Fiscal Decentralization in Developing Countries

A Review of Current Concepts and Practice

Paul Smoke

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Acronyms

GPT	graduated personal tax
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development
STDP	Small Towns Development Project
UNCDF	United Nations Capital Development Fund
UNDP	United Nations Development Programme
USAID	United States Agency for International Development

Summary/Résumé/Resumen

Summary

The reform of economic systems in developing countries during the 1980s focused largely on increasing the role of the market and improving the environment in which it operates. For some years, there was a preoccupation with the private sector, such that reformers almost seemed to forget the potential role of the public sector in promoting development. In recent years, there have been widespread attempts both to redefine the role of the public sector in developing countries and to improve its performance. An increasingly important component of these reforms is the introduction of policies to decentralize the functions of government.

During the 1990s, fiscal decentralization and local government reform have become among the most widespread trends in development. Many of these wide-ranging and costly efforts, however, have made only modest progress toward meeting their stated goals. Given this uneven performance, there has been extensive debate about the desirability of fiscal decentralization and how to approach it.

This paper examines the origins, conceptual foundations and practice of fiscal decentralization in developing countries. First, it considers why fiscal centralization has been so prominent historically in developing countries, and why this trend has been reversing. Second, it summarizes conventional fiscal decentralization theory and considers its relevance for developing countries. Third, it reviews some popular claims made for and against fiscal decentralization, and considers the available empirical evidence. Fourth, it outlines some key elements of fiscal decentralization as it is being promoted in selected countries, including some of the problems being faced and successes being realized. The paper concludes with some observations on how to think about designing more appropriate and effective fiscal decentralization in developing countries.

As economic and political pressures for fiscal decentralization escalate and forces driving democratization develop, many countries will feel increasing pressure to decentralize. In spite of this growing interest and support, fiscal reform of local government is likely to be a slow and painful process because serious constraints on decentralization are not going to disappear suddenly, and some standard analytical tools may have limited applicability. Available conceptual frameworks for analysing fiscal decentralization are useful, but they are not designed to deal with some of the most important factors affecting effective fiscal decentralization.

The most critical problem fiscal decentralization analysts face is a dearth of good comparative information on the extent to which and the conditions under which the alleged benefits and disadvantages of fiscal decentralization have been realized. Anecdotal evidence and case studies provide some insights, but additional policy experimentation and more systematic research are needed to understand more broadly the realities of and prospects for fiscal decentralization in developing countries. Such information would lead the way to better conceptual development and more effective public policy.

When this paper was written, Paul Smoke was an Associate Professor in the Department of Urban Studies and Planning at the Massachusetts Institute of Technology. He is currently based at New York University.

Résumé

La réforme des systèmes économiques dans les pays en développement durant les années 1980 a largement ciblé le rôle du marché et l'amélioration de l'environnement dans lequel il opère. Depuis quelques années, en raison de la préoccupation qui entourait le secteur privé, les réformateurs en étaient presque venus à oublier le rôle potentiel du secteur public dans la promotion du développement. Au cours de ces dernières années, on a assisté à des tentatives, tant pour redéfinir le rôle du secteur public dans les pays en développement que pour améliorer ses prestations. Une composante de plus en plus importante de ces réformes est l'introduction de politiques destinées à décentraliser les fonctions du gouvernement.

Durant les années 1990, la décentralisation fiscale et la réforme du gouvernement local ont fait partie des tendances les plus répandues en matière de développement. Plusieurs de ces efforts considérables et onéreux n'ont cependant débouché que sur de modestes progrès par rapport aux objectifs fixés. Au vu de ces résultats inégaux, un large débat a été lancé sur l'attrait de la décentralisation fiscale, ainsi que sur la meilleure manière de l'aborder.

Cette étude examine les origines, les fondements conceptuels ainsi que la pratique de la décentralisation fiscale dans les pays en développement. Premièrement, elle examine la raison pour laquelle la centralisation fiscale a eu une telle importance sur le plan historique dans les pays en développement, et pourquoi cette tendance est en train d'être renversée. Deuxièmement, elle résume la théorie classique de la décentralisation fiscale et examine sa pertinence pour les pays en développement. Troisièmement, elle réévalue certaines affirmations faites en faveur ou en défaveur de la décentralisation fiscale et étudie les preuves empiriques disponibles. Quatrièmement, elle souligne certains éléments clefs de la décentralisation fiscale, tels qu'ils sont promus dans des pays choisis, notamment certains des problèmes auxquels ils sont confrontés, ainsi que les succès enregistrés. L'étude conclut par des observations sur la manière de concevoir une décentralisation fiscale plus appropriée et plus efficace dans les pays en développement.

Tandis que les pressions économiques et politiques en vue de la décentralisation fiscale montent et que les forces incitant à la démocratisation se développent, nombre de pays subiront une pression accrue en vue d'une décentralisation. Malgré cet intérêt et ce soutien croissants, la réforme fiscale des gouvernements locaux est susceptible d'être un processus lent et douloureux car les fortes contraintes sur la décentralisation ne vont pas subitement disparaître et certains outils analytiques standard ont une applicabilité limitée. Les cadres conceptuels disponibles pour analyser la décentralisation fiscale, bien qu'utiles, ne permettent pas de maîtriser les facteurs les plus importants affectant une décentralisation fiscale véritable.

Le problème le plus crucial auquel les analystes de la décentralisation fiscale font face est la pénurie de données comparatives fiables pour savoir à quel point et dans quelles conditions les avantages et les désavantages présumés de la décentralisation fiscale ont été obtenus. Des preuves anecdotiques et des études de cas fournissent un certain aperçu, mais une expérimentation politique supplémentaire et une recherche plus systématique sont requises afin de comprendre de façon plus générale les réalités et les perspectives de la décentralisation fiscale dans les pays en développement. De telles informations ouvriraient la voie à un meilleur développement conceptuel et à une politique publique plus efficace.

Quand il a écrit ce papier, Paul Smoke était Professeur associé au Département d'Études urbaines et de planification du Massachusetts Institute of Technology. Il est actuellement basé à New York University.

Resumen

En los años 80, la reforma de los sistemas económicos en los países en desarrollo se centró principalmente en ampliar la función del mercado y en mejorar su ámbito de acción. Durante algunos años, el sector privado fue motivo de preocupación, hasta el punto en que los reformadores olvidaron prácticamente la función que el sector público podía desempeñar en el fomento del desarrollo. En estos últimos años, se han adoptado amplias iniciativas para definir nuevamente la función del sector público en los países en desarrollo asi como para mejorar su funcionamiento. Un, elemento cada vez más importante en estas reformas es la introducción de políticas con el fin de descentralizar las funciones del gobierno.

Durante los años 90, la descentralización fiscal y la reforma del gobierno local han sido las tendencias más generales en materia de desarrollo. Sin embargo, muchas de estas amplias y costosas iniciativas han conseguido, tan sólo, un limitado avance en la consecución de los objetivos fijados. En vista de estos resultados disparejos, la conveniencia de la descentralización fiscal y el modo de enfocar la misma han sido objeto de un amplio debate.

En este estudio se examina el origen, los fundamentos teóricos y la práctica de la descentralización en los países en desarrollo. En primer lugar, se considera el motivo por el cual la centralización fiscal ha sido tan destacada en estos países a lo largo de la historia, y el por qué de la inversión de esta tendencia. En segundo lugar, se resume la teoría de la descentralización fiscal convencional y se considera la importancia que reviste para los países en desarrollo. En tercer lugar, este estudio examina algunas de las reivindicaciones populares a favor y en contra de la descentralización fiscal, y se consideran los datos empíricos disponibles. En cuarto lugar, se subrayan algunos factores clave de la descentralización fiscal, tal como se fomenta en determinados países, inclusive algunos de los problemas a los que se enfrenta y los éxitos logrados. El estudio concluye con algunas observaciones sobre cómo diseñar un plan de descentralización más apropiado y eficaz en los países en desarrollo.

Muchos países se verán cada vez más presionados a descentralizar, a medida que aumenten las presiones económicas y políticas sobre la descentralización fiscal, y se evolucionen las fuerzas impulsoras del proceso de democratización. Pese a este creciente interés y apoyo, es probable que la reforma fiscal del gobierno local sea un proceso lento y arduo, ya que las grandes limitaciones que conlleva la descentralización no desaparecerán de repente, y puede que incluso la aplicación de algunos de los instrumentos analíticos típicos sea limitada. Los marcos conceptuales disponibles para analizar la descentralización fiscal son útiles, pero no están diseñados para abordar algunos de los factores más importantes que influyen en la consecución de una eficaz descentralización fiscal.

El problema más importante al que se enfrentan los analistas de la descentralización fiscal es la falta de una buena información comparativa sobre el alcance de las supuestas ventajas y desventajas de la descentralización fiscal asi como las condiciones bajo las cuales ambas se han producido. Los datos anecdóticos y los estudios de casos son orientativos, pero se necesita una mayor experimentación con políticas complementarias y una investigación más sistemática para comprender de un modo más general las realidades y las perspectivas de la descentralización fiscal en los países en desarrollo. Esta información conduciría a un mejor desarrollo conceptual y a una política pública más eficaz.

Cuando Paul Smoke escribió este documento, ocupaba el cargo de profesor adjunto en el Departamento de Estudios y Planificación Urbanos en el Massachussets Institute of Technology. Actualmente, trabaja en la New York University.

Introduction

The reform of economic systems in developing countries during the 1980s focused largely on increasing the role of the market and improving the environment in which it operates. For some years, there was a preoccupation with the private sector, such that the potential role of the public sector in promoting development received little attention.[1] In recent years, there have been widespread attempts to both redefine the role of the public sector in developing countries and improve its performance. An increasingly important goal of these reforms is the decentralization of government functions.

During the 1990s, fiscal decentralization and local government reform were among the most widespread trends in development (World Bank, 2000:chapter 5). Many of these extensive and costly efforts, however, have made only modest progress toward meeting their stated goals.[2] Given this uneven performance, there has been considerable debate about the desirability of fiscal decentralization and how to approach it.

This paper examines the origins, conceptual foundations, and practice of fiscal decentralization in developing countries. Several issues are covered. First, I briefly consider why fiscal centralization has been historically prominent in developing countries, and why the trend has been reversing. Second, I summarize conventional fiscal decentralization theory and consider its relevance for developing countries. Third, I review some popular claims made for and against fiscal decentralization and consider available empirical evidence. Fourth, I outline some key elements of fiscal decentralization as it is being promoted in selected countries, including some of the problems being faced and successes being realized. Finally, I make some concluding observations on how to think about designing more appropriate and effective fiscal decentralization in developing countries.

The Historical Basis of Fiscal Centralization

Although fiscal decentralization has emerged as a focus of public sector reform in many less-developed nations, the substantial body of theory and research on public finance in developing countries includes little substantive work on the fiscal role and performance of local government. Most analysis of this topic has been in the form of occasional case studies or chapters in studies of national tax systems, usually conducted by special commissions or international development agencies, such as the World Bank or the International Monetary Fund (IMF). Only a few attempts to conceptualize the issues broadly and/or to compare decentralization and local finance policies across a group of countries have been made (Ter-Minassian, 1997; Bird and Vaillancourt, 1998). Some of this literature predates the recent

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1 Overseas Development Institute (1989); Perkins (1991:11–53); Roemer and Radelet (1991:55–80); and World Bank (2000:chapters 1–3).

2 Mawhood (1983); Olowu (1987:48–59 and 1988); World Bank (1989); Stren (1991:9–22); Wallis (1991:121–129); Olowu and Smoke (1992:1–17); Smoke (1993:901–923); K.-H. Kim (1993); Dillinger (1995); Tendler (1997); Rondinelli (1997); Bird and Vaillancourt (1998); Litvack et al. (1998); Manor (1998); Cohen and Peterson (1999); and Blair (2000:21–40).

emphasis on decentralization,[3] and much of the rest focuses primarily on major urban areas[4] or nonfiscal aspects of decentralization (Manor, 1998; Blair, 2000).

This scarcity of research reflects the small fiscal role that local government has traditionally played in most developing countries. In the 1980s, just prior to the emerging fiscal decentralization trend, local governments in Organisation for Economic Co-operation and Development (OECD) countries accounted for, on average, 11 per cent of total public employment, and in some countries as much as 25 per cent. In contrast, local governments in developing countries accounted for an average of 4.5 per cent of public employment, ranging from 2.5 per cent in Africa to 8 per cent in Asia (Cochrane, 1993). Public expenditure data from the late 1980s and early 1990s indicate that the local government share of total government spending averaged 32 per cent in the industrialized countries versus 15 per cent in the developing world (Bahl and Linn, 1992:chapter 1).

In evaluating the suitability of fiscal decentralization, it is important to consider the historical basis for fiscal centralization and the factors that have been undermining it. Traditional systems in some parts of the world, particularly in Asia, have been highly centralized for centuries. Local governments were introduced in many developing countries through colonization and development assistance, often taking a form that neither met their intended purpose nor gained acceptance from the local people.[5] Post-independence leaders, who were left with an institutional framework that was not consistent with their culture and needs, commonly used local governments for administrative and control purposes rather than to promote self-determination, democratization and economic development.

Early development economists also discouraged the development of local government by advising officials of developing countries that they could maximize growth by centralizing control over the economy. Development strategies were based on central planning, large-scale technology transfer, industrialization and spatial centralization to capture economies of scale and promote growth.[6] Thus, development responsibilities were concentrated at the centre, and local authorities were largely neglected.

In many developing countries, a general lack of managerial and technical expertise has precluded—or been used as an excuse to avoid—the formation of local government institutions and an effective working relationship between the central and local governments.[7] Given the limited pool of human resources and the scarcity of training and educational facilities, some central governments feared competition for qualified staff if decentralized governments were strengthened.

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3 For example, Hicks (1961 and 1978) and Hicks et al. (1961).
4 Bahl (1979 and 1981); Bahl et al. (1981, 1983 and 1984:215–230); Bahl and Miller (1982); Davey (1983 and 1989); Cochrane (1983); Bahl and Linn (1992 and 1983); Mawhood (1983); and Campbell et al. (1991).
5 For a more detailed discussion of this issue, see Mawhood (1987:10–22).
6 W.A. Lewis (1954); Hirschman (1958); Brenner (1966); Alonso (1971); and Richardson (1973 and 1977). For a more recent look at this topic, see Henderson (2000:65–68) and Mills (2000:69–73).
7 Cochrane (1983); Rondinelli et al. (1983); Rondinelli and Nellis (1986:3–23); and World Bank (1989).

The most important reason local governments have been neglected in developing countries is that strong central governments often oppose decentralization.[8] Some reasons for this reluctance are legitimate, such as the need for nation building in ethnically fragmented societies and central macroeconomic control in fragile economies. Equally important, however, is the reality that the governing elite, who may be dominated by particular ethnic groups, fear the loss of power and wealth inherent in meaningful decentralization. In addition, central ministries and/ or political parties that control substantial resources rarely want to share them with autonomous local governments.

An Emerging Fiscal Decentralization Trend

Although many developing countries are likely to remain fairly centralized in the near term, a few emerging realities have collectively generated a growing interest in developing or reviving local government (World Bank, 2000:chapter 5). First, economic planning by central governments has not been successful in promoting adequate development. Although there have been periods of strong economic performance in the developing world during the past few decades, particularly in Asia, many countries have faced a variety of economic problems that central governments have been unable to cope with.[9]

Second, changing international economic conditions and structural adjustment programmes designed to improve public sector performance have created serious fiscal difficulties for developing countries. Growing service demands and underperforming economies resulted in large budget deficits, which were financed primarily by external borrowing. Over time, interest payments claimed an increasing share of public resources, and a vicious cycle of borrowing and overspending ensued. In response, central governments are trying to reduce their role in managing development and to rely more on local governments, which are often underutilized and may have considerable untapped revenue potential.

Third, changing political climates also encourage the development of local governments in developing countries. As people become more educated, better informed through improved communications and more aware of the problems of central bureaucracies, they desire to bring the control of government functions closer to themselves. In numerous developing countries, there has been movement toward greater democracy as military regimes and dictatorships are forced to relinquish power and institute political reforms.[10] This sets an example for other countries and emboldens people to push for further changes, including efforts to decentralize.

The new focus on a greater fiscal role for local government has been increasingly supported by international development agencies. The **World Development Report 1988/1989** devotes an entire chapter to local government, and a widely cited World Bank report states that an effective

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8 Cochrane (1983); Rondinelli et al. (1983); Rondinelli et al. (1989:57–87); Rondinelli (1990); Wunsch and Olowu (1990); and Olowu and Smoke (1992).

9 Ballassa (1982:23–38); Killick (1984); Michalopolous (1987); Peterson et al. (1991); and Roemer and Radelet (1991).

10 Huntington (1991); Diamond (1997); and Manor (1998).

public sector in a modern developing country "depends on the ability of the central government to harness the resources of lower levels of government" (Cochrane, 1983). The **World Development Report 1999/2000: Entering the 21st Century** places considerable emphasis on decentralization and urban development. More generally, donors are increasingly assisting efforts to decentralize and strengthen local governments.[11]

Conventional Fiscal Decentralization Theory and the Developing Countries

Mainstream economists have traditionally defined a suitable role for local government in the industrialized countries using the basic theory of fiscal decentralization known as fiscal federalism.[12] Drawing on the standard Musgrave model of public sector responsibility for stabilization, distribution and allocation (Musgrave, 1959), the decentralization theory provides direction for sharing these functions among different levels of government.

Stabilization

Primary responsibility for the stabilization function has conventionally been assigned to the central government, partly because of the obvious problems that would result if subnational jurisdictions had independent control over their own money supplies. In addition, local economies were considered highly open, so that the effects of local fiscal policy would be dissipated into other areas. Finally, deficit finance policies at the local level have not been considered desirable because of concern that repayment would involve substantial real income transfers to creditors external to debtor jurisdictions.[13] On the revenue side, the types of revenues considered most appropriate for local governments tend to be income inelastic, constraining the ability of local governments to pursue appropriate fiscal policy.

Although the international macroeconomic environment has changed in ways that raise questions about the conventional case for fiscal decentralization, and there is increasing recognition that decentralized levels of government can play a more important stabilization role in industrialized economies than was formerly believed,[14] it is not difficult to justify stabilization as primarily a central function in developing countries. First, macroeconomic fluctuations can be particularly severe in emerging economies, especially in agricultural countries subject to substantial and unpredictable climate variations and countries heavily dependent externally for basic production inputs, manufactured goods and credit. Under such conditions, stabilization policies must be planned and co-ordinated centrally by well-trained and experienced people.

[11] World Bank (1989, 1991 and 1996) and UNDP (1992 and 1997).

[12] The theory of fiscal federalism is set forth in detail in Oates (1972).

[13] The case for centralization of the stabilization function is laid out in Oates (1972). The standard arguments are challenged in Gramlich (1987:299–313); Roy (1995); Shah (1997a); and Spahn (1998).

[14] Gramlich (1987) argues in the case of the United States that the macroeconomic developments and large federal deficits of the 1980s—financed to a significant extent by externally held debt—have constrained the ability of the central government to pursue countercyclical policy. He also demonstrates that state governments successfully played a greater stabilization role in the 1970s and 1980s than they had in the past.

A second important consideration is that, as noted earlier, local governments in developing countries often have only a minor role in the economy relative to industrialized nations, frequently accounting for modest percentages of public sector employment and spending. Moreover, they are typically very dependent on central governments for resources and regulated by central agencies, even under relatively decentralized regimes.[15] The impact of their fiscal behaviour is, therefore, extremely limited.

Finally, the local revenue situation in developing countries can be even more problematic than in industrialized countries. In some cases, local governments are more dependent on taxes related to economic activity (agricultural, business and market) than on more stable wealth-based taxes (land and property) and charges (for example, water and sewerage).[16] These dominant taxes are often structured such that they are inelastic during growth, but the fragility of the local economy can result in dramatic yield reductions during contractions, undermining local ability to behave countercyclically.

Distribution

The fiscal federalism theory also places principal responsibility for distribution with the central government. First, only the central government is in a position to redistribute resources from wealthier to poorer jurisdictions. Second, differential local redistribution programmes would be expected to create problems if factors of production were mobile. Wealthy residents and businesses might move out of a jurisdiction practicing redistribution, while poor individuals eligible for benefits would try to move in, thereby undermining the redistributive base. Third, local governments tend to have access to revenue sources that are not easily levied in a way that is progressive with respect to income.

Although there have been challenges to the conventional recommendation that distribution be centralized, it is still generally accepted that decentralized governments are typically more constrained than the central government in altering the distribution of income. They may play a role in intrajurisdictional redistribution, but they clearly control what happens across jurisdictions.[17] Constraints on intrajurisdictional redistribution may not be as problematic in developing countries as in industrialized countries. Domestic mobility of the rich may be less significant in developing countries because there are few cities that provide high levels of public services and wealth-responsive amenities. Thus, the wealthy have little choice about where to live if they wish to enjoy the standard of living of a major urban centre. They are unlikely to flee the few major cities in large numbers, even as these cities grow rapidly from high birth rates and the in-migration of rural peasants unable to make an acceptable living from agriculture.

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15 See, for example, Cochrane (1983) and Bahl and Linn (1992).

16 The impact that such a revenue structure can have on the stability of local tax yields is demonstrated in Smoke (1993).

17 The case for centralization of the distribution function is set forth in Oates (1972), but it has been challenged by a number of analysts on both theoretical and empirical grounds. Pauly (1973:33–58) suggests that income redistribution may increase the utility of higher income people and that taxpayers would try to raise the incomes of the poor primarily in their own local area, where poverty most directly affects them. Gramlich (1987) argues that, in recent years, state governments in the United States have been playing a more substantial role in redistribution than was previously believed possible. Crane (1992:84–98) demonstrates that the effects of local redistribution policies on social welfare are not nearly as unambiguous as conventional wisdom holds.

Despite the possibility of fewer mobility problems in less-developed countries, there is no strong case to be made for assigning substantial distribution responsibility to local governments. Local resource bases are often limited, as are the expenditure role of local authorities and their capacity to administer major redistributional programmes. Finally, prominent local residents with substantial influence might undermine the development of significant local redistributional policies.

Allocation

The prescribed role of decentralized levels of government in the allocation function is substantial because demand for many public services is not likely to be uniform across space. Welfare gains would thus be enhanced through decentralization because residents in different jurisdictions could choose the mix of public goods and taxes that best conforms to their preferences. In the absence of a market and competitive pricing for public services, community-wide demand would be articulated through the collective decision-making process, that is, voting. In this framework, decentralization is desirable not only because of preference differentiation, but also because expenditure decisions are tied more closely to real resource costs in smaller jurisdictions. In addition, when there are a large number of decentralized governments, there is likely to be greater experimentation and innovation in the provision of local public goods, potentially leading to improvements in overall resource productivity.

Extensions of the logic of preference variation suggest that in a system where there are opportunities for mobility, people will move to an area where a local government provides their preferred mix of public services. This produces a market-like solution to the local service provision problem.[18] Equilibrium occurs when people distribute themselves across differentiated communities in such a way that there is no incentive for anyone to move; everyone is satisfied with the services being provided in the jurisdiction in which they reside.[19]

There are important exceptions to the general rule of decentralizing to maximize allocative efficiency. Certain capital-intensive services, such as electric utilities and transportation systems, may exhibit economies of scale in production. In these cases, it is more efficient to provide services on a larger scale and over a wider area.[20] In addition, the provision of some services, such as water and roads, may generate interjurisdictional externalities. In such cases, resource allocation is more efficient when the service provision area is drawn such that externalities are internalized.

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[18] This theory was set forth by Tiebout (1956:416–424) during the early development of public finance theory and prior to the advancement of the fiscal federalism theory. However, it fits neatly under efficiency in resource allocation and so is considered under the umbrella of fiscal federalism.

[19] This "voting-with-the-feet" theory is based on strict and unrealistic assumptions: no externalities; perfect mobility of consumer-voters; perfect information about public goods and services in a very large number of heterogeneous communities; zero government fixed costs; and constant costs of production. Nevertheless, it is useful conceptually, and the results of relaxing the strict assumptions can be analysed. There has been a variety of theoretical writing and empirical research on the fiscal federalism and Tiebout theories. Much of this work is summarized, critiqued and analysed in King (1984). Bennett (1990) supplies a set of more interdisciplinary readings on related issues.

[20] It is technically efficient to assign service provision to a larger jurisdiction only if cost savings from joint consumption outweigh the potential welfare loss involved in providing the service over a wider jurisdiction, where preferences may be less homogeneous.

Defining an efficient decentralized structure is a complex process because optimal service area may vary greatly for different public goods and may in few or no case correspond exactly to the boundaries of existing political jurisdictions. The welfare gains from establishing new levels of government with efficient boundaries for providing a particular public good must be weighed against the institutional and transaction costs involved in having a larger number of jurisdictions. It is often more practical to pursue alternative policies that have the same overall effect, such as the formation of co-operative agreements among existing decentralized political jurisdictions; or provision, subsidy, or regulation of services by a more centralized level of government.

On the revenue side, four basic guidelines are suggested as a starting point for defining or evaluating a revenue system (Oates, 1972). First, local taxes should be as neutral as possible in terms of their effect on economic behaviour. Second, the benefits and costs of local taxes should be clear to those for whom services are to be provided. Third, the pattern of incidence of local taxes should meet basic equity standards. Fourth, administration and compliance costs should be minimized by avoiding the assignment of complex taxes to local governments.

In addition to these four basic guidelines, three other broad issues regarding local revenue systems emerge from the local finance literature. First, the spatial dimension of local government actions requires that interdependence and competition across jurisdictions be explicitly considered and that mobile tax bases be avoided.[21] Second, central governments have national goals regarding public service provision and interjurisdictional equity that justify intergovernmental transfers and service standards.[22] Third, the optimal criteria for assigning revenue sources to local authorities will generally differ from the perspectives of central and local governments.[23] These differences in perspective and their potential effects must be recognized when designing local revenue systems.

Relevance for developing countries

Theories by definition involve simplification and generalization. The type of abstraction that theorizing requires is problematic with respect to considering fiscal decentralization in developing countries. Although context should never be ignored in public policy analysis, there are some relatively established practices and standard institutions that must be considered in assessing macroeconomic structure and performance, international trade management and many other economic functions. The rules of the game for considering fiscal decentralization in complex and

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[21] Mobility has already been mentioned in connection with local redistributional programmes, but the problems it generates are broader. If taxes in one jurisdiction were higher than in others, affected taxpayers would be rational to move to lower tax areas, all other things being equal. This violates the principle of neutrality because local taxes are affecting the basis on which individuals and firms make decisions about where to consume and produce.

[22] Transfers are controversial for some economists because they reduce the direct link between the services local residents receive and the taxes they pay.

[23] Bahl and Linn (1992) argue that from the central point of view, the most important criteria are to: (a) limit local competition for key national tax bases; (b) limit local taxes whose burden is exportable to residents of other jurisdictions; (c) provide local authorities with buoyant revenues to limit demands on central government resources; (d) minimize local reliance on regressive taxes; (e) encourage the use of taxes that can be easily administered at the local level; and (f) encourage the use of taxes that closely reflect the costs of infrastructure and congestion. Local governments are likely to agree more or less with criteria (c) through (f), and will be particularly concerned with having taxes that are buoyant and easily administered. However, local authorities will have the opposite priorities from those reflected in criteria (a) and (b). They would prefer a share of productive national tax bases and, as noted earlier, it is in their interest to rely on exportable taxes.

varied contexts are much less clearly defined, and there is much less "good practice" experience for policy makers to draw on.

I already commented above on the relatively straightforward case for centralization of the stabilization and distribution functions in developing countries. The issues surrounding assignment of responsibility for both the expenditure and revenue dimensions of the allocation function in developing countries are considerably more complex.[24] First, a number of explicit and implicit assumptions underlying public finance theory in general, and fiscal federalism in particular, may be violated in some developing countries. Among the potential concerns are: the relevance of individual preferences as the principal basis for defining demand; the potential role of mobility in generating an efficient spatial pattern service provision; the applicability of conventional models of public choice; and the existence of an adequate legal basis for an effective intergovernmental system. To the extent that such mechanisms and assumptions are not valid, some of the standard policy prescriptions of the theory may have to be discarded or adapted.

Second, even if basic principles are essentially valid, local conditions that are fairly common in developing countries can substantially affect the way they should be interpreted. Widespread poverty, for example, may make preferences more homogeneous across local jurisdictions, justifying greater centralization of some functions. This could be offset, however, by substantial spatial diversity in local environments and economic bases, and/or by the existence of widely dispersed and poorly linked settlements, both of which might suggest the need for greater decentralization. In addition, a wide variety of cultural, political and institutional conditions can also influence the need and prospects for fiscal decentralization. Since these factors can vary across countries and can move the system in different directions, their relative importance must be understood in analysing a specific case.

The greatest challenge for analysts is that the structure and characteristics of decentralized institutions are so diverse across countries. Systems of government are basically of two types: unitary and federal. The overwhelming majority of developing countries are unitary states in which local governments are the creation of the centre. True federal states exist by virtue of a voluntary union of decentralized units, which agree to surrender certain powers to the central government. Most of the few developing countries with semi-autonomous state governments, such as Argentina, Brazil, Mexico and Nigeria, are really quasi-federal in that the state structure was at least partially imposed from above.[25]

Unitary governments display a wide variety of decentralization practices. Some have no local governments, although there may be decentralized administrative units of the central government. Under the field or local administration system, local governments operate as extensions of the state bureaucracy with few autonomous powers, as in former French colonies. In extreme cases, the central government may appoint the members of local government councils rather

[24] Smoke (1989 and 1994); Bahl and Linn (1992); Prud'homme (1995:201–220); Tanzi (1995:295–316); Bird and Vaillancourt (1998); Ter-Minassian (1997); and Litvack et al. (1998).

[25] For a good discussion of these systems and the logic behind them, see Smith (1985).

than permit their election by popular vote. In contrast, a system of semi-autonomous local government was established in some developing countries, such as those colonized by the British. Local authorities under this system are legal entities, which can sue and be sued as well as enter into independent contracts. Significant central control is often retained, but local authorities are usually governed with some degree of independence by locally elected councils.

In either the local administration or local government system, there are several dimensions along which governments can vary. First, systems differ in the number of levels of government that exist and the constitutionally and legislatively mandated relationships among them. Second, local authorities differ in their degree of political decentralization and grassroots legitimacy. Some have significant political power and are popularly elected, while others are appointed councils that follow the directives of a more centralized level of government. Third, local authorities differ in their degree of autonomy in revenue-raising and expenditure decision making. Some have significant autonomy in both, others in one area, and still others have little autonomy of any sort. Fourth, local authority systems differ in the average degree of fiscal capacity relative to service responsibilities. Local authorities in some developing countries can more or less finance their designated services, while others raise only a small percentage of the resources they spend. In some cases, the central government steps in with financial assistance, while in others there are few or no grant systems and the revenue shortfalls remain. Thus, there are enormous differences in the way public sectors are structured and the way they share functions and resources across levels of government.

The difficulties of comparison are further complicated by the lack of adequate data, particularly for smaller and least-developed countries and crisis states.[26] There are large differences across countries in the way fiscal data are classified, so that even if data were available, it could be difficult to compare them. An attempt to collect comparative intergovernmental fiscal data from IMF sources for a sample of 12 developing countries left so many holes that it was impossible to make more than a limited number of comparisons, usually with different subsets of countries for each type of comparison.[27]

In this paper, three neighbouring countries in East Africa will be used to illustrate the importance of contextual differences across countries and the complexities of interpreting fiscal data.[28] The public sector expenditure-to-gross domestic product ratios for Ethiopia, Kenya and Uganda are, respectively, 24.1 per cent (1995), 28.7 per cent (1995) and 18.1 per cent (1996). Their respective fiscal deficits in the same years were –5.5 per cent, –11.4 per cent and –6.6 per cent. Thus, the overall size of the public sector is moderate in each country, but Kenya has a more serious deficit problem than Ethiopia and Uganda.[29]

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[26] The IMF standardizes data classifications, but data for decentralized levels of government are not as fully collected as central government data.

[27] Data for Argentina, Brazil, Cambodia, India, Indonesia, Kenya, Mexico, the Philippines, Poland, South Africa, Uganda, Venezuela and Viet Nam were collected from the **IMF Government Finance Statistics Yearbook.**

[28] Most of the data reported here were taken from the **IMF Government Finance Statistics Yearbook** or individual World Bank reports for the three countries being compared.

[29] The relative position of the three countries changes when looking at the data over a longer time period.

The relative importance and independence of decentralized governments varies considerably across the three countries. Ethiopian decentralized governments accounted for 43.5 per cent of expenditures (1996), while Kenyan local governments accounted for only 4.2 per cent (1995). Kenyan local governments, however, raised 5.6 per cent of total public revenues and received only token grants, such that they are essentially fiscally independent from the centre. Ethiopian local governments, on the other hand, raised only 17.8 per cent of total public revenues, such that they were dependent on transfers for nearly 60 per cent of their resources. In Uganda, local governments accounted for 21 per cent of total public expenditures (1995), but they raised only about 8 per cent of total public revenues.[30]

Functional responsibilities are quite different in these three cases. In terms of health and education services, for example, Ethiopia's decentralized levels of government have nearly 80 per cent responsibility. In contrast, only a few of Kenya's colonial-era municipalities are involved in health and education—social service expenditures are almost entirely funded and provided by the central government and NGOs. In Uganda, local governments have significant legal responsibilities for health and education, but many of them have not been able to deliver much to date.

The three countries also have dissimilar local revenue structures. Ethiopian decentralized governments rely on shared percentages of central taxes (personal income, business, excise, sales) and have only a few modest independent taxes and nontax revenues, especially enterprise profits and various kinds of charges and fees. Since Kenya's independence in 1963, local governments have relied heavily on a local property tax, and since the late 1980s on the local authority service charge, a combination payroll and business tax. Various kinds of charges, fees and licenses also raise nontrivial amounts of revenue. In Uganda, the most important source of local revenue (and the dominant source—around 70 per cent outside of Kampala) is the graduated personal tax (GPT), an unusual and complex hybrid of a PAYE income tax, a presumptive income tax, a wealth tax and a poll tax.[31] Local governments have access to the property tax, but in practice few use it, and it is significant only in the large cities. As in Ethiopia and Kenya, there are various types of fees, licenses and other minor local revenues.

Finally, the three countries have significantly varied approaches to intergovernmental transfer systems. As noted above, their relative importance varies considerably—but so does their structure. In Ethiopia, there is a single block transfer programme based on a fairly complex formula. In Kenya, there have been no transfers for many years, except for teachers' salary grants to the few municipalities with responsibility for primary education and a very small grant to needy councils allocated at the discretion of the Minister for Local Government.[32] Uganda's transfer system is designed to provide three types of grants—block, equalization and matching—but the system is not yet fully implemented.

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[30] In the Uganda case, these data include only recurrent expenditures, as the development budget has not yet been decentralized.

[31] The GPT suffers from a number of serious weaknesses, including possibly severe efficiency and equity effects and major complexities in its administration. Thus, even though it is a productive tax, it may not be seen as a desirable one.

[32] A new but modest intergovernmental transfer system was introduced by the Kenyan government in fiscal year 2000.

A few contextual issues that affect interpretation of the data with respect to these three countries must be emphasized. First, state governments are the main actors in Ethiopia, whereas local governments are the principal units in Kenya and Uganda. Second, Kenyan local governments certainly have capacity problems, but they are generally stronger than their counterparts in Ethiopia and Uganda. Third, Kenyan local governments, even though they account for a smaller percentage of public activity than decentralized entities in Ethiopia and Uganda, function with fewer restrictions and are less dependent on the centre for financial and technical assistance. Fourth, experience with local democracy varies widely, with Kenya having the most and Ethiopia the least.

The point of making these detailed selective comparisons is to demonstrate the significant differences among developing countries in intergovernmental fiscal structure and the broader environment in which local governments function, even across a few neighbouring countries in one region of the world. Even with good data, no single framework could take full account of all of the highly complex issues involved in assessing an appropriate fiscal role for local governments. The great variations in the internal context of developing countries along many dimensions can significantly influence the "optimal" assignment of public service responsibilities and revenue-generating powers among levels of government, as well as the types of reforms required to deal with existing system deficiencies. Traditional economic concerns must, therefore, be balanced with careful consideration of the unique economic, cultural, institutional and political environment in a particular case and an understanding of how this affects the desirability of and possibilities for meeting the normative prescriptions of public finance theory.

Benefits and Negative Effects of Decentralization

Having briefly reviewed the relevance of conventional fiscal decentralization theory for developing countries, I now turn to whether there is clear empirical justification for pursuing fiscal decentralization in developing countries. Unfortunately, evidence is scant and mixed. This section considers several common propositions about the desirability of fiscal decentralization, including that it: retards economic development and has undesirable macroeconomic effects; negatively impacts distribution; improves local service delivery; and enhances government accountability to local citizens.

Is development hindered?

Some analysts have long maintained that the more pronounced role of decentralized governments in industrialized countries suggests that decentralization may stimulate development and that local authorities have an important role to play in the management of development.[33] Some recent empirical evidence suggests, on the contrary, a negative effect of fiscal decentralization on

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[33] A number of analysts have found a positive correlation between decentralization and the level of development, as measured by income levels or urbanization, which is itself positively correlated with income. These include Kee (1977:79–97) and Bahl and Linn (1992). Correlation, of course, is not causation, so the direction of influence is unclear, and these findings do not imply that a country must achieve a certain level of income before decentralizing. A more interdisciplinary approach to this issue is elaborated in Bennett (1990).

growth.[34] These studies typically use regression analysis that relates income levels or growth rates to fiscal decentralization. In addition to the static nature and limited time frame of some of these models, there is a problem with the key independent variable: fiscal decentralization is typically defined as the subnational share of total government expenditure.

At one level, this is the obvious choice of variable, but it problematically abstracts from political and institutional context, the importance of which was discussed above. An example drawn from two countries will help to illustrate the potential problems involved. As noted above, decentralized governments in Kenya are responsible for only 4–5 per cent of total government expenditure, but they do provide some level of many basic local services, they receive virtually no intergovernmental transfers and their elected councils conduct their fiscal affairs with an unusual level of autonomy for a developing country. And while Indonesian subnational governments account for a substantially larger share of total public expenditure, many local services are not their formal responsibility, they are heavily dependent on intergovernmental transfers and they have little autonomy in making decisions about how to spend their resources.[35] In this case, the positive attributes of decentralization promoted by its proponents are more clearly embodied in the Kenya situation, but the empirical models would consider Indonesia to be more fiscally decentralized. The implication, for example, is that any growth-inhibiting fiscal decisions attributed to the "fiscally decentralized" Indonesian local governments would in fact be determined largely by central government decrees.

Such anecdotal evidence does not disprove the case of the "fiscal decentralization harms national growth" analysts, but it does raise questions about the interpretation of their results. Until there are more sophisticated analyses that can control for critically important contextual variations across countries, definitive generalizations should not be made on this issue.

There is also a small literature that examines the impact of public infrastructure provision on local economic development. Most of this literature, which focuses on industrialized countries, suggests a positive and significant effect, including when infrastructure is a local responsibility. The topic, however, has not been widely studied in developing countries.[36]

Are there undesirable macroeconomic effects?

A number of analysts have gone beyond broad analysis of the aggregate impact of decentralization on economic growth to suggest specific ways in which fiscal decentralization harms macroeconomic stability.[37] The list of alleged problems is long, but a number of propositions are particularly prominent and tend to recur in attacks on the desirability of fiscal decentralization.

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[34] Two recent examples of empirical analysis suggesting that fiscal decentralization has a negative effect on economic growth are Zhang and Zou (1998:221–240) and Davoodi and Zou (1998:244–257). One recent study that found a positive effect using a similar model is S. Kim (1995). The results of another study (Huther and Shah, 1996) using a different approach suggested a positive relationship between fiscal decentralization and growth. A detailed review of the studies on fiscal decentralization and economic growth and an attempt to replicate the dominant models can be found in Shankar (2000).

[35] The situation in Indonesia will change as the new government moves to implement two new laws on decentralization passed in 1999. One of these laws focuses on fiscal decentralization.

[36] See B.D. Lewis (1998), which reviews the broader literature and develops a model that finds a positive impact of local roads and water infrastructure on municipal economic development in Kenya.

[37] Tanzi (1995); Prud'homme (1995); and Ter-Minassian (1997).

First, critics argue that local governments in many countries tend to run deficits, and they draw on the central government budget to cover their shortfalls. Second, the anti-decentralization camp argues that strictly defined arrangements for sharing central resources with local governments take control from the centre over how to use public resources. Third, some analysts charge that local governments fail to repay loans from the central government, again forcing the latter to dip into its general funds, often to repay loans to international development organizations, such as the World Bank. Fourth, it is alleged that local governments extract resources from the centre because they have political power over it. Fifth, there is an argument that local governments tend to be more corrupt than central governments, leading to bad spending decisions and misuse of public resources. Sixth, anti-decentralization analysts worry about the extent to which decentralized units of government compete with the centre for tax bases, or compete with each other by undertaking policies that may affect business costs and free domestic trade. Collectively, these and a variety of other problems are said to undermine macroeconomic stability.

Such arguments are both difficult and easy to counter. They are difficult to counter because most people with applied public finance experience would agree that at least some of these problems exist in a significant number of developing countries. They are easy to counter, or at least question, for four reasons. First, these conditions certainly do not exist in all developing countries, and some of the most prominent generalizations in the literature are drawn from nonrepresentative cases. Second, the impact of a number of these potentially problematic types of behaviour is not likely to be significant in the context of the "typical" developing country. Third, the elaboration of these problems is myopically focused on potential short-term macroeconomic concerns. Even if these concerns are real, it is important to consider whether they are eventually offset by the potential microeconomic gains that are the primary justification for decentralization in the fiscal federalism model and its derivative literature. Finally, and most importantly, many of these problems, where they exist, are empirical manifestations of undisciplined fiscal behaviour that is potentially correctable. Not a single one of them establishes fiscal decentralization as an *inherent and unavoidable* danger to macroeconomic stability. I will briefly discuss each of these points in turn.

First, the empirical evidence on the macroeconomic dangers of fiscal decentralization is mixed and anecdotal. Some of the literature cited above does provide examples in which the alleged problems exist and are substantial. Many of the highly publicized stories about dramatic negative effects of decentralization, however, have occurred in countries where decentralized entities are unusually significant and substantially autonomous. Thus, critics of fiscal decentralization often cite the clearly documented, negative post-decentralization macroeconomic effects resulting from the behaviour of lower tiers of government in such countries as Argentina, Brazil and Russia. As noted above, local governments in many developing countries, even post-decentralization, remain relatively modest players in the overall public sector fiscal scene. Few countries decentralize substantially enough or allow uncontrolled access to capital markets, particularly in early stages, to give local governments anywhere near the level of power and influence that, for example, state governments in Brazil had during the fiscal crisis of the mid-1990s.[38] Although there are a few cases—such as Ethiopia and Uganda—in which fiscal or political crisis led to plans for excessive fiscal decentralization, there were "natural" constraints on the situation getting out of hand. In Ethiopia the planned level of decentralization never materialized due to capacity constraints, and in Uganda the government has backtracked in response to weak local performance.

There are also cases in which exactly the opposite conditions of those alleged by the anti-decentralization camp are said to prevail.[39] For example, several analysts see corruption as a much greater problem at the central level than the local level, particularly in countries where adequate accountability has been established through the development of local democracy.[40] Similarly, I believe that many knowledgeable analysts of decentralization would argue that the central government typically has a lot more control over local governments than the local governments have over the centre. This includes the power of the central government to quickly stop local attempts to compete in a serious way with the central tax base.

Second, the effects of some of the alleged pitfalls of decentralization may be greatly overstated. Consider, for example, the debate about whether local governments can compete with each other in undesirable ways that undermine development.[41] There may, of course, be some interjurisdictional tax competition among local governments in fiscally decentralized countries, but it is generally unlikely to be a major problem. The absolute levels of most local taxes in many developing countries are fairly low, and they are of little significance compared to national taxes that all firms must pay (Bahl and Linn, 1992). In addition, research in industrialized countries indicates that local tax differentials often have only a marginal influence on behaviour—other relevant considerations, particularly access to inputs and amenities, tend to be more significant in business and household location decisions.[42] There is little research in developing countries, but the effects are likely to be similar or even less important than in industrialized countries.

Third, the concerns are focused on the immediate negative macroeconomic effects of fiscal decentralization. Even if these exist, it is important to consider whether the potential microeconomic gains of fiscal decentralization (discussed below) may eventually offset short-term macro problems.[43] This raises an important policy question that has received virtually no serious attention in the literature: Are any negative effects on the central budget acceptable to lay the foundation for attaining the potential microeconomic gains of decentralization that should also eventually yield macroeconomic benefits? If so, what is an appropriate limit? In addition, a few specific dimensions of the micro-macro "trade-off" require special attention. For example, giving local governments a fixed share of central revenues does undermine central budgetary flexibility to some extent, but it also provides local governments with a predictable source of revenue that

[38] Smoke (1994); Shah (1997a); Manor (1998); and Spahn (1998).
[39] See, for example, Walsh (1992); Sewell (1995); Shah (1997a); and Huther and Shah (1996).
[40] See, for example, Shah (1997a) and Manor (1998).
[41] For a discussion of the conceptual issues involved, see Bucovetsky (1991:167–181).
[42] For example, see Carrol and Wasylenko (1994). For a good review of the literature see Gilbert (1995).
[43] There is, of course, a relationship between macroeconomic and microeconomic concerns, but it has been little explored in the literature on fiscal decentralization.

allows them to undertake regularized activities that support local economic growth. More empirical evidence is needed to understand the dynamic relationship between micro and macro impacts as well as the potential effects of particular tensions and trade-offs.

Finally, although some of the anti-decentralization charges are real, *they are not inherent flaws of fiscal decentralization; rather, they are empirical problems that ought to be the target of sensible fiscal decentralization programmes*. For example, local governments in some countries do impose taxes that might impede free economic activity, such as the infamous *octroi* on interjurisdictional trade prominent in South Asia.[44] Economists berate such taxes, but they often remain in force because they are so productive for local governments with few other reliable sources. The existence of such problematic taxes is a weak excuse for not decentralizing; rather, the policy conclusion should be that the decentralized fiscal system ought to be structured in a way that both prohibits such potentially growth-constraining local taxation and provides local governments with viable alternatives for raising revenue. More generally, many "problems" of fiscal decentralization, particularly those related to local governments' large and pervasive budget deficits and their failure to repay debts, exist not because local governments are naturally irresponsible; rather, they are a function of poorly designed intergovernmental fiscal institutions and rules and a lack of capacity and incentives at both the local and central level to make the system work properly. To say that such problems require the maintenance of fiscal centralization is equivalent to saying that it would be best to keep a dictator in power rather than attempt to develop democracy in countries where people are not adequately educated and familiar with democratic concepts.

In summary, there can be no argument with analysts who point to *potential* macroeconomic dangers and growth-retarding effects of fiscal decentralization. Most of the evidence, however, is anecdotal, relevant only under particular uncommon circumstances or focused on correctable rather than inherent problems. The reality is that the appropriate degree of fiscal decentralization will vary with the context of particular countries, and some steps can be taken in most countries to neutralize potential macroeconomic dangers. Simply decentralizing is not going to bring development, and failing to decentralize is not necessarily going to undermine it. The challenge is to devise an appropriately structured system that mandates and provides incentives for responsible local government fiscal behaviour and enables the creation of a climate conducive to private investment. It is also critical to develop the skills of local government employees to meet the requirements of the system and the abilities of central government officials to assist local governments in the process of their evolution to greater autonomy.[45] This issue is part of the broader problem of decentralization strategy—what to decentralize and when and how to do it—to which I return later.

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44 This was a major topic of conversation at a workshop on the implementation of the 74th Amendment to the Indian Constitution on decentralization to the municipal level, sponsored by the Ministry of Urban Affairs and Employment and the World Bank and held in Hyderabad in March 1996.

45 Some of the specific requirements of a decentralized fiscal system are discussed in Shah (1994 and 1997b); Roy (1995); Ter-Minassian (1997); Bird and Vaillancourt (1998); and Spahn (1998).

Is there a negative impact on distribution?

The impact of decentralization on income distribution is not well studied in developing countries. For the reasons discussed above, it is clear that interregional redistribution cannot be effected in a highly decentralized system with substantial disparities in fiscal capacity across local governments. The burden for such redistribution should always be placed on the central government, which could effect the desired results through appropriate national tax policies, intergovernmental transfers, and expenditure programmes that target the poorest local governments. There is some evidence that appropriately designed transfer programmes can effect meaningful interregional redistribution, but there is not a great deal of empirical research on this topic, and some of it shows that redistributional transfers can be offset by other types of transfer programmes and government activities.[46] There is also some evidence that decentralized federal countries (of which there are few), such as Brazil, have been more successful at redistribution than more centralized federations, such as Mexico, India and Pakistan.[47]

How decentralization would affect the interpersonal and inter-area inequalities *within* local government jurisdictions is particularly unclear. Although a major redistributive role for local government is not likely, it is possible for local authorities in developing countries to be reasonably progressive internally in the way they finance local services. In some countries, for example, most local taxes are raised from relatively well-off local businessmen in the form of property taxes, trading license fees and charges for urban services (Crane, 1992; Smoke, 1994). This revenue may be used to help provide basic services for the general population, including the urban poor and rural peasants, who pay little to no local tax. If such a system were standardized throughout the country, there would be scant opportunity for avoiding local taxes by moving to another location. Thus, some redistribution can take place at the local level without necessarily inducing undesirable spatial efficiency effects. Much more research is needed on this topic, however, before definitive recommendations can be made.

Are service delivery and revenue generation improved?

Many alleged benefits of decentralization have been claimed in the literature, most of which relate to improvements in the level and quality of local services and revenue sources, better matching of local services to the preferences of local constituencies, and greater accountability.[48] The evidence on service delivery is limited and mixed. Given that claims of service improvements are so central to the arguments of decentralization advocates, it is somewhat surprising that so little research has been conducted to see if decentralization indeed increases the level of services delivered and their quality. A fairly recent study of 10 developing countries found that decentralization does increase total and subnational expenditures on public infrastructure (Estache and Sinha, 1995). Leaving aside the issue of whether increases in spending improve services, such increases do not seem to be related directly to increases in transfers, so that concerns about local overspending

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46 Schroeder (1988); Bahl and Linn (1992); Shah (1994); and Bahl (2000b).

47 Shah (1997b) reviews the evidence on this point.

48 There is a substantial and diverse literature that focuses on the benefits of decentralization and its role in rural and urban development. See, for example, Hicks (1961); Montgomery (1972); Oyugi (1978); Rondinelli (1978, 1981, 1982 and 1990); Esman and Montgomery (1982); Cheema and Rondinelli (1983); Davey (1983); Mawhood (1983); Rondinelli et al. (1983); Evans (1986); Mawhood (1987); Baker (1990); B.D. Lewis (1991:147–153); Evans (1992:640–667); and Gaile (1992:131–148).

from the national budget do not seem to be realized. Other anecdotal evidence suggests that—particularly in countries where few services were being provided at the local level—decentralization seems to lead to a genuine addition to the types and levels of services being provided to local government constituents.[49] The major constraint on further expansion of local services under decentralization appears to be a lack of balance between the revenue sources (including transfers) allowed to local governments and the increases in service functions assigned to them.

Data on whether decentralization improves the quality of services is even more scant. One major study develops a set of objective indicators on this question for three services traditionally provided by the public sector—roads, electricity and water—in a large sample (a minimum of 75 countries per sector) of developing countries. The results are neither highly encouraging nor discouraging. The only negative impact was for one measure in the electricity sector, while there was an increase in at least one indicator in each sector studied. For many indicators, however, decentralization had no statistically perceptible impact. In some cases, there was evidence of a functional split, such that facilities are better provided centrally, but operation is less expensive and more effective when decentralized. Country studies are rare, but a recent study of Kenya found that public water infrastructure services provided by local authorities are more accessible and reliable than those provided by the centre (B.D. Lewis, 1998).

Three important points emerge from this discussion. First, whether decentralization has positive effects on service delivery is a somewhat country- and sector-specific issue. There are surely some types of local-impact, low capital-intensive services that are more likely to be efficiently decentralized, but variations in available technologies, institutional structures, and local capacities will influence the desirability of decentralization of a specific function in a particular country. Second, existing "objective" studies of service quality focus primarily on productive efficiency—for example, whether more of a service is being provided at a lower cost. Questions regarding allocative efficiency—whether people are getting the level and quality of a service they want and are willing to pay for—are not often deeply considered, although some evidence on this is discussed below. Third, there is little attention given to the often substantial initial transaction costs of undertaking decentralization programmes and how these relate to expected benefits. There is obviously a need for much more research on the impact of fiscal decentralization on service delivery—in terms of quantity, breadth of coverage and level of sophistication.

Are local participation and accountability improved?

By this time, it will come as no surprise to the reader that the evidence on the extent to which decentralization improves accountability is mixed. There is certainly evidence that participation, in terms of elections and interaction between elections and local government officials, can be substantially enhanced by decentralization.[50] There is also some modest evidence that democratic decentralization can enhance the speed, quantity and quality of responsive actions from local

[49] Proceedings of the Technical Consultation on Decentralization held at FAO headquarters in Rome in December 1997.
[50] See, for example, Crook and Manor (1994), Manor (1998); and Blair (2000).

governments.[51] The quality and distribution of participation, however, varies, and it does not always result in improved accountability of the local government to local residents. Several issues seem to matter here.

First, the extent of genuine autonomy is a critical concern. Local governments, fuelled by local participation, might make decisions that represent the interests of their constituents. If there is insufficient local autonomy, central authorities could overturn such decisions, angering local residents who might blame the local government. This is not to say that some degree of central control is inappropriate; on the contrary, in developing decentralized systems, there are some national priorities that should take precedence, and some types of supply-side standards may be appropriate for certain services and activities. Even so, it is critical that decision rules are clearly specified and adhered to, and any standards for particular services should be disseminated in advance of the decision-making process.

Second, it is well known that local elites can dominate local decision-making processes in developing countries.[52] Where this is the case, other local people may become alienated from the local government and withdraw from participatory opportunities. Such a situation reduces the local government to an institution that is accountable to a small, powerful group with little connection to the broader community.

Third, the quality of participation may vary with the development of local experience with social decision making.[53] In some cases, there may be considerable experience with local decision making, such that residents are able to articulate their demands clearly and forcefully to local governments after decentralization. In other cases, local people do not clearly understand the choices they have or the basic rights and responsibilities of citizenship. They may automatically elect the person who would have been chosen as the local leader according to traditional rules, even if they do not believe that person will fairly represent their interests in making decisions.[54]

Fourth, it must be recognized that the development of genuine local participation and accountability is a process, not an administrative action. Local governments themselves are often quite used to heavy subsidization from central governments, and they are not accustomed to feeling particularly accountable to anyone.[55] Local government constituents may be accustomed neither to paying for services nor to expecting much responsiveness from local governments.[56] The mindsets and patterns of behaviour that have developed under such circumstances will require years to

[51] See, for example, Crook and Manor (1994); Panganiban (1994); de los Reyes and Jopillo (1995); Slater (1994); Souza (1994); Brillantes (1994:576–586); World Bank (1995); Rajas and Verdesoto (1997); Shah (1997a); Manor (1998); Porter and Onyach-Olaa (1999:56–67); UNCDF (1999); Blair (2000); and UNDP (2000).
[52] For a review of some of this literature, see Cernea (1985); Chambers (1986); Moser (1989); and Tendler (1997).
[53] This argument draws on Robert Putnam's (1993) famous book on Italy.
[54] See, for example, Evans and Smoke (1997).
[55] An article in Harare's **Sunday Vision**, 1 November 1998, reported that local authorities were demanding that the central government of Zimbabwe take more responsibility for roads from them.
[56] A recent study in South Africa found that citizens considered local governments to be the least responsive level of government and the people did not want to pay for local services even if they were improved. See Taylor and Mattes (1998).

change. In some cases, higher levels of government can help to build the awareness of people about the types of demands they can legitimately place on their local governments.[57]

Finally, it is important to keep in mind that there is a difference between responsiveness in terms of process and responsiveness in terms of outcomes. Residents may be genuinely satisfied with the mechanism that local governments develop to consult them about decisions. For many people, simply being consulted will seem like such an achievement that they may, at least initially, worry more about this process than the actual results. Ultimately, however, accountability requires that local governments both develop processes that make residents feel their opinion is being solicited, and provide outcomes that make residents feel that their public service needs are being met.

Thus, decentralization guarantees neither local participation nor accountability of local governments to their residents, and neither of these things comes about immediately or automatically as a result of decentralization. This is a critical point for two reasons. First, some of the alleged benefits of decentralization can be realized only if local governments are able to develop—even if gradually—a genuine accountability to their constituents. Second, bringing about accountability should not be expected to occur rapidly—it will typically require a strategic, gradually implemented process for building trust between local government officials and their constituents.

The Elements of a Good Fiscal Decentralization Programme

Having considered whether the broad benefits and disadvantages commonly attributed to fiscal decentralization are genuine, I now turn to a consideration of the key elements that should be included in a good fiscal decentralization programme. These include: an adequate enabling environment; assignment of an appropriate set of functions to local governments; assignment of an appropriate set of local own-source revenues to local governments; the establishment of an adequate intergovernmental fiscal transfer system; and the establishment of adequate access of local governments to development capital. Each of these is discussed in turn, first outlining principles, and then turning to commonly encountered problems and possible ways to mitigate them.

An adequate enabling environment

An enabling environment for fiscal decentralization can begin with constitutional or legal mandates for some minimum level of autonomy, rights and responsibilities for local governments. This provides a foundation on which to build decentralization, but it does not by any means guarantee successful fiscal decentralization. There are many countries with constitutional clauses and laws on local government that have not managed to decentralize successfully. A good example is Indonesia, which became more fiscally centralized after a major decentralization law was passed in 1974 (Smoke and Lewis, 1996).

A number of elements appear to be critical in establishing a sustainable enabling environment for fiscal decentralization. I will illustrate them in the context of Ethiopia and Uganda, two

[57] See, for example, the cases analysed in Tendler (1997).

often-cited cases of recent good performance.[58] First, in both countries, emerging political conditions have led to a strong national will to decentralize. Ethiopia and Uganda adopted decentralization in response to a perceived need to surrender certain powers to their regions as a way of holding their ethnically fragmented nations together.[59] This domestic political interest has taken the initiative away from the international donor community, which has driven recent decentralization efforts in many developing countries. In Ethiopia and Uganda, donor agencies were invited to assist only after the respective governments laboriously determined the general direction in which they intended to move.

Second, both countries have recently developed unusually robust and clearly defined constitutional and legal provisions to support decentralization and the strengthening of decentralized levels of government. The 1995 Ethiopian Constitution provides for a federal system, with different service provision and revenue responsibilities for the federal and regional governments.[60] In Uganda, the Local Governments Statute of 1993, the 1995 Ugandan Constitution and the Local Governments Act of 1997 provide considerable detail about the service and revenue powers of local governments.

Third, fiscal decentralization programmes in many developing countries are under the direction of fairly bureaucratized, often competing, and poorly co-ordinated central agencies with a direct stake (loss of power) in decentralization. These include broad-purpose ministries, such as Local Government, Home Affairs, Finance and Planning, as well as various sectoral ministries (Smoke, 2000a). In contrast, both Ethiopia and Uganda have developed special-purpose, somewhat more "neutral", and high-level mechanisms to oversee and co-ordinate decentralization and local government reform. In Ethiopia, the Regional Affairs Department in the Office of the Prime Minister has substantial overall responsibility in this regard, and a Decentralization Secretariat was set up for similar purposes in Uganda. Although the Secretariat reports to the Permanent Secretary for Local Government, staff members are not civil servants, and they are in principle detached from the normal government bureaucracy. In addition, the Local Government Finance Commission, a broad-based, constitutionally mandated, independent body that reports directly to the President, has considerable control over local revenue and intergovernmental transfer design.

Fourth, function off-loading and local revenue inadequacy are major concerns in many developing countries. Both Ethiopia and Uganda recognize that effective local governments must have adequate resources to meet their responsibilities under decentralization. Accordingly, both countries have developed significant transfer programmes that account for substantial proportions of total central revenues (around 30 per cent in Uganda and more than 40 per cent in Ethiopia).

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58 There are several good references on Ethiopian and Ugandan decentralization policy, including Cohen (1995); Bahl (1997); and World Bank (1999).

59 This central government attitude toward local governments is particularly interesting because the historical (post-independence) trend in many post-colonial developing countries, particularly Africa, has been to increase state control in order to build national unity. Here the opposite has happened despite the fact that both countries are ethnically fragmented, economically fragile and governed as essentially one-party states.

60 This builds on Proclamation 41 of 1993, which provides more information on a number of issues related to regional government functions, detailing on a bureau-by-bureau basis certain fairly specific responsibilities. Revenue bases and provisions for their administration are defined in greater detail in Proclamation 33 of 1992.

Although both Ethiopia and Uganda have strong enabling environments for decentralization, their perceived political imperative to decentralize has led to some of the other common problems of decentralization discussed below, including attempts to move forward more rapidly and less strategically than a complex process like decentralization merits. Thus, the basic policy frameworks for the decentralization programmes in Ethiopia and Uganda can, at least in some respects, serve as models for other countries, but care must be taken to learn from their mistakes in implementation.

There are also other countries in which a solid enabling environment is laying or likely to lay a strong foundation for fiscal decentralization. The 74th Amendment (1994) to the Indian Constitution, for example, lays a constitutional base and process for proceeding with decentralization to municipalities. Bolivia passed the often-cited Law on Popular Participation (1994), defining a strong legal and institutional framework in which to pursue decentralization. The South African Constitution (1996) sets out an important role for local governments, which the central government is now struggling to deliver on. In other cases, such as Cambodia and Indonesia, there are new efforts under way to develop legislation that gives local governments a solid foundation of autonomy and responsibility before moving ahead with additional reforms. Such experiences merit comparative analysis to see how they might serve as examples for other countries in transition to a more decentralized system, with the caveat that a strong enabling framework is clearly not a sufficient condition for effective fiscal decentralization.

Assignment of appropriate functions to local governments

The principles for assignment of services to local governments as developed in the fiscal federalism literature summarized above are fairly clear, and there is no need to elaborate on them further here. Many countries do in fact follow these principles in a broad way (Bahl and Linn, 1992; Shah, 1994). The problems with fiscal decentralization on the expenditure side appear to be related more to a lack of attention to implementation than to decentralizing inappropriate services. Two aspects are particularly worth noting.

First, no matter what a constitution or law says, central government agencies rarely have a desire to decentralize services they have been providing, particularly if decentralization involves a loss of prestige and resources to these agencies and they perceive each other as competitors. Thus, they almost invariably try to slow the process. Second, if too many sectors are decentralized too rapidly and local governments do not have the capacity to handle these new responsibilities, they will perform poorly, as in the Ethiopia and Uganda cases. If this happens, central agencies hostile to decentralization can use poor local performance as an excuse for keeping the services centralized.[61]

This common scenario is directly linked to the earlier discussion on the effects of local government fiscal behaviour on macroeconomic variables and central government deficits. Although poor fiscal performance of local governments is often a genuine problem, this does not necessarily prove that fiscal decentralization is inappropriate. It may simply mean that the fiscal

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[61] Smoke and Lewis (1996); Litvack et al. (1998); and Smoke (2000a).

decentralization or local government reform programme is giving local governments too much functional responsibility too rapidly and without appropriate capacity building and local governance development support from the central government.

Some recent experiments with approaching intergovernmental fiscal reform demonstrate possible ways to get around this problem. Kenya, for example, has a long history of local government, but its system was weakened by the centre in the post-independence period, primarily in the name of national unity.[62] Various efforts made during the 1980s and 1990s were purportedly designed to re-decentralize and re-strengthen local governments, but most were donor driven and undermined by national authorities. As a result, the performance of many local governments in terms of service delivery deteriorated considerably. In recent years, however, fuelled by political and economic pressures to reform, some genuine attempts to strengthen local governments have been undertaken.

Given the number of local governments, the magnitude of their problems and the ineffectiveness of earlier efforts, the government realized that not all required reforms could be undertaken at the same time or in all places. Recognition of the need for a clear, gradual, pragmatic strategy was manifested in the design of the first of a new generation of reform programmes, the Small Towns Development Project (STDP). This Ministry of Local Government-based project, which started in the mid-1980s with Kenyan and German funding, has thus far involved experimentation with about 15 smaller towns.

Under this project, there have been some broad common reform goals for the local authorities participating in the programme, but the exact steps each local authority took and the pace at which they took them differed depending on their capacity and willingness to accept new responsibilities and to undertake needed reforms. In addition, a mobile technical assistance team periodically worked on-site with the local governments to implement the negotiated reforms gradually and, as necessary, to modify them. Citizen participation mechanisms were required to develop local governance and improve accountability, and some training opportunities were provided for local officials and community groups. Local governments that met the goals they agreed to were rewarded in various ways, such as with increased funding and reduced central interference in expenditure decisions. Performance in most of the participating local governments has improved considerably.[63] The Kenyan government, with substantial World Bank funding and technical assistance, is now defining a much broader programme of reform—the Kenya Local Government Reform Program—largely based on the successful experiences of the STDP and lessons learned from past donor efforts.

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62 The history of Kenyan local government and current reform efforts are detailed in Smoke (1993, 1994 and 1999b).

63 It is important to note that the STDP project developed slowly (over a period of more than five years), in very close consultation with Ministry of Local Government officials; it is now in its twelfth year of operation. Thus, the project gradually developed very strong credibility with local counterparts, which is an extremely important factor in helping to get project ideas on limited, gradual, negotiated, individually tailored reforms accepted by Kenyan government officials and policy makers. It is also important to note that the STDP did not start from scratch—it built on other, more modest donor efforts, primarily a USAID market towns project that started in the early 1980s. By the mid-1980s, when the STDP came on the scene, USAID had already begun to focus more on financial and managerial capacity building than on simply producing infrastructure projects.

The gradual, tailored approach to fiscal decentralization and capacity building is increasingly becoming a common element in reform, albeit to various degrees and in different ways. Some other countries—including Cambodia, Ethiopia, India, Indonesia, South Africa and Uganda—are beginning to struggle with how to take incremental, realistic steps toward service decentralization to local governments.

Assignment of appropriate revenues to local governments

The fiscal federalism principles for assignment of revenues to local governments, like the service assignment principles discussed above, are well defined and generally appropriate. Many developing countries basically follow these principles, with a few prominent exceptions, such as the infamous South Asian *octroi* noted above (Bahl and Linn, 1992; Shah, 1994). Thus, central governments generally attempt to assign local governments revenue bases that are relatively immobile and should therefore not lead to serious spatial efficiency effects, that do not compete seriously with central tax bases and so on.

Four particularly problematic concerns remain on the revenue side. First, assigned revenues are almost never adequate to meet local expenditure requirements. This means that central government transfer programmes are inevitably required. Second, local governments often use too many unproductive revenue sources that barely cover the costs of collecting them. Third, the same lack of attention to implementation discussed above in relation to service decentralization also plagues the revenue side. Fourth, individual local revenue sources suffer from some serious design problems, such as static bases, overly complex structures and ineffective collection mechanisms. Issues related to transfers are discussed below, focusing on local own-source revenue design and implementation strategy.

One of the most critical international lessons of local tax reform is that local governments should focus their energies on a few local sources of revenue that can provide substantial yields and pay less attention to the many minor taxes that they typically have access to (Bahl and Linn, 1992; Shah, 1994). The concentration here is on property taxes and user charges, two significant sources of revenue that local governments might use more effectively in developing countries.

The property tax is known to suffer from a variety of obstacles, inequities and inefficiencies, particularly in developing countries.[64] First, there can be serious local political problems with adopting and enforcing it. Although the property tax is an appropriate local tax, it is also very visible, not hidden in deductions from income or in prices of goods consumed, and is notoriously difficult to administer. Local residents may be particularly reluctant to pay if they do not feel they are getting adequate or desired local services. In addition, powerful leaders often own a large proportion of property, leaving not much middle-class housing to tax. Better local services, improved local political mechanisms and more broadly based participation can help remove political obstacles to more effective use of the property tax.

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[64] Much of the discussion here is based on Bahl (1979); Bahl and Linn (1992); Dillinger (1992); Kelly (1993); and my own experiences in various countries.

Second, there has been a tendency in some countries to overtax business property through higher assessments and higher rates. This could lead to relocation or shifting of the tax burden in the form of higher prices to the very residents the differential property taxation is trying to protect. There is an increasing trend in property tax reform toward reducing or eliminating differentials in property tax rates on different classes of property. Thus, residential classifications, special exemptions, plot subdivision and other forms of tax avoidance and evasion are minimized.

Third, valuation procedures tend to be too complex and too infrequently applied, such that the tax base stagnates for long periods. Simplified assessment procedures that use standardized land and building classifications have been employed in successful property tax reforms throughout the world, improving yields and reducing administration costs. Provisions to revalue at regular intervals and to index between valuations can improve the buoyancy of the tax revenues.

Fourth, collection is a major concern in most countries and it often receives less attention than valuation reform. The successful property tax reform in Indonesia in the late 1980s and early 1990s was among the first to replace a valuation-led strategy with a collection-led reform. The logic was that improved valuation without improved collection could not bring about significant gains in yields. Some key elements of collection-led reforms include legal provisions that broadly define liability and allow renters to deduct property tax payments from rent; steps to make it easier for taxpayers to meet their obligations, such as more convenient payment points and simpler payment procedures; and measures to enhance enforcement, such as stiff penalties for nonpayment and seizure of properties in default.

Finally, strategic implementation, as on the expenditure side, is critical for successful property tax reform. Simple and more acceptable reforms should be undertaken before more complex and contentious ones. New systems should be tested in pilot areas, allowing the government to improve them before widespread application. Better linkages should also be created between the tax policy and tax administration officials. This would improve the ability to respond in a timely manner to unworkable rules and problems that develop during implementation. In addition, contentious reforms should be phased in, for example by gradually increasing assessment ratios and negotiating with taxpayers. Property tax reforms that have worked in some countries may not be applicable everywhere, but the general strategies and principles involved can often strengthen a local tax that has considerable potential to support fiscal decentralization.

A second type of local government own-source revenue with considerable potential is user charges. There is agreement among local finance experts that user fees are underutilized, and that they could be implemented to some degree for many services, even those that are routinely subsidized.[65]

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[65] Good discussions of local government user charges and willingness to pay are found in Mushkin (1972); Jimenez (1987 and 1990); Gertler (1987:67–88); Anderson (1989:525–542); Gertler and van der Gaag (1990); Bahl and Linn (1992); Whittington et al. (1991:179–198); Crane (1994); and Beede and Bloom (1995:113–150).

There are powerful arguments for charging for services, including the potential benefits of creating a close connection between consumption and cost; ease of collection due to the direct nature of charges; and for excluding nonpayers. There are also, however, serious problems with instituting and increasing user charges for public services. These include political sensitivity; the difficulty of choosing among marginal cost, average cost and hybrid pricing schemes that have different implications for cost recovery and efficient resource use; a reluctance to raise charges over time, such that revenues may fall below costs in times of inflation; and equity concerns about the effects of charges on the poor.

While it is difficult to make specific recommendations regarding user charges without referring to the context of specific sectors and countries, successful reforms in a number of countries suggest several principles. First, it is most appropriate and easiest to charge for services that have some private characteristics—particularly where benefits vary among individuals and nonpayers can be excluded from consumption. Second, even for more "public" goods, some level of charges can be appropriate to establish a link between consumption and costs and to discipline use of scarce resources. There is increasing evidence from many countries that people are willing to pay something for services if adequate quality and reliability are maintained. Third, equity must remain a key concern in setting charges; even so, cost recovery may still be possible if demand elasticities vary such that price discrimination can occur across users, which allows cross-subsidization of target groups. Fourth, public education and consultation schemes are normally required to get people to accept new and increased user charges. Fifth, user charges invariably need to be phased in over time to prevent harsh equity effects, undesirable changes in patterns of service use, administrative and political resistance and so on. If care is taken to follow these basic principles, user charges have great potential in many countries to provide substantial resources to support fiscal decentralization programmes in an efficient way.

Developing an appropriate intergovernmental transfer system

Because local own-source revenues generally do not cover local government expenditure responsibilities, virtually all governments have intergovernmental transfer programmes. These serve multiple, often interrelated purposes, three of which are particularly important. First, they help to cover local government fiscal imbalances, supplementing inadequate local own-source revenues to improve the ability of local governments to meet their expenditure responsibilities. Second, they can be used to meet national redistributional objectives as discussed above, helping to offset fiscal capacity differences among local governments. Third, they can be used to encourage local expenditures on particular goods and services that exhibit positive externalities or are considered to be basic needs that should be distributed less unequally than the ability to pay for them. Most transfer systems, even in developing countries, are intended, at least officially, to meet these objectives.[66]

There are several typical issues and problems involved in designing transfer programmes. First, it is important to recognize explicitly that different types of transfers are appropriate in different circumstances. Unconditional grants, for example, are best for income redistribution purposes,

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[66] Much of the literature on this topic is reviewed in Bahl and Linn (1992); Schroeder (1988); Shah (1994); and Smoke (1994).

while conditional grants are a cheaper way of encouraging expenditures on particular types of target services. If designed properly, both types can help to encourage local resource mobilization and to ensure over time the provision of a basic minimum of services in all local governments regardless of fiscal capacity.

Second, fiscal equalization grants are often considered important, but they are very difficult to design because of the technical and political complexities involved in defining an "optimal" distribution of income across decentralized jurisdictions and in determining a fair way to raise the revenues to be redistributed. Equal resources do not guarantee equal results, and there are often inequalities within recipient jurisdictions that may not be lessened by transfers. In spite of these problems, redistributive grants can generally be designed to improve on the *status quo*.

Third, macroeconomic problems can be created, as highlighted by the anti-fiscal decentralization camp discussed earlier, if too large a percentage of central resources are guaranteed to local governments each year. The potential dangers, however, must be weighed against the value of providing local governments a stable revenue base and the potential microeconomic gains of decentralized service delivery. The most likely solution is to start a fiscal decentralization effort with modest transfer programmes that involve substantial central control and monitoring. The significance of transfers can be increased as local governments develop the capacity to deliver services and to behave in a fiscally responsible way. Some flexibility in determining the size of the transfer pool during crisis situations can give central governments the fiscal power they need to meet macroeconomic challenges.

Fourth, transfer programmes may have conflicting objectives or unintended results that must be recognized. For example, an equalizing grant may be offset by types of categorical grants that go to wealthier areas. Careful research prior to transfer system design can help to understand and minimize, as appropriate, such effects. Grants may also substitute for rather than stimulate local tax effort, thereby failing to increase public spending as much as expected. Including a simple local tax effort variable in a transfer allocation formula can alleviate, but not eliminate, this problem. Finally, multiple transfer programmes with different allocation criteria for a particular sector can confuse local officials and provide incentives for unproductive competition and strategic behaviour. Consolidation and simplification can reduce such problems.

Fifth, many transfer systems—by design or by manipulation—are allocated with a degree of subjectivity that undermines basic economic objectives. Given the political nature of transfers, it would be unreasonable to expect any system to be fully rationalized in terms of achieving basic efficiency and equity goals. More objective and transparent distribution formulas, however, can help move the system in the right direction.

In the final analysis, it is difficult to make generalized prescriptions for the appropriate structure of an intergovernmental transfer system, which should be expected to vary across countries depending on national objectives, the extent of service and revenue functions assigned to local governments, the fiscal capacity of local governments, the extent of inequalities across local governments and so forth. In a very basic system, such as the one under development in Cambodia, local governments need not be given specific mandatory responsibilities initially, only modest resources to provide local services that are considered important by the community and are not provided by the central government.[67] This approach can make local people better off and help to develop governance and capacity. Because the local governments will be responsible for such a small portion of public expenditures in a country with one of the lowest aggregate tax rates in the world, there is no conceivable threat to macroeconomic stability from the local public sector in this case.

In advanced systems where local governments have significant service responsibilities and inadequate sources of revenue, such as South Africa, a more substantial and sophisticated system of transfers is being developed. This system includes redistributive grants designed to alleviate fiscal inequalities and conditional grants designed to cover priority investment needs. In this case, local government revenues and local autonomy over certain taxes are being enhanced at the same time that transfer programmes are being reformed (Reschovsky and Smoke, 1999). Under such conditions—in which local governments have significant expenditure responsibilities and increasing control over major revenue sources, and intergovernmental transfers are significant and growing—the National Department of Finance is justified in keeping watch over the size and performance of the local fiscal system (Republic of South Africa, 1998; Reschovsky and Smoke, 1999).

Developing adequate local access to investment capital

Local governments in many developing countries get most of their capital budget from intergovernmental transfers, but some decentralized governments, typically states, provinces and large cities, are able to borrow. In some cases, such as Brazil and Colombia, there is direct and significant access to commercial banks and the bond market. In other cases, such as India and Poland, access is limited, but some decentralized governments borrow and there are efforts to improve access to loans. In still other countries, such as Kenya and Indonesia, virtually all borrowing occurs through special government accounts or lending institutions along the lines of a municipal development bank.[68]

The issue of local government borrowing cannot be separated from the broader question of investment finance, including the role of intergovernmental grants. In many countries, local government investment has been financed largely by grants, which have often been allocated through complex, fragmented programmes that leave significant discretion to central and state officials and often fail to meet basic economic goals. Where local borrowing occurs, often through some type of municipal credit institution, it is normally subsidized, and repayment is often inadequate.

Substantial dependence on grants and subsidized loans developed during a period when funds for infrastructure were abundant and developing countries faced fewer internal or external pressures for good fiscal performance than at present. Moreover, many analysts long believed

[67] Royal Government of Cambodia (1999), Draft Commune Government Law.

[68] Davey (1988); Peterson and Ferguson (1991); Ferguson (1993); Smoke (1999a); Peterson (2000); and Petersen and Crihfield (2000).

that subsidization would improve equity in service delivery, a key objective of donors and governments. The recent economic and fiscal changes discussed above, however, as well as increasing evidence that subsidization does not primarily benefit those in need, have pushed many countries into reforms.[69] On the grant side, as noted above, fragmented programmes are being consolidated and standardized formulas developed. On the loan front, countries are adopting objective appraisal techniques, charging near-market interest rates and enforcing repayment, often through municipal development funds or banks assisted by the major donors. Some central governments—particularly in Latin America, but also in India and South Africa—are trying to develop a municipal bond market.

The real challenge for fiscal decentralization is to develop a *spectrum* of options to finance capital investment—from grants and subsidized loans for poorer local governments and non-self-financing projects, to various types of loans and bonds for fiscally sound local governments and self-financing projects. As with grants, the approach that a central government takes toward enhancing local government access to loans depends on the fiscal context, as does the extent to which these efforts pose any danger to macroeconomic stability. In cases like Brazil or Argentina, where decentralized levels of government are relatively strong, efforts to develop direct access to capital markets make sense. As the Brazilian debt crisis discussed above demonstrates, however, it is critical in such cases that the central government regulate municipal bond markets, develop and enforce credit limits and stop bailing out local governments that default on their debt.

In more typical cases, in which local government investment responsibilities are smaller and they are fiscally weak, some type of municipal development bank will generally be the correct approach. Municipal credit institutions are initially regulated or managed and substantially capitalized by central governments, either with their own resources or donor loans. This approach gives central fiscal authorities considerable control over borrowing activities of local governments, although this power must be structured to minimize abuse. In addition, such institutions are likely to be increasingly privatized as local governments develop greater creditworthiness, which will help limit the extension of nonviable loans. Thus, serious impacts of local debt on the broader economy can generally be avoided if municipal credit institutions are properly structured, managed and developed over time (Peterson, 2000).

Central government involvement in municipal credit institutions also creates a rarely used opportunity to improve the overall effectiveness of fiscal decentralization programmes by creating an explicit relationship between the grant and loan systems. In most developing countries, grant and loan reforms have been independent of one another, except to the extent that grant allocations are sometimes reduced if local governments fail to make loan repayments. Most countries—except a few in Latin America and Southern Africa—and the Indian state of Tamil Nadu have not used grants and loans together in an integrated package.[70] The failure to

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69 Bahl and Linn (1992); Dillinger (1994 and 1995); and Shah (1994).

70 The South Africa proposal is discussed in a speech by Deputy Minister of Finance Alexander Erwin to the South African Infrastructure Investment Conference, March 1996. The Tamil Nadu experience is examined in Allaudin and Rajaraman (1996).

link grants and loans when investment decisions are made can create conflicting signals for local fiscal behaviour. Most importantly, local governments have no incentive to borrow from a development bank if they have access to grants or highly subsidized loans from other central or state agencies. If wealthy municipalities use grants for self-financing projects, they divert scarce resources from projects with weak revenue potential and from poorer local governments unable to borrow.

A direct grant-loan linkage has the potential to improve resource use considerably in some cases. In adopting such an approach, all infrastructure projects that seek central government financing assistance, at least those with significant self-financing potential, could be evaluated as if they were to be financed by loans. If loan repayments were to cause an unacceptable burden on project beneficiaries, grants would be provided to cover all or part of capital financing. Affordability would have to be measured according to clear rules, and a grant would be approved only if operating expenses fell within an acceptable range and tariff collection efficiency meets specified standards. Such rules ensure that local governments are not subsidized, even if deserving on affordability grounds, unless they meet minimum performance standards, which would require technical assistance to some local governments.[71]

If this type of system were adopted, municipalities making a new investment would have a greater incentive to operate more efficiently and to recover costs from service users. Equity objectives would also be better served because well-off local governments and revenue-generating projects would rely more heavily on loans, while poorer local governments and important projects that could not recover costs would be subsidized with grants. Such a system could help to prevent the type of local government debt crisis feared by opponents of fiscal decentralization.

A note on the role of donors and international agencies

Donors and international agencies, as noted above, often play a key role in driving and/or supporting fiscal decentralization programmes. In spite of current international rhetoric, however, the donors do not always behave in ways that genuinely support gradual and strategic decentralization, institution building and sectoral co-ordination.[72] Such efforts are time consuming and difficult and, therefore, likely to cause substantial delays in donor efforts to move funds. Given common pressures on programme officers to keep to expenditure schedules, particularly in large lending institutions, substantial funds continue to flow for investment, even if it is clear that recipient governments lack the capacity to ensure that funds will be well spent and that projects being constructed will be maintained.

Donors often try to get around the difficult problem of sectoral co-ordination by carving out their own project territory in terms of particular sectors, specific regions, or particular local units. Since donors tend to impose preferred systems and procedures on the various areas they are working in, and central governments rarely exercise much control over such donor sharing

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71 For more detailed discussion of grant-loan linkages, see Smoke (1999a).
72 See, for example, Smoke (2000a).

schemes, the process of building a consistent fiscal decentralization system may be greatly hindered. Moreover, because individual donors often develop client relationships with particular ministries or local governments, they may exacerbate interagency competition for control of the decentralization process. Thus, the behaviour of the donors supporting fiscal decentralization initiatives may sometimes paradoxically contribute to the failure of these programmes in meeting their ambitious objectives.

Moving Forward

This paper covers considerable territory related to fiscal decentralization, offering throughout a variety of ideas about the extent to which fiscal decentralization is desirable and the way that supporting programmes might be designed. Social scientists like to conclude such review papers by making concrete generalizations. I would argue, however, that overgeneralization has been the enemy of good fiscal decentralization in developing countries. Defining a reasonable fiscal role for local governments is not a neatly generalizable exercise because the economic, political, fiscal and institutional context in which they operate varies so substantially across developing countries. I will, therefore, conclude this paper much more modestly by offering a summary of a few key issues that I believe are critical in evaluating and designing an appropriate fiscal decentralization programme.

Fundamentals of fiscal decentralization

Before thinking about fiscal decentralization, consideration must be given to the appropriate role of the public sector in a particular case. Once there is broad understanding of this issue, it makes sense to consider which level of government should take responsibility for key functions. Fiscal decentralization is appropriate from an economic perspective when there are variations in demand for public services across local jurisdictions, and the benefits of decentralized service provision are not offset by the need to account for scale economies or to correct for interjurisdictional externalities. Such factors are not easy to measure precisely and to balance empirically, but careful analysis can set some basic boundaries for the appropriate functions of different levels of government. In addition, gains to local governments from fiscal decentralization must be balanced against the start-up costs of decentralizing and the possible negative macroeconomic consequences discussed earlier. It is also important to recognize that decentralization of fiscal functions gives primary responsibility to local governments, but they may contract with private providers to deliver these functions.

Assuming macroeconomic concerns are not serious or can be controlled through appropriate institutional mechanisms, three important "prerequisites" must be in place to maximize the potential long-term benefits of fiscal decentralization. First, and often ignored, there must be a viable local political mechanism to determine local preferences and to hold the local governments accountable to their constituents. Second, local governments must have the institutional, technical and managerial capacity to deliver the services demanded by their constituents. Third, local governments must have access to the financial resources required to meet their responsibilities. Almost by definition, these prerequisites do not exist in developing and transitional economies. Thus, even if analysts are able to use the economic, spatial and demographic characteristics of a country to determine an "ideal" degree of fiscal decentralization and an "ideal" structure of local government jurisdictions, such a system is not going to appear smoothly and rapidly. A number of concerns should be considered with respect to the design and implementation of fiscal decentralization.

Developing a process

The first system design issue is that normative fiscal principles are not likely to be the starting point for many of the actors involved in fiscal decentralization. Different institutions will typically have different perspectives on how far to push decentralization and what form it should take. There will often be political and bureaucratic resistance to even the most carefully defined programme of fiscal decentralization. As discussed earlier, competing central government agencies that would lose power and resources under a fiscal decentralization programme may try to undermine progress. In some cases, local governments may also resist decentralization if they are comfortable being served and financed by the centre. When such conditions exist, there is a need to develop a political negotiation process for defining the fiscal decentralization goals and strategy, such as the ones recently experimented with in Indonesia and under development in South Africa.[73] Getting consensus from key institutional actors on how to define fiscal decentralization may be more critical, at least initially, than the specific initial form the intergovernmental system takes. If the process is fair, it should result in a system with at least some basic checks and balances among various organizations and individual employees in key institutions, so that none are too powerful in the process of defining what fiscal decentralization means or controlling its implementation.

Defining a starting point

Even if broad consensus can be forged on the type of intergovernmental fiscal system a country would ultimately like to have, there is an enormous degree of work involved in developing fiscally effective and responsive local governments. Decentralization must generally be seen as a lengthy process in which attitudes of key actors at all levels must be changed and capacity at all levels must be built. Thus, an effective fiscal decentralization programme requires a strategic implementation approach in which reforms are pragmatically phased in. Initial steps should be undertaken in sectors and functions for which rapid success is likely. This requires prioritizing reforms, focusing on simple tasks that don't immediately threaten the central power base or overwhelm local capacity. However, even if initial reforms are defined modestly, they should be based on a broader conception of what the government ultimately wants to accomplish. For example, programme designers should have a sense of how the reform of a particular local tax or the introduction of a new operating procedure helps to build the intergovernmental fiscal system the government intends to have 10 or 20 years from now.

A second component of the starting point is the treatment of local governments. Decentralization programmes tend to treat all local governments (or classes—large urban, small urban, rural and so on) by default, as if they were very similar in capacity and staffing. In fact, there are

[73] For a discussion of Indonesia, see Smoke and Lewis (1996). For a discussion of South Africa, see Bahl and Smoke (1998).

great differences among local governments in most countries, even among those of a particular type. It will generally be more effective, even if sometimes politically and administratively difficult, to differentiate among local authorities. Treating those with weak capacity as if they can handle responsibility invites failure. Unduly controlling and providing technical assistance to capable local authorities wastes resources.

Creating an integrated implementation strategy

A fiscal decentralization implementation strategy must be built on the starting point discussed above. There are two key concerns in this regard. First, the individual elements of fiscal decentralization programmes must be closely linked. Local sources of revenue should be matched as closely as possible to local expenditure responsibilities. Intergovernmental transfer systems should target local expenditure needs and local fiscal capacity differences. Local government lending mechanisms cannot be defined independently of local fiscal capacity and transfer programmes. Fiscal mechanisms cannot be expected to work if there is not an adequate degree of local political development and accountability. The historical tendency in many countries of dealing with these various elements as separate aspects of intergovernmental finance has resulted in imbalances between expenditure responsibilities and sources of revenues, transfer programmes that undermine incentives to collect local own-source revenues, unnecessary grant financing of local governments that can afford to tap capital markets, and the awarding of loans to local governments without adequate managerial and fiscal capacity to repay them.

Second, the various elements of fiscal decentralization reforms should also be linked to central government efforts to build capacity and performance progressively. These reforms can be implemented in a way that makes it clear to local governments exactly what they must do before they will be assigned additional responsibility or resources. Specific steps should be designed in a way that helps to build local political and institutional capacity, such that what I cautiously labelled prerequisites above should more accurately be considered key elements or building blocks of a strategic fiscal decentralization programme. The central government normally has considerable leverage in helping to build capacity and governance. In this regard, the centre can strategically use access to grants, loans and technical assistance to encourage the development of political mechanisms, the adoption of new procedures and other key reforms.

Overall benefits of a strategic approach

The type of gradual, strategic, integrated approach broadly outlined here will inevitably require a different and slower path to fiscal decentralization than would have been expected from a more conventional technocratic approach. It is, however, better to embed political compromises in a fiscal decentralization process from the beginning than to risk having powerful forces sabotage it before it begins or in mid course, perhaps effectively removing fiscal decentralization from the policy agenda for years to come. Such an approach also raises the prospects for initial success, creating a base on which to build additional reforms. Finally, by slowing the fiscal decentralization process and building capacity in a controlled way, this type of approach reduces the likelihood that the negative macroeconomic effects attributed to fiscal decentralization by its opponents will materialize.

Concluding Statement

As economic and political pressures for fiscal decentralization continue to escalate and as forces driving democratization continue to develop, many countries will feel an increasing urgency to decentralize. In spite of this growing interest and support, fiscal reform of local government is likely to be a slow and painful process because serious constraints on decentralization are not going to disappear suddenly, and some standard analytical tools may have limited applicability. Available conceptual frameworks for analysing fiscal decentralization are useful, but they are not designed to deal with some of the most important factors affecting the prospects for effective fiscal decentralization. Moreover, implementation is complex and requires careful attention.[74]

The most critical problem fiscal decentralization analysts face is a dearth of good comparative information on the extent to and conditions under which the alleged benefits and disadvantages of fiscal decentralization have been realized.[75] Anecdotal evidence and case studies can give us certain insights, but additional policy experimentation and more systematic research is needed to help us understand more broadly the realities of and prospects for fiscal decentralization in developing countries.[76] Such information would lead the way to better conceptual development and more effective public policy.

[74] Recent considerations of the design and implementation of fiscal decentralization programmes include Bahl (2000a) and Smoke (2000b:101–109).

[75] For a discussion of some of the key research questions on decentralization that are not well understood, see Sanyal and Smoke (1998) and Smoke (1999).

[76] The World Bank is undertaking a study in Latin American to look at many of the underexplored questions raised in this paper. These include: Does decentralization lead to unsustainable fiscal deficits? Does decentralization make the provision of public services less equal? Does decentralization increase the efficiency of service delivery? How does the design of decentralization influence its effects?

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