

A major reason for higher local corruption may have to do with the fact that arm's-length relationships among the various parties involved (officials, politicians, contractors, and interest groups) are much more scarce at the local level. One of the central results of the literature on collective action is that small group size and proximity help collective action. Collusions are thus easier to organise and enforce in proximate groups, risks of being caught and reported are easier to manage, and the multiplex interlocking social and economic relationships among the local influential people act as formidable barriers to entry into these cosy rental havens. In rent-seeking at the national level there is more competition; 'capture' of central government institutions is more difficult as the local mafia of different regions neutralise one another to some extent. On account of more competition at the central level there are also more institutional mechanisms for checks and balances usually at place. These include not only the various constitutional forms of separation of powers and adjudicatory systems in some countries, but also more regular auditing of public accounts, which is often absent or highly ineffective at the local level.

There is clearly some tension here between local accountability and the increased possibility of local-level collusion in corruption. This is why in the Indian administrative system, even with the recent attempts at decentralisation (following upon the 73rd and 74th Constitutional Amendments), there is much more concern for accountability upwards (i.e. to the higher-up funding authority) than downwards to the local people, and the financial autonomy of the local bodies is severely restricted. It is, however, arguable that when institutions of local democracy are firmly in place

(they are not in many parts of India) along with a vigorous opposition party and free press, the political process is more transparent and the theft of funds and the sale of influence become more visible compared to the system of centralised corruption. This, as Crook and Manor (1994) point out on the basis of indirect but strong evidence in the case of Karnataka in South India, may reduce the overall amount of money and resources siphoned off through corruption: even though there are more hands in the till, it is difficult for people to steal very much (in big central-government projects, on the other hand, a single transaction can yield very large bribes). But, ironically, on account of the increased openness and visibility of the system compared to the earlier centralised system, local people believed, often wrongly, that corruption has increased.

In many parts of India the recent attempts at devolution of power have been partly neutralised by the state government officials and politicians hustling in to retain their authority in the local bodies (for fear that they will lose their command over the local patronage network). This has also resulted in a great deal of dual authority structure and overlapping administrative jurisdictions at the local level observed in Gaiha's study (1996) of the Panchayats in Uttar Pradesh, Maharashtra, and Karnataka. It seems that large-scale theft and corruption may be more effectively resisted if regular local elections to select representatives in the local bodies are supplemented by an institutionalised system of public hearings on items of major public expenditure. Some people have attributed the relative success of the decentralisation experiments in parts of rural West Bengal to these public hearings in villages and small towns (apart from the influence of a relatively disciplined ruling party in restraining decentralised malfeasance). It is heartening to note that even in backward districts of Rajasthan a movement is growing (under the leadership of the Mazdoor Kisan Shakti Sangathan) for the villagers to demand information in public hearings (*jan sunwayis*) on bills, vouchers and muster rolls on development works. There is also some demand for repealing the Official Secrets Act of 1923 which officials usually cite as an excuse for not making the information public.

In the literature on bureaucratic corruption it is sometimes suggested - see, for example, Rose-Ackerman (1978) - that jurisdictional competition, by allowing clients who are not well-served to move across jurisdictions for the service, may act as a check on local corruption. But this does not quite work in developing countries with low mobility and information, and in any case the local public goods are often site-specific, as we have noted before. In cases of what Shleifer and Vishny (1993) have called corruption with theft (i.e. where neither the briber nor the bribee has an incentive to report or protest the corrupt transaction), competitive pressure may actually increase the points at which theft from the government and malpractices (including relaxation of minimum quality standards) take place.

The 'capture' problem we have discussed above is more severe in countries with marked social and economic inequalities. It is possible to think of situations in which decentralisation may leave the poor grievously exposed to the mercies of the local overlords and their malfeasance. There are certain fixed costs of organising resistance groups or lobbies. As a result the poor may sometimes be more unorganised at the local level than at the national level where they can pool their organising capacities. In these situations they may even be able occasionally to play pivotal roles in national coalitions and get redistributive transfers in their favour under centralised systems. (In the history of the United States, for example, movements in favour of 'state rights' diminishing

the power of the federal government have often been interpreted as regressive, working against poor minorities). Decentralisation without adequate redistributive transfers also exacerbates inter-regional inequality, as localities with better endowments and infrastructure tend to do better (generating the usual centripetal forces of the growth process, analysed in the economic geography literature).

As Tanzi (1995) emphasises, decentralisation can also have important effects on macroeconomic stabilisation. Subnational governments' spending often far exceeds their revenue, and as they accumulate heavy debt, the central government is often obliged to come to their rescue, contributing to central fiscal deficit and macroeconomic problems. In Italy borrowing by subnational jurisdictions has contributed significantly to the deterioration in the fiscal situation. In Argentina provincial fiscal deficits, financed either by central transfers or by borrowing, used to be a regular contributor to inflation. In Brazil, Prud'homme (1995) suggests that the 1988 constitutional reforms towards more decentralisation reduced the central government's ability to conduct macroeconomic policies, contributing to poor macroeconomic performance in recent years. In China the absence of a unified monetary system has frequently allowed the provincial and city governments access to credit in a way that expanded the money supply, feeding inflation. In Mexico the finances of its thirty-two states have been reported as precarious and some states are practically bankrupt. Such examples can be multiplied from other developing countries.

Finally, there are administrative imperatives for going beyond the usual centralisation-decentralisation dichotomy, as Prud'homme (1995) suggests. For many economic activities and services two or three levels of government have to be involved simultaneously, as each level of government will have different, but equally legitimate, interests and comparative advantages. Prud'homme gives the example of primary education: the local government can provide accountability to its specific needs; the regional government can have the economies of scale in designing curricula and correct for the inequities of local financing of schools; the central government can provide minimum quality standards and auditing and evaluation of local performance. The important task is to design mechanisms of cooperation among these three levels of government and to avoid unnecessary treading on one another's toes in overlapping jurisdictions and perverse incentives (like free-riding opportunities, leading to negligence of essential functions). To take an example from a different area, there have been some successful cases in India of joint management of forest resources between the central forest service and the local community organisations. Another successful example of cooperation between central and local agencies is the Malawi Self-Help Water Project, which is one of the outstanding rural water projects in Africa.

Sometimes it may also be useful to have special single-purpose quasi-political government agencies (such as water districts or school boards) to which some functions of the local government may be delegated. At any level if the government has too many tasks, while this may bring the benefit of internalising the spillover of information across tasks, political accountability gets diluted, as the electorate has to judge a government in terms of its over-all performance. On the other hand, special-purpose bodies may compete for the same resources and weaken a local government.

4. FISCAL DECENTRALISATION

Let us now turn to fiscal decentralisation. This largely involves assignment of expenditures and revenues to lower-level governments. In a way we have already discussed in sections 2 and 3 the merits and demerits of decentralisation of public expenditures. On the revenue side the main argument for devolving power to tax to the local level is to induce fiscal responsibility and a stake in the cost-effectiveness of expenditure. On the other hand, this can generate various kinds of inefficiencies and factors across localities and hamper the operation of the domestic common market. Many developing countries do not have a constitutional provision akin to that in the U.S. preventing restraints on interstate commerce; under the circumstances, interjurisdictional beggar-thy-neighbour tax competition can easily lead to social inefficiency like in a prisoner's dilemma. Inequities from the social point of view will be created by different localities having different fiscal capacities and different preferences for redistribution. The federal government therefore needs to retain sufficient control of the tax structure in order to achieve some harmonisation of the tax system, better redistribution and lower costs of tax collection.

As can be expected from the general theory of tax assignment (see, for example, Musgrave (1983)), the federal government in most developing countries largely controls direct taxes which are levied on mobile factors (like capital), which redistribute wealth (like progressive taxes on income, wealth or gifts), or are assessed on unequally distributed deposits of natural resources (like oil and gas taxes in Indonesia and Nigeria). Sometimes the tax bases and their revenues are shared with lower levels of government, but their administration is carried out centrally: As Broadway, Roberts and Shah (1994) point out, China differs (at least until the tax reforms of 1994) from most developing countries in that its central government played a limited role in tax collection; most revenues were collected at the local level and 'shared up'. (With the loosening of central control and monitoring in the post-1978 market reforms, the local governments now have both the motive and opportunity to shield local revenues from sharing with higher levels). In Nigeria the federal government collects only a limited share of income taxes and this hinders its redistributive objective.

In some countries there is a lot of scope for efficiency gains from harmonisation of state-level sales taxes or other tax instruments which affect a common internal market. This is a major problem, for example, in India where the array of state sales taxes is quite complex, and the introduction of a VAT (which is now being attempted) raises complicated issues of centre-state relations. In Brazil some of the conflicts arising from the VAT as a state levy have been managed by a Council whose members are the finance ministers of all states.

In most developing countries even when the local governments below the state have some authority to charge fees and taxes, it is not uncommon for the central or the state government to exercise effective control. In Indonesia, for example, all local taxes must be approved by the central government, while fees can vary across jurisdictions, the central government tries to standardise major local taxes.

In general in developing countries expenditure assignments are more decentralised than revenue collection. Assessing the balance of arguments for and against fiscal decentralisation, this is to

some extent appropriate. One can, of course, expect that more local accountability and direct visibility of benefits should encourage local resource mobilisation. But given the tax delimitations and restrictions from above and the geographic concentration of income generation (partly caused by agglomeration economies in production and trade and initial endowment advantages) often there are very few elastic sources of revenue left for the state or the local governments to tap.¹ There is thus a built-in tendency towards vertical fiscal imbalance and a dependence on central transfers, which seriously restrict local financial autonomy. Transfers from the centre are the predominant source of funds for provincial and local governments in, for example, Indonesia, Nigeria, South Africa, Tanzania, Zimbabwe and Mexico. In recent years in large parts of Africa while local dependence on central transfers has increased, there has been a general decline in central transfers on account of structural adjustment programmes; this has played havoc with local social and economic services.

Unconditional transfers (revenue-sharing and grants) from the centre usually address the problem of horizontal equity and that of the fiscal gap at the sub-national level. The allocation of funds is according to some pre-determined formulae (periodically revised by constitutional bodies like the Finance Commission in India) in some cases and to negotiation in some others. Needless to say that the latter makes the transfer process less transparent and more ad hoc and uncertain. In general gap-filling transfers discourage mobilisation and give perverse signals of a “soft budget constraint” to the subnational governments. Conditional transfers (usually negotiated, and largely discretionary on the part of the central government) are used for addressing problems of jurisdictional spillovers, regional backwardness, unforeseen contingencies, etc., but purely political goals of buying support are also quite common.

The idea of matching grants with the purpose of encouraging local fiscal responsibility is around but not very frequently used (examples of exceptions are in the cases of India, Indonesia and South Africa, and also recently in rural development programmes in Colombia and Mexico). Since regions with better fiscal capacity can utilise more of matching grants, the transfer process in this way can become regressive. On the other hand, taking into account some measure of a region’s fiscal capacity usually increases the complexity of grant design which works against the objective of transparency. (There is some evidence in India that central transfers have been on the whole regressive from the point of view of interprovincial equity.) There is similar evidence in China in recent years that the distribution of central subsidies favours richer provinces).

One common feature of local government financing is the practice of earmarking of transfers and taxes. McCleary (1991) provides a useful survey of the arguments for and against earmarking, and Crémer, Estache and Seabright (1995) reformulate them applying the theory of incomplete contracts. Earmarking is a second-best solution by which a government provides a commitment (and thus better accountability) that money coming from a specific source should go to a specific use. There have been cases (McCleary cites examples from Ghana, Mali and Zaire) where a government has not always kept to this commitment, but in general it does increase government commitment and makes it somewhat easier to use private contractors through competitive

¹ For a discussion of the fiscal domain and scope for additional resources at the local Panchayat level, see Rajaraman, Bohra, and Renganathan (1996).

bidding. In the perennial recurrent cost problem (i.e. where the central or the provincial government pays for, say, the construction of a road, but needs to goad the local government for its maintenance) earmarking of receipts from local tolls and petrol taxes for road maintenance may provide a way out (although this usually has high opportunity costs in terms of other decentralised expenditure needs like education and health).

On the question of vertical fiscal imbalance the Chinese case shows an important variation. Wongt (1994) in her study of subnational finance in China points out that within the local fiscal hierarchy the province and county levels spend a greater share of revenues than they collect, while the opposite is true for the levels of prefectures/cities and townships (where industry and commerce generate the bulk of the revenues). One of the most important aspects of subprovincial finance in China today is the growing importance of “extra-budgetary funds” (*yusuanwai zijin*) under the control of local governments and administrative agencies, and “self-raised funds” (*zichou zijin*) at the county and township levels. These funds are not subject to sharing with higher tiers of government, and so the governments have the incentive to shift funds to this sector from the sector subject to revenue sharing. This has also amplified the growing gap in provision of social and economic services at the local level between rich and poor regions.

5. LOCAL DEVELOPMENT AND RESOURCE MOBILISATION

That decentralising reforms in China have seriously eroded the redistributive capacity of the fiscal system is not unexpected, and this is one of the usual costs of decentralisation, as we have noted in section 3. But what is more striking is the way decentralisation has unleashed the forces of rapid economic growth at the local level in China. In particular the dramatic success story of the township and village enterprises (TVE) in rural industry has important lessons for the economic theory of decentralisation.

There is already a large and growing literature on the TVE's and analysts differ considerably on the explanation of their success. We shall concentrate here on the incentive structures they face and their impact on economic performance. There are many variations among TVE's, but in general the control rights in these enterprises are vested in the local government - see, for example, Wang and Chang (1994), and Che and Qian (1994). Even though they are thus in some sense public enterprises (and not entirely free from rent appropriation by bureaucrats and politicians), the crucial difference from the usual state-owned enterprises lies in the incentive structures they face. The three aspects of the institutional mechanism of the TVE that made a big difference are: (a) vigorous competition among the enterprises of different localities for the market (the local governments do not have the administrative authority and capacity to protect the enterprises by, say, erecting barriers to keep out competition); (b) a hard budget constraint implemented by the higher-tier fiscal and credit authorities - unlike the state-owned enterprises the TVE's may go bankrupt and lay off workers, without any bail-out from above; and (c) residual claimancy status by which the enterprises and the local government get to keep much of the profits they make. Not all these aspects apply with equal force in the case of TVE's in different parts of China, but in the successful coastal provinces the combination of these three aspects provides a decentralised incentive structure that compels local governments to be self-reliant and fiscally prudent and at the same time encourages them to “get rich gloriously” (to cite Deng's

famous maxim). Qian and Weingast (1994) call this system 'market-preserving federalism', which is rather unique among developing countries in its institutional mechanism of effective economic decentralisation.

In many parts of the world where there have been isolated cases of somewhat effective decentralisation, more often than not the mobilisation of local resources has been difficult. Take the case of rural West Bengal in India, where under the leadership of a leftist government over the last eighteen years some institutions of genuine local democracy have struck roots, as we have noted earlier. But the main success so far has been with respect to the fact that sections of the rural poor have been mobilised to demand and get some of the benefits and subsidies flowing from the top which in other Indian states are often misappropriated by the rich. The institutions of local democracy in West Bengal have so far not succeeded in mobilising any significant amount of their own resources or in launching self-reliant cooperative projects of rural development.² The case of Chinese TVE's suggests that under appropriate incentive structures decentralised public authorities at the local level can initiate projects of rural industrialisation and from the resultant profits raise resources for funding rural infrastructure.

Market competition that the TVE's operate under plays an important role here. Decentralised decision-makers have an inherent bias (see Sah and Stiglitz (1986) for a general discussion of the architecture of economic systems) towards accepting too many bad projects (what is known as Type II error) - just as centralised hierarchies tend to reject too many good projects (Type I error) - and the market process directly help in disciplining against Type II errors. But the most difficult part is for a decentralised democracy to credibly precommit to maintaining a hard budget constraint; when a publicly sponsored local enterprise is in danger of folding with hundreds or thousands of livelihoods at stake the pressure on democratic politicians for a bail-out is likely to be inexorable.

This is not to deny that there is considerable scope for mobilising contributions from the intended beneficiaries of small locally specific infrastructural projects, when their consensus and involvement are sought early in the process of the formulation of the projects and when there is initial financial pump-priming on the part of the government. The usual problems of free ridership and strategic (mis)revelation of preferences that are emphasised in the public economics texts are (or can be) limited in the case of most such local public goods in small communities. Even the poor who may not be able to contribute in cash are often willing to contribute labour and local materials for construction and maintenance. Klugman (1994) points out that in a detailed survey of development resources and constraints in one of the better administered sub-districts in Bangladesh it was found that among those people who indicated their readiness to contribute to local developmental activities (about half the respondents), the poorer groups were more willing to do so than the better-off, provided that they did not have to carry a disproportionate share of the burden. The WDR 1994 cites examples from successful self-help initiatives in constructing

² In the last few years the West Bengal government has started an interesting experiment in local mobilisation of resources in minor irrigation. There are now hundreds of small tubewell groups, where the beneficiaries (usually small and marginal farmers) have taken over the responsibility of financing the operations and maintenance of their public tubewells.

suspension bridges in the Banglung district in Nepal, in constructing roads in Gurage villages in Ethiopia, and in supplying power in the village of Purang in Nepal's Mustang district. Similar examples from poor urban areas are provided by the Orangi project in a Karachi slum in Pakistan which mobilised self-help activities to co-finance and construct water, sanitation and other facilities, and in poor districts of Lima, Peru, by informal local community associations financing projects such as roads and sewage by systems of informal taxation.

People are often unwilling (even hostile) to contribute in the form of taxes or user fees if the services are poor, enforcement is weak, the funds are wasted or misappropriated, or the central government reneges on its promised contribution, as many examples from Zimbabwe, Nigeria and Liberia corroborate. In other cases, the lack of real autonomy and of a protected, stable source of funding discourage local administrators: key responsibilities of local governments, including the ability to tax or to charge user fees, can be suspended by the upper-tier bureaucracy without proper consultation.

6. LOCAL COMMUNITY AND THE STATE

For far too long in developing countries large-scale technocratic development projects have been directed from above, administered by a distant, uncoordinated and occasionally corrupt bureaucracy, insensitive to local community needs and concerns. These projects have not involved the local people and simply treated them as objects of the development process. Vast sums of money have been spent in the name of the poor, but very little has actually reached them. Even when it does reach them it often perpetuates a cycle of dependency and attitude of malfeasance and opportunism among the poor with an eye to milking the state cow for its uncertain bounties. The disproportionate benefits, of course, go to those who have the resources, connections and dexterity to manipulate the milking process and to the large army of middlemen, contractors, officials and politicians.

Many development practitioners are now coming around to the view that participation by the intended beneficiaries improves project performance considerably, although the case studies usually cited in favour of this view are not always econometrically convincing. The econometric objections to the claimed association between project participation and performance relate to the subjectivity in much of the data, investigator bias (as some of the investigators start with the prior belief that participation is good, it creates a "halo effect" in their observations), and a simultaneity problem (better project performance may cause increased beneficiary participation rather than vice versa). In a rare and careful exercise to deal with these objections Isham, Narayan and Pritchett (1995) show, on the basis of the one hundred and twenty-one diverse rural water projects we have referred to in section 1, that the strong causal relation between participation and project performance still survives relatively unscathed. More such exercises for projects in other sectors should be useful.

In general one should resist the temptation to romanticise the value of decentralised, participatory development, as is common among those whom I have described as 'anarcho-communitarians' in the beginning of the paper. We have already seen that such development, for all its undoubted advantages, cannot resolve some major equity and efficiency problems. In particular, in situations

of elite domination in local governance structures, the benefits percolation to the weaker sections of the population will be slow and uncertain. This is so, for example, even in the best of the four (i.e. in Karnataka) case studies of decentralisation of Crooke and Manor (1994). One can, of course, cite the cases of Indonesia and Taiwan where substantial decentralisation of expenditures on social and economic infrastructure in recent years has contributed to the sharp decline in poverty, but such examples are more difficult to find from countries that are growing at a much slower rate.

If decentralisation in the context of pre-existing inequality is of limited benefit to the poor, it may also be asked if inequality helps or hinders the cause of decentralisation. In general the complex relationship between socio-economic inequality and successful collective action in building self-governing institutions at the local level is still an under-researched area in economics. On the one hand there is the well-known suggestion of Olson (1965) that in a heterogeneous group a dominant member enjoying a large part of the benefits of a collective good is likely to see to its provision even if he has to pay all of the cost himself (with the small players free-riding on the contribution of the large player). On the other hand, there are cases where the net benefits of coordination for each individual may be structured in such a way that in situations of marked inequality some individuals (particularly those with better exit options) may not participate and the resulting outcome may be more inefficient than in the case with greater equality;³ besides, the transaction and enforcement costs for some cooperative arrangements may go up with inequality.

Empirically, there is some fragmentary evidence - see Bardhan (1993) for examples from local irrigation communities - that community-level institutions work better in enforcing common agreements and cooperative norms when the underlying property regime is not too skewed and the benefits generated are more equitably shared. Putnam's (1993) study of the regional variations in Italy also suggests that 'horizontal' social networks (i.e. those involving people of similar status and power) are more effective in generating trust and norms of reciprocity than 'vertical' ones. One beneficial byproduct of land reform, underemphasised in the usual economic analysis, is that such reform, by changing the local political structure in the village, gives more "voice" to the poor and induces them to get involved in local self-governing institutions and management of local public goods. It is also arguable that the market discipline and the hard budget constraint that have contributed to the success of decentralised development in China (led by the TVE's) were rendered politically tolerable by the secure social safety net made possible by the highly egalitarian redistribution of private access to land that the post-1978 decollectivisation has effectively implied for the rural population.

In this paper we have discussed the various advantages and disadvantages of decentralisation and also the conditions that predispose toward success or failure in beneficial decentralised development. In particular, we have focussed on the argument that in governance structures control rights should be assigned to people who have the requisite information and incentives, and at the same time will bear responsibility for the (political and economic) consequences of their decisions. In many situations this calls for more devolution of power to local authorities and communities (including the local citizens' right to information and public hearings on major

³ For a theoretical analysis on these lines, see Dayton-Johnson and Bardhan (1996).

projects of public expenditure). We have also tried for a balanced assessment of the efficiency and equity effects of such assignments of control rights and how they operate differentially under different initial conditions. One should add that the analysis in this paper suggests that we also need a more nuanced theory of the state than is usually available from the age-old state-versus-market debate. On the one hand we should, of course, recognise the limitations of the state as an economic governance structure arising from its lack of access to local information and local accountability and its vulnerability to wasteful rent-seeking processes. On the other hand, the state is not to withdraw into its minimalist role of classical liberalism, and instead is to play an activist role in enabling (if only as a 'catalyst') mobilisation of people in local participatory development, in providing supra-local support in the form of pump-priming local finance and underwriting risks (but at the same time avoiding the moral hazard of encouraging dependency), supplying technical and professional services towards building local capacity, acting as a watchdog for service quality standards, evaluation and auditing, investing in larger infrastructure and providing some coordination in the face of externalities across localities. This is a delicate but complex task for any state, underappreciated by the usual enthusiasts for decentralisation.

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