



**DECENTRALIZATION, GOVERNANCE AND PUBLIC SERVICES  
THE IMPACT OF INSTITUTIONAL ARRANGEMENTS**

**A REVIEW OF THE LITERATURE**

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# 1 Introduction

An increasing number of countries are decentralizing the administrative, fiscal, and political functions of the central government to lower-level governments. Though these decentralization efforts are typically politically motivated, they have profound impacts on economies by influencing, among other things, governance in the public sector, including public services.

With regard to *governance*, decentralization is often thought to “bring government closer to the people.” Furthermore, when there are problems of cooperation on the national level among factions—which might be ethnically, regionally, religiously or historically based—devolution that leads to local jurisdictions along factional lines might be expected to remove obstacles to government decision-making, and public acceptability of government decisions, and in general facilitate collective action and cooperation. This is so because of the greater trust, capacity for collective action, and legitimacy of decisionmaking that are sometimes found among more homogeneous groups (see Meagher 1999). Under the right circumstances—e.g., where government actions are transparent and civil society is permitted to operate freely—devolution should increase the accountability of government officials and discourage most forms of corruption. The advocates of decentralization, moreover, argue that decentralizing the delivery and in some cases the financing of *local public goods* (i.e., public goods that do not have substantial inter-jurisdictional spillovers) **improves the allocation of resources, cost recovery, and accountability, and reduces corruption in service delivery.**

Such evidence as there is, however, suggests **that decentralization has not led to better governance and economic performance.** At the same time, it is widely acknowledged that this evidence is weak, and in particular fails to distinguish among different forms of decentralization.

This paper will address the above issues through a selective review of the literature dealing with the effects of institutional arrangements on decentralized governance, and public service provision in particular. Institutions refer to formal and informal rules and practices that govern (a) the behavior and actions of individuals and (b) policymaking. In this sense, institutions include jurisdictional design, the political system and the structure of government administration. Specifically, the paper will review factors that are likely to influence the impact of decentralization on resource allocation, cost recovery, accountability and corruption. These factors include not only the powers, boundaries, and capacity of subnational governments, but also social and economic characteristics of jurisdictions.

The paper proceeds as follows. Section 2 discusses the argued impacts of decentralization on public service delivery, and reviews the existing empirical evidence. Factors that are likely to influence the performance of decentralized service delivery are studied in Section 3, and Section 4 concludes the paper.

## 2 Impact of Decentralization on Public Services: Theory and Evidence

### 2.1 Theory

Decentralization of local public good finance and delivery—provided these are without substantial inter-jurisdictional spillovers—is argued to improve governance in public service provision in at least three ways: **by improving the efficiency of resource allocation; by promoting accountability and reducing corruption within government; and by improving cost recovery.** These three dimensions of governance are closely linked, and depend on local governments being at least quasi-democratic.

#### 2.1.a Allocative Efficiency

The most common theoretical argument for decentralization is that it improves the efficiency of resource allocation.

Decentralized levels of government have their *raison d'être* in the provision of goods and services whose consumption is limited to their own jurisdictions. By tailoring outputs of such goods and services to the particular preferences and circumstances of their constituencies, decentralized provision increases economic welfare above that which results from the more uniform levels of such services that are likely under national provision. The basic point here is simply that the efficient level of output of a “local” public good (i.e., that for which the sum of residents’ marginal benefits equals marginal cost) is likely to vary across jurisdictions as a result of both differences in preferences and cost differentials. (Oates 1999, 1121-22)

One pillar of this argument is that **because subnational governments are closer to the people than the central government, they are considered to have better information about the preferences of local populations than the central government** (Hayek 1945, Musgrave 1959). Hence, they are argued to be better informed to respond to the variations in demands for goods and services.

Second, subnational governments are also **considered to be most responsive to the variations in demands for and costs of providing public goods.** Decentralization is thought to increase the likelihood that governments respond to the demand of the local population by promoting competition among subnational governments (Tiebout 1956). Competition among subnational governments is said to allow for a variety of bundles of local public goods to be produced, and individuals are said to reveal their preferences for those goods by moving to those jurisdictions that satisfy their tastes—that is, by “voting with their feet.” This is seen to pressure subnational governments to pay attention to the preferences of their constituents and tailor the service delivery accordingly, whilst risking the loss of tax revenues (Oates 1968, 1972, 1999; Salmon 1987; Breton 1996; Qian and Weingast 1997). This “voting with feet” is thus argued to enhance the efficiency of resource allocation by increasing the likelihood that governments satisfy the wishes of citizens. Where geographic mobility is constrained, as in many developing and transition

countries, alternative service providers such as private firms and NGOs are potentially important in providing exit options.

### *2.1.b Accountability*

Decentralization is also argued to promote accountability and reduce corruption in the government (Ostrom, Schroeder, and Wynne 1993). **Since subnational governments are closer to the people, citizens are considered to be more aware of subnational governments' actions than they are of actions of the central government.** Also, the resulting competition between sub-national providers of public goods is seen to impose discipline on subnational governments, as citizens averse to corruption may exit to alternative jurisdiction or providers. (See discussion of exit and voice in Section 3.4)

Corruption represents a breakdown of cooperative behavior, in which the few collude to the detriment of all. **Devolving functions to smaller units that are closer to the population should, in theory, increase consensus and legitimacy concerning the choice of public services.** This, in turn, can be expected to foster cooperation, vigilance, as well as acceptance of and adherence to rules of public sector integrity (“rule-obedience”). This would be especially true where the financing of public services is devolved via the assignment of tax instruments or the collection of user fees. In plural or socially fractionalized nations, the question then arises whether jurisdictions can be so designed so as to maximize social (e.g. ethno-linguistic) homogeneity and social capital, and therefore the propensity to cooperate at the local level (Meagher 1999).

### *2.1.c Cost Recovery*

Making services more demand responsive through decentralization is argued to have the added benefit that it **increases households' willingness to pay for services** (Briscoe and Garn 1995, Litvack and Seddon 1999). **Households are argued to be more willing to pay for and maintain services that match their demand.** This is the flip side of the allocative efficiency coin.

Moreover, a relatively close match between supply and local demand, **if coupled with transparency and with local cost-sharing or cost recovery, can provide the incentives and information base for effective local monitoring.** The latter is a necessary ingredient in an overall anti-corruption strategy, and in particular helps to shrink the information asymmetries and leakages that can undercut both allocative efficiency and cost recovery.

Does decentralization have these effects on service delivery in practice? The next section will briefly review the existing empirical evidence.

## **2.2 Evidence**

The empirical evidence on the impact of decentralization on the efficiency of resource allocation, accountability and corruption, and cost recovery is surprisingly

limited. Studies conducted, however, indicate that the experience with decentralization is mixed.

There has been little empirical research on developing countries with regard to the argument that decentralization promotes demand responsiveness of government services. The existing research tends to focus on the effect of decentralization on expenditure allocation or on the impact of public services provided, and tends not to address whether the resource allocation is tailored to local demand. The results of this research are mixed. For example, Bird, Ebel, and Wallich (1995) examined decentralization in Eastern and Central Europe. Their results suggest that public services can suffer as a result of decentralization, at least in the short run. By contrast, Matheson and Azfar (1999) explored the impact of decentralization on health and education outcomes in the Philippines. In Filipino provinces where national minorities formed local majorities after decentralization, decentralization improved health outcomes.

Further, some studies indicate that decentralization may widen regional disparities in social spending if local governments are made responsible for their funding and delivery. For example, West and Wong (1995) show that in China decentralization increased regional disparities in the provision of health and education services. Similarly, Winkler and Rounds (1996) demonstrate that decentralization created inequities in school expenditures in Chile. Though undesirable, inequity appears difficult to avoid in genuine decentralization reforms – the issue here is whether (and over what time frame) local initiative and equalization transfers improve welfare compared to the *status quo ante*.

One empirical study that addresses the demand-responsiveness of decentralized service delivery is Isham and Kähkönen (1999b). They analyzed the performance of community-based water services in Central Java and found that only if user themselves were directly involved in service design and selection, were services likely to match users' preferences. Their results indicate that informed user participation in service design and decision-making led to different water technology choices: households expressed a willingness to pay for more expensive technologies than village leaders and government officials would have chosen. The study also shows that water services that matched user preferences were likely to perform better.

The developing-country evidence on the impact of decentralization on accountability and corruption is scanty. One study suggests that corruption is greater in decentralized than in centralized countries (Treisman 1998). Also, anecdotal evidence indicates that there is plenty of corruption among local officials. On the other hand, there are case studies of governance improvements arising from local efforts in decentralized systems. (See Litvack et al. 1998, Klitgaard 1988)

Overall, these studies, as well as anecdotal evidence and theoretical work, suggest that the performance of decentralized service delivery depends on the design of decentralization and institutional arrangements that govern its implementation. Thus, research and practice both suggest the importance of understanding under which sets of arrangements decentralization works and under which it does not. The next section will

discuss factors that are likely to influence the performance of decentralized service delivery in terms of allocative efficiency, accountability, and cost recovery.

### **3 Factors Influencing the Performance of Decentralized Service Provision**

A host of factors is likely to influence the performance of decentralized public service delivery. These include the political framework; fiscal aspects of decentralization; transparency of government actions; citizen participation in public service delivery; the effectiveness of civil society; aspects of the social structure; the capacity of subnational governments, and other factors. This section will briefly review each of these factors and how they influence the effect of decentralization on resource allocation, accountability, and cost recovery.

#### **3.1 The Political Framework**

Decentralization is thought to bring government closer to the people by way of introducing or strengthening the electoral process at subnational levels, the formation of councils and citizens committees, and direct participation of the users of services and beneficiaries of public goods delivery. Even where not locally elected, **sub-national government is thought to have greater knowledge of local preferences**, so decentralization may encourage allocative efficiency. An efficient division of responsibilities among different levels of government requires, however, that **the role of each level of government must match its capability, and a set of rules defining who has authority and who will be held accountable**. These rules should be explicit and transparent. Fundamental rules are most often spelled out in the constitution, leading to laws and regulations covering specific implementation of the fiscal system and public goods delivery.

##### *3.1.a Constitution and Legal Framework*

There are two aspects of constitutional structure. The first consists of political offices and how powers are allocated to them. The second aspect establishes electoral procedures (Myerson 1998). In a federal or devolved system the jurisdiction of national and subnational political units overlap. The constitution defines the scope of authority of the differing units. Additionally, the constitution and national laws may define situations in which provincial governments can be investigated, disciplined, or removed by arms of the national government (Meagher 1999)—or, alternatively, sub-national governments can monitor and bring political or legal action against the central government. The World Bank (1999) defines the purpose the constitution serves in the process of decentralization, and the respective roles of laws and regulations:

- The constitution should be used to enshrine the broad principles on which decentralization is to operate, including the rights and responsibilities of all levels of

government, the description and role of key institutions at central and local levels, and the basis on which detailed rules may be established or changed.

- One or more laws should define the specific parameters of the intergovernmental fiscal system and the institutional details of the local government structure, including key structures, procedures (including elections), accountabilities, and remedies.
- A series of regulations associated with each law should interpret and detail the practices and measures by which the related law will operate. Laws that deal with tasks that are shared between national and subnational governments should include sections on intergovernmental relations. (Litvack and Seddon, 1999).

In summary, the constitution **should adequately express basic principles and the rules for changing the constitution must be special and limited**, so that the guidelines laid out in the constitution are perceived as stable. The legal framework emanating from the constitution **must be such as to ensure the credibility, accountability and transparency of institutional structures**. While it is preferable to have formal, written rules, “weaknesses in the formal rules can be offset by strengths in the political system” (Burki, Perry, Dillinger 1999, 6). For example, a policy of no fiscal bailouts for subnational governments can be made clear through informal channels, as well as by formal laws or regulations.

### *3.1.b Political and Electoral Systems*

One could seriously question whether more honest and effective governance, and specifically, efficient provision of public goods, is more likely to be **achieved in an autocracy or a democracy**.<sup>1</sup> How decentralization is likely to be affected by the degree of autocracy or democracy in the government is also not clear. Although the experience of Anglo-Saxon countries suggests that in a democratic system there might be greater support for decentralization, with election of local officials, there are plenty of examples of democratically elected central governments that have chosen centralized administration as a mode. Even autocratic central governments may prefer local democracies, which out of their concern for social welfare may preserve incentives. Democracies, too, may not maximize social welfare: in particular, majoritarian democracies may try to maximize the welfare of their majorities. Indeed, one can find among both democracies and autocracies both predatory, inefficient governments and honest, efficient ones.

Also important to the quality of governance in a decentralized setting are the differences among the various political and electoral systems. For example, the distinctions between presidential and parliamentary systems can be critical, since power is not only divided vertically between central and local authorities, but also horizontally among the executive, legislative and judicial branches of government. Stepan and Skach (1993) believe the parliamentary system to be superior for emerging democracies wishing to build strong institutions, because the system lessens the strength of the executive, balancing it, in their view, with the power of the legislature. They present evidence on

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<sup>1</sup> This issue is nicely summarized by Gourevitch (1993). See also Olson (1993), Olson and McGuire (1996), and Lanyi and Lee (1999).



how parliamentarianism leads to a more stable, less fragmented government in which legislative impasses are minimized and military coups are less likely to be supported. In a parliamentary system, regional interests may be better represented on the national level, whereas a strong president may override regional interests. Parliamentary systems, however, depend upon stable coalitions, but fractionalism is common in an electoral system based on proportional representation.

There are a large variety of electoral systems. The most common are first-past-the-post or single-seat systems (US, UK, France) and proportional representation (much of Europe, Latin America), in which the ballot choices consist of party lists rather than individuals. Entry into the government may depend upon a minimum percentage of the vote in this system, usually 1% as in Israel and the Netherlands or 5% as in Germany (de Silva 1998). Proportional representation (PR) systems may help reduce conflict by increasing minority representation, thereby reducing (in some cases) the likelihood of uneven distribution of public goods (Alesina et al 1991, Betancourt and Gleason 1998). A lack of empirical evidence, however, suggests caution on this point. (de Silva 1998).

To increase political participation, it has been suggested that the political system “adopt ward- or neighborhood-based electoral districts, ... adopt open, unblocked electoral systems for local elections, ... and change the timing of subnational elections” so local government elections are not overshadowed by the national (Burki, Perry, Dillinger 1999, 32). Besides regular elections, “local referendums, permanent public-private councils, and other institutional structures are other easily identifiable conditions that may improve the ability of local governments to identify and act on citizen preferences” (Litvack and Seddon, ed., 16). In a more general sense, increasing the number of elected governments in a given territory, and decreasing the links in the bureaucratic hierarchy between citizens and elected officials, should maximize the impact of citizen voice and minimize principal-agent conflicts within the government. (Cooter 1999) In theory, each of these steps should have a positive effect on governance.

Without empirical evidence as to the success or failure of decentralization policies in each system, we cannot assume one will increase the likelihood of a successful decentralization policy over another. We can, however, identify some basic principles. For example, the greater the fragmentation in a government, national or subnational, the greater the difficulty in policymaking. **Coalition governments frequently result in increased fragmentation, and coalitions are more likely to be necessary in proportional representation systems.** As previously stated, PR systems may at times help overcome the fragmentation of a heterogeneous society by increasing minority representation. A greater number of veto points can lead to delays in policymaking, and lack of party discipline is likely to cause difficulties in decision-making; but, a greater number of veto points may signal an effective separation of powers, thereby increasing confidence in the stability of rules (World Bank 1997).

No single type of regime can guarantee economic and social progress. We do know, however, that one kind of regime—the so-called predatory state—can be almost guaranteed to produce economic stagnation. The

focus of such a state is on the extraction of economic rent from the citizenry by those in power. It does so by specifying property rights in a way that maximizes the revenue of the group in power, regardless of the impact on the wealth of the society as a whole (World Bank 1997, 149).

Since the basic advantage of decentralization is that it induces the government to respond to the wishes of the local population, it follows that giving authority to local governments that are not responsible to their local populations may not improve outcomes.

### *3.1.c Unitary vs. Federal Government*

Whether the state is unitary or federal may also influence the performance of decentralization. In regimes with elected legislators, a unitary state vests its lawmaking ability in the national legislature, while a federal state has subnational legislatures as well, which have their own ability to make laws within their jurisdictions. A federal state is not necessarily more decentralized than a unitary government. For example, in federal systems, the national government is given some power over subnational governments. Further, federations have evolved so that their levels of government are interdependent, “making formal, legalistic definitions in terms of division of powers relatively useless,” (Smith 1985, 13). Also, a unitary system can “devolve substantial powers to provincial governments so that a quasi-federal arrangement exists” (Smith 1985, 14). These arrangements are sometimes uniform, sometimes asymmetrical. The Philippines, for example, gave greater regional autonomy to Muslim Mindanao and Cordillera in 1989, while maintaining a fiscally centralized system and a unitary government.

The view has been expressed that in unitary or centralized regimes, government may suffer from a lack of sophisticated means (such as communications infrastructure) of governing large territories, thus resulting in “ineffective, corrupt, or even merely nominal” government (Olson 1987, 91). Such problems, it has been argued, might be lessened if governance functions were fragmented into many smaller units, whether independent or within a larger constitutional framework (Meagher 1999).

### *3.1.d Size of Government*

In addition to the type of political system and the scope of the central government, size of government can also affect the relative performance of centralized and decentralized public goods provision. Large political units and big government tend to pose governance challenges and corruption risks everywhere. First, on the simplistic level, there is evidence that smaller polities suffer less corruption than larger ones; this is shown in Meagher (1999, 14). The same dynamic may well apply to small political and administrative units of all kinds, whether at the national level or otherwise.

Not only is government of a big unit especially subject to failures of cooperation, so is big government. Managing the provision of public goods is complex in the best of circumstances, due to the difficulty of defining incentives and performance criteria for non-market production (Olson 1987, Tirole 1994). When the scope of government responsibilities grows, and the society lacks resources and capacities for resolving major

asymmetries in principal-agent relations, weak governance and high corruption become likely. Yet many developing and transition countries are committed to highly centralized, activist, and organization-intensive approaches to government. Studies indicate that (other things being equal) high public investment in these countries is associated with high corruption, and high corruption in turn is associated with poor quality of basic publicly provided goods and services such as infrastructure, health and education. Poor performance in these areas appears to result from a combination of organizational weakness, direct effects of corruption within these areas, and diversion of funds to more lucrative fields of public investment (Mauro 1995, Tanzi and Davoodi 1998).

### *3.1.e The Role of the Central Government*

A large, active, and centralized public sector increases information asymmetries between public sector principals (e.g. ministers) and agents (e.g. line bureaucrats at central and provincial levels). Combined with frequent monopoly power of agents over their control or distribution points, varying but often wide scopes of discretion built into planning and implementation processes, and the absence or weakness of monitoring mechanisms, this opens up broad avenues for illicit gain by the agents (Rose-Ackerman, 1978, Klitgaard 1998).

On the other hand, some forms of central initiative and coordination are obviously critically important for a well-governed state. Centralized authority may be most effective for income redistribution, defense, foreign policy and other government functions. Central government intervention is also frequently needed to help lower level jurisdictions cope with spillovers, crises, problems of coordination, resource shortfalls, and the like. Additionally, some uniform discipline is needed to sustain cooperative policymaking and governance. In East Asia for example, financial, competition and industrial policy were often successfully managed (notwithstanding the setback of recent years) from a central coordinating point. Deliberation councils in Japan and Korea managed competition among firms for credit and foreign exchange by consensus, thus encouraging cooperation in the business community, including information-sharing and avoidance of rent-seeking that would harm collective interests. It has also been suggested that informal discipline and coordination in systems of corruption contributed to these countries' success by limiting overall extraction, and that therefore a potential peril of decentralization would be the removal of such restraints (World Bank 1993, Campos and Root 1996).

Governments differ as to the type and effectiveness of formal hierarchical discipline they impose. Unitary systems frequently rely on the appointment of central bureaucrats at each level to handle deconcentrated functions and to exercise some form of authority over local elected officials and bureaucrats – referred to variously as liaison, coordination, monitoring, or control. Such authority is usually exercised *ex ante* and includes within its ambit substantive policy decisions. Additionally, unitary systems (some of them nominally federal) provide the center with wide authority to remove the heads of subnational government units. A contrasting model would be a devolved (e.g., federal) system in which subnational units have ample and well-defined powers of policy initiative, and where central authority may be exclusive in some tightly-delimited areas

and concurrent in others. In these systems, actions of subnational governments are often subject only to *post hoc* constitutional and legal review. Removal of governors and lower officials may be tightly constrained or implicit at best.

These different systems have dramatically different implications for governance. The unitary model relies on administrative oversight, i.e., supervision from within the government hierarchy, and tends to dictate substantive results to subnational policymakers. By contrast, the devolved model supports local initiative and elicits information and participation from a range of stakeholders in the legal processes in which the vertical separation of powers is policed. Most systems contain elements of each of these ideal types. The configuration of these elements plays a major role in defining incentives in the system, hence in determining governance outcomes (Meagher 1999).

### 3.2 The Fiscal Dimension of Decentralization

Another important dimension in assessing the extent and efficiency of decentralization is how the **authority to tax and spend is distributed between the central and local government**. This raises a complicated set of issues, because there are several different kinds of taxes and many more kinds of expenditures, and there are many different ways in which jurisdictions can be defined, and tax expenditure assignments divided among jurisdictions.

#### 3.2.a Welfare Analysis of Fiscal Decentralization

One way to model the interaction between sub-national and central governments, where both have real fiscal authority to tax and spend, is as a game played by the two levels of government. At least three recent papers have done so (Dahlby 1996; Dixit and Londregan 1998; and Boadway, Marchand and Vigneault 1998). As is often the case with game theoretic modeling, the results may depend on the order of the moves (whether the central or local government sets tax rates first) and other details that have no clear real-world parallels. Thus, it is difficult to know how useful these metaphors are. However, it does seem that decentralization creates the possibility of coordination problems (see Bardhan and Mookherjee 1999) and can lead to sub-optimal outcomes.

One problem with overlapping tax bases is that the tax rate set by each layer of government creates “vertical externalities” by reducing the tax base of the other layer.<sup>2</sup> Competition between the two layers may lead to tax rates that are too high (the argument is similar to the industrial organization literature on vertically differentiated monopolies, which set prices too high to maximize their joint profits). Besley and Rosen (1998), in fact, find evidence that there is such a vertical externality and U.S. state taxes rise in response to federal tax increases on cigarettes and gasoline.

The devolution of the power to tax can, it seems, create counterproductive vertical externalities. One possible solution is to devolve expenditure authority more seriously

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<sup>2</sup> The more familiar “horizontal externalities” caused by spillovers, tax exporting etc are reviewed in Inman and Rubinfeld 1996. Gordon 1983 is the classic theoretical reference.

than tax authority. This still allows many of the gains from decentralization (lower cost production, etc. as suggested by Loehr and Manasan, 1999; see also Oates 1999) without producing vertical externalities. Nevertheless, some of the arguments for fiscal federalism, like people choosing low tax-low spending jurisdictions over high tax-high spending jurisdictions, involve the devolution of the power to tax and these benefits would be lost if only expenditure responsibilities were devolved.

### 3.2.b *Political and Jurisdictional Aspects of Fiscal Decentralization*

One of the fundamental decisions that must be taken in connection with fiscal decentralization is whether the devolution of tax and expenditure responsibilities to sub-national governments is accompanied by greater political self-determination at the sub-national level. Tax and expenditure policies that are determined and implemented by locally elected officials constitute a very different system from one in which such powers are granted to governors, mayors or other officials who are appointed by the central government, even if that government is democratically elected. **When devolution of fiscal authority is accompanied by devolution of political authority and legitimacy, there is a priori reason to suppose greater citizen participation in local governmental decision-making** (see Section 3.4).

Nevertheless, whether this favorable outcome is in fact achieved depends crucially on jurisdictional design. As already noted, if jurisdictions correspond to ethnic or other self-identified groupings, the ability to cooperate and take collective action is likely to be enhanced (Meagher 1999). However, this outcome depends on the degree of local political participation and self-determination that is permitted. And there is also the problem that closely aligning jurisdictions with factional groupings may discourage healthy inter-jurisdictional competition (to provide the best public services with the lowest tax burden), since citizens are unlikely to move to jurisdictions where they are in a minority. Where physical exit is a live possibility, it may in some circumstances make sense to devolve to sub-communal units. To the extent that people only feel mobile within areas where their communal or language groups have majorities, the presumptive gains from actual or potential mobility would only be reaped if there were several jurisdictions where their ethnic group had a large majority. (For further discussion of the social and economic characteristics of jurisdictions, see Section 3.6).

Finally, **the economically optimum size of a subnational jurisdiction may differ among public services being provided, because of different areas over which a particular public service generates benefits and externalities.** In the United States, to take an extreme example, there are jurisdictions for governance of schools, water, environmental management, and public transportation that do not necessarily coincide with the political units of state, counties, and municipalities (see Oates 1999). There are a range of other considerations, going beyond the scope of this paper, determining the desirable depth (vertical integration) and breadth (range of public services and activities) that should be covered by each level of government. Suffice it to say that the desirable depth of a particular level of government has to do both with the capabilities of a bureaucracy (see Section 3.6)—including its ability to deal with principal-agent problems—and with the ability of citizen voice to be expressed to the top of the chain of command (see Section

3.4), while the desirable breadth of responsibilities tackled at a particular level of government is related both to official capacities and the structure of citizens' preferences for various public goods in a particular locality (Cooter 1999).

### *3.2.c Incentive Effects of Fiscal Decentralization*

As a practical matter in most poor countries, usually the only subnational jurisdictions with a significant tax base are the major municipalities. Thus, **the governance outcomes of decentralization depend in large part on the design of fiscal transfers from the central government.** These take many forms, including discretionary allocations to regions or parliamentary constituencies; block, conditional, and matching grants; assigning shares of taxes collected by the central government; and funded central mandates.

This variety of forms brings with it an equally wide array of incentive effects. **Discretionary transfers** frequently depend on the party loyalty of lower-level officials, and therefore tend to strengthen the **patronage networks of national political structures,** besides opening up opportunities for bribery and nepotism. Depending on their design, matching **grants and tax revenue assignments** may spur fiscal effort at subnational levels, but in doing so produce asymmetrical results that may be viewed as inequitable. Many grants and mandates arise from centrally-determined policy priorities. Thus, they help advance these priorities in a coordinated fashion across the country, but sometimes at the cost of distorting the political and fiscal initiatives of regions and localities that may have divergent priorities. Perhaps most important is the potential for soft budgets and moral hazard created by transfer systems that do not make revenue-matching or other conditions part of their formulae. Ill-designed transfers, like the two-tier tax "game" cited above, and a politicized system of development banks, can end up underwriting inertia, waste, and corruption (Litvack et al. 1998, Meagher and Korsun 1997).

## **3.3 Transparency of Government Actions**

Access to information on the actions and performance of government is critical for the promotion of government accountability. Unless the public knows what goods and services are provided by the government, how well they are provided, who the beneficiaries are, and how much they cost, it can not demand effective government. Also, the central government needs to be able to monitor the performance of subnational governments, and there are good reasons for the latter to be fully informed about the actions of the central government.

Access to information complements mechanisms for citizen participation in service delivery discussed in section 3.4. Meaningful and effective participation, though itself increasing information flows, requires informed citizens. Participation then provides an avenue for the public to react to the information received and influence government actions. Access to information, by allowing the public to monitor government's subsequent actions, also enhances the impact of participation by creating a pressure on the government to take into account citizen preferences in decision-making.

Of particular importance is access to fiscal information of governments.

### *3.3.a Fiscal and Administrative Transparency*

The central government needs to be able to monitor subnational governments and thus needs information on their budgets and expenditures, as well as on outputs and outcomes of these policies on a regular and uniform basis. The systematic collection, analysis, and reporting of fiscal information can be used to verify compliance with policy goals and to guide future decisions. Such monitoring can also help restrain uncoordinated subnational fiscal policies and avoid planning and expenditure overlaps that create opportunities for misappropriation.

To promote overall government accountability, government budgets and expenditure programs need to be disclosed also to the public—that is, to recognize their right to know how tax revenues are spent. Many decentralizing countries, however, have weak or inadequate mechanisms for citizens to monitor actions of subnational governments. In some cases, the monitoring task is further complicated by broadly applied official secrets acts.

Another mechanism that potentially promotes transparency and thereby accountability is the periodic public sector audit. However, despite the utility of this mechanism in the best-governed countries, in most parts of the world, making audits a useful tool of good governance is a tall order. Common practices include exclusively paper audits (i.e. without spot-checks to verify audit information), the lack of any sanction for late submission of accounts, and the prohibition of any release of audit information to the public. As a result, audits have in several countries become yet another control point attracting bribes and favors, and audit findings are routinely buried. The existence in audit systems of physical audit (spot check) requirements, sanctions for late submission or manipulation, and especially the requirement of making audit reports available to the public or at least to an independent body capable of following up any problems, is critical for restraining corruption.

Government contracting and procurement procedures play a major role in public service provision, and also account for a significant share of resource leakage and corruption. The provision of goods, services, and infrastructure to regions and communities at a distance from the capital poses special problems of information and monitoring. These challenges include the potential for bid-rigging and collusion, manipulation of engineering specifications, over-invoicing or undersupply of materials and output, the exploitation of planning overlaps, and the wholesale diversion of centrally-budgeted funds. Administrative oversight and audit can help to restrain corruption in this area, but are frequently weak or compromised. Detailed release of information to parliamentary committees and the general public is a necessary condition for integrity here.

The effect of such information depends crucially on the incentives and capacity of the public (e.g. communities and watchdog groups) to understand this information and to police governmental activity on that basis. These, in turn, are shaped by the role of user

communities in designing and contributing to any given public works projects, as will be discussed in Section 3.4. There is also reason to believe that the socioeconomic composition of such communities and jurisdictions is an important determinant of the quality and efficacy of public participation, which will be addressed in more detail below in Section 3.5.

### *3.3.b The Role of the Media*

The media—both print and broadcast—can act as an important external promoter of government transparency and accountability by disseminating information about government actions. It can serve the public by monitoring and investigating the actions of public agents. The presumption is that the risk of public exposure and humiliation through the media is likely to curb politicians and civil servants' temptation to abuse their positions for private gain.

How effectively the media do this job depends on the degree to which they are independent, hence free from control and the threat of retaliation by government and other powerful stakeholders. Media independence needs to be reflected both in ownership and management. In many countries, the government is the largest media owner, which greatly undermines the independence of the media. Also, the media are sometimes part of the political patronage system, which means that editors and journalists are selected not based on merit but on political grounds. The independence of the media is particularly problematic in developing countries, where there is often very little advertising money to support the media. As a consequence, the media in these countries are often underfunded and dependent on government funding.

Laws and regulations, such as freedom of information laws, also influence the independence of the media (Vogl 1999). These laws curb the ability of politicians to subjectively determine what information to provide to the public. Citizens are given the legal right of access to government documents without having to first prove special interest, and the burden of justifying non-disclosure falls on the government. However, only a few countries have legal systems that actually guarantee freedom of the press. Constitutions and laws generally uphold the notion of a free press, but also often include constraints in the form of what are often described as reasonable limits on grounds of national security or individual privacy.

The effectiveness of the media also depends on the existence of meaningful competition. Unfortunately, meaningful competition is often lacking. Even in many US cities and towns, a single daily newspaper may have a monopoly (Vogl 1999). The monopoly position of a paper is likely to diminish the interest of editors to investigate local politicians and businessmen. And in many regions in developing countries, there may be no local media at all.

## **3.4 Citizen Participation in Public Services Delivery**

The argument that decentralization improves resource allocation, accountability, and cost recovery relies heavily on the assumption that subnational governments have



better information than the central government about the needs and preferences of the local population, and that the population is more aware of actions of subnational governments than of the central government. Subnational governments, however, do not automatically have better information about user preferences than the central government. The sheer physical proximity to constituents does not ensure that subnational governments have the needed information unless they make an effort to elicit it. Similarly, the local population is not necessarily aware of the activities of subnational governments.

Whether subnational governments have information about the preferences of citizens depends critically on the existence of mechanisms for the local population to participate in the delivery of public services and have their voice heard in decision-making.<sup>3</sup> Citizen participation in service delivery facilitates information flows between the government and local population and thereby reduces asymmetric information. It provides means for demand revelation and helps the government to match the allocation of resources to user preferences.

Citizen participation in service delivery also can promote government accountability by increasing citizens' awareness of actions of and control over subnational governments. For example, Fiszbein (1997) found that community participation increased demands for effective local governments and forced government accountability in Colombia. Participation made local authorities more accountable to citizens by increasing the political costs of inefficient and inadequate public decisions. As a result, local governments started changing their personnel to make them more effective. Putnam's (1993) study of Italian regional governments also found that governments that were more open to constituent pressure managed and delivered services more efficiently.

#### *3.4.a Mechanisms*

Mechanisms available for users to participate in service delivery and express their preferences for public policies can be divided in two categories: voice and exit (Hirschman 1970).

##### *A. Voice*

The extent of voice users have about service delivery depends on decision-making processes that citizens are allowed to use. Governments can establish several mechanisms through which the local population can participate and express in a systematic way their preferences and perceived problems with public service delivery. Participation through these mechanisms can take many forms: voicing demand and perceived problems with delivery; making choices; or being involved in projects and service management. These mechanisms include the following:

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<sup>3</sup> It is important to recognize that decentralization can itself increase the opportunities for citizen participation (Litvack and Seddon 1999).

**Elections.** Regular local elections are the most common channels for citizens at large to convey their preferences for local public policy. However, promises made during the election campaigns are not always kept in practice. Indeed, Inman and Rubinfeld (1996) show that electoral competition alone is unlikely to produce efficiency. Also, in many countries local governments are not elected. Therefore, it is important to have other channels to obtain citizen input.

**Surveys.** Surveys are another tool that subnational governments can use for refining service delivery. Simple surveys of local population that are carried out on a regular basis can be used to assess citizens' satisfaction with government programs and to identify the needs and preferences of constituents. For example, in Colombia local governments have used surveys successfully to gauge local preferences and reshape political programs (Fiszbein 1997). Twice a year they ask the communities to evaluate the current administration's performance with special emphasis on works done during the period, and then to list and rank works and programs that the next administration should take. Also, in the Indian state of Bangalore, surveys have been used with promising results to evaluate user satisfaction with services and identify areas that need improvement (Paul 1994). Based on survey results, "report cards" have been produced for different public agencies and agencies ranked according to their service performance.

**Town meetings/public hearings/hotlines.** Preferences of citizens can also be conveyed through town meetings, public hearings, or hotlines, where people have an opportunity to provide feedback on local policies. Some projects have instituted this type of participation through a combination of community planning and project-identification, open project books or placards with all relevant project and cost information displayed, and public or community audits in which all works progress and wage payments are publicly verified.

**Legal recourse.** In some systems, citizen input may take the form of constitutional, administrative, or civil lawsuits against government agencies. This depends on the existence of a right, an entitlement, or a procedural standard that has been breached, as well as the provision of a remedy at law. Alternatives to this include actions against private parties who have gained unfair competitive advantage through government, e.g. bid protests and private anti-monopoly actions, and the legal protection of "whistleblowers." In many developing and transition countries, such legal recourse is either formally excluded or more theoretical than real, although it is not uncommon in the more robust legal cultures of, for example, India and South Africa.

**Ombudsman office.** When things go wrong, grievances arise, and complaints about government bureaucracy fall on deaf ears, citizens in many countries turn to the Ombudsman. The Ombudsman, independently of the government, receives and investigates allegations of maladministration. Citizens can contact the Ombudsman directly—there is no need to involve lawyers—and the process is free. The Ombudsman system has proven to be adaptable and has worked well in both developed and developing countries (Transparency International 1999).

**Local referenda.** A local referendum is another way to elicit information about citizen preferences regarding specific public services and to involve citizens in decision-making. In a referendum a proposed measure is submitted to popular vote. For example, in the cantons of Switzerland, local referenda are frequently held on a number of issues, including the setting of a tax rate (Feld 1997). Also, in many US states, the bulk of spending on public primary and secondary education is subject to a referendum (Romer, Rosenthal, Munley 1992). Involving citizens in decision-making this way gives them a perception of higher procedural fairness and often increases their loyalty towards their representatives in the local government. Obviously, the use of local referenda is not always feasible. Their organization requires administrative and managerial capabilities that are often in short supply in subnational governments in developing countries. Also, their feasibility depends on the prevailing political and legal system.

**Direct community involvement in service delivery.** Citizens can also have their voice heard through direct participation in service delivery. They may participate in the implementation of specific projects by contributing to the design, construction and/or operation and maintenance of services. In other words, government and communities may coproduce the services.<sup>4</sup>

Failure of governments alone to provide adequate levels of services has in the past decade led to the adoption of a community-based approach to the delivery of some local services, in particular rural infrastructure services such as village water and irrigation. This approach typically relies on coproduction of services by the government and users, and adopts a demand-responsive focus on what users want and what they can afford. In projects following the community-based approach, users typically participate in service design and manage the service as a group. Indeed, the evidence on the rural water sector indicates that water systems provided by projects that followed the community-based approach have, on average, performed better than systems built and managed by government alone (Narayan 1995; Sara and Katz 1998; Isham and Kähkönen 1999a,b).<sup>5</sup>

**Demonstrations.** Finally, people can also express their discontent with public policies through demonstrations and strikes. Isham, Kaufman, and Pritchett (1997) find that civil unrest—frequency of demonstrations, strikes, and riots—are positively associated with government performance. Civil unrest, according to the authors, is an indicator of an environment in which mechanisms for voicing dissatisfaction with government performance are available.

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<sup>4</sup> For further discussion and theoretical underpinnings of coproduction, see Isham and Kähkönen (1998).

<sup>5</sup> The community-based approach is argued to have three benefits: it provides means to better tailor the services to users' needs and preferences by involving users in service design; it enables the use of local resources (such as labor and materials) by involving users in construction and service management, thereby alleviating fiscal pressures on government; and it increases transparency and accountability in resource use by increasing the flow of information and interaction between users and government (Korten 1986, Isham and Kähkönen 1998).

## *B. Exit*

When voice mechanisms either do not exist or have proven ineffective and the service provided is unsatisfactory, citizens have in principle the option to “exit”—that is, to stop using the service. Citizens can exercise this option by either switching to alternative service providers within the same jurisdiction or by moving to another jurisdiction.

Whether citizens can exit by simply switching the service provider in the same jurisdiction depends on the existence of alternative suppliers (Hirschman 1970, Paul 1992). The existence of alternative suppliers, in turn, depends, among other things, on the nature of the service.<sup>6</sup> If the service in question is a toll or private good, alternative suppliers in the private sector or civil society are often available and exiting by switching the service provider within the jurisdiction is possible.<sup>7</sup> Examples of these types of services are curative health services, many education services, and potable water. For example, in Uganda, due to inefficiencies in public health clinics, people tend to rely on the private sector for primary health care (Ablo and Reinikka 1998). By contrast, in the case of pure public goods, such as law and order, the government is typically the sole service provider. Thus, exiting by switching the service provider is not commonly feasible. Moving to another jurisdiction is often the only remedy.

Citizens can also exercise the exit option by moving to another jurisdiction, as suggested by Tiebout (1956). Of course, this presumes that government policies vary across jurisdictions so that moving makes people better off. Further, the feasibility of this option depends on the mobility of labor and capital, as will be discussed later in the paper.

### *3.4.b Access*

The impact of decentralization on service delivery hinges not only on the existence of mechanisms for user participation but, perhaps even more crucially, on who has access to those mechanisms and whose voice eventually influences decisions. This determines whose interests government will eventually serve.

If participation in service delivery is not broad-based—in a sense that all intended beneficiaries of specific services have a voice—groups with narrow interests may capture the resources. Usually, it is the local elite with established ties that has the voice and bargaining power. As Schönwalder (1997, 754) has written:

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<sup>6</sup> The economic, legal and regulatory environment also influences the existence of alternative suppliers—private sector firms or civil society organizations. For example, there may be legal barriers to entry in the private sector or to recognition of non-governmental organizations.

<sup>7</sup> Based on the presence or absence of rivalry and excludability, goods and services can be classified into four categories: private, public, toll, and common pool goods. Both toll and private goods exhibit high excludability: that is, it is easy to exclude non-payers from their consumption and they can be provided by markets. But private goods, unlike toll goods, are rival: the use of the good or service by one person reduces its availability to others. See Ostrom, Gardner, and Walker (1994) and Picciotto (1997) for more detailed discussion.

...even decentralization initiatives that are in fact designed to devolve power to regional and local governments can have unintended effects, in the sense that they strengthen traditional local elites who have no interest in furthering the participation of the poor. Thus, decentralization may lead to a decrease in the political clout of the lower strata. Local elites, local governments and other actors operating on the local scene, such as political parties and even some NGOs, have often been prone to co-opt popular movements in order to further their own agendas...

How common and broad-based the participation is depends partly on the effectiveness of civil society and on certain aspects of the social structure within the jurisdiction. Also, to what extent subnational governments take into account user preferences is influenced by these factors. Sections 3.5 and 3.6 will discuss how the civil society and social structure influence citizen participation and public service delivery.

### **3.5 Civil Society and Social Structure**

The extent and impact of citizen participation on public service delivery depend partly on the effectiveness of civil society and on certain aspects of the social structure. Civil society encompasses non-governmental and non-profit organizations such as civic groups and associations, cooperatives, and user groups. Aspects of the social structure that matter include the extent of social and economic heterogeneity of the population, trust among different groups of people, and cultural norms and traditions that affect relations among people and cohesiveness of the society.<sup>8</sup>

#### *3.5.a Civil Society*

The existence and effectiveness of civil society matters, because NGOs, user associations, and other civic groups may not only help to coordinate citizens' actions and get their voice heard in the government, but they may also **act as checks on government actions and enforce leaders' compliance with the wishes of citizens.** Active civil society can influence electoral processes and outcomes directly, or complement local administration in the search for more responsive and effective governance. It may thus guide the direction of resource allocation and help push for the accountability by creating external pressure on the government. In fact, Putnam (1993a) demonstrates that the Italian regions in which the public actively participates in civic activities are also the regions in which local governments exhibit higher performance, for example, with respect to the delivery of public services.

Active civil society can, however, be a mixed blessing. Olson (1982), for example, emphasizes that the existence of a large number of civic groups can also have a negative impact on the economy, because these groups often have a tendency to engage in growth-impairing rent-seeking. These groups are seen to have an incentive to engage in costly and inefficient rent-seeking—that is, lobbying for tax breaks, colluding to

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<sup>8</sup> This is also commonly referred to as social capital. There are several definitions and interpretations of social capital in the literature. See for example, Putnam (1993b), Coleman (1988), and Grootaert (1998).

restrain competition, etc—that benefits the group, but they lack incentives to provide productive public services that would benefit everybody in the jurisdiction.

Who has a voice in the decision-making—that is, in whose direction resource allocation gets adjusted—and how well in unison different civic groups act to promote accountability depends, among other things, on certain aspects of the social structure. Specifically, it depends on jurisdictional cohesion influenced by social and economic heterogeneity, trust among people, and tradition of working together. Homogeneity of the population is argued to influence collective action by increasing the number of social ties and norms that people can draw upon in building cooperation. However, these same social phenomena may present obstacles to cooperation where group identity is strong and the population encompassed by a government unit is diverse. In this situation generally, the more socially or economically heterogeneous the population is, the less likely it is to organize for collective action. Heterogeneity is seen to increase the potential factionalism within the population, which can be manifested in disputes and conflicts or in one faction's dominance.

### *3.5.b Social Heterogeneity of the Population*

Social heterogeneity of the population with respect to ethnicity, language, and religion has the potential to reduce the efficiency of resource allocation and public service delivery.<sup>9</sup> Two reasons have been adduced for these detrimental effects.

First, it has been argued that **ethnic heterogeneity may increase rent-seeking and reduces the incentive to spend on productive public services**. This argument builds on the assumption that different ethnic groups are exclusive, competing with one another, and primarily interested in furthering the welfare of their own group members, as postulated by Olson (1982). In fact, the ethnic group in power has been argued to limit the spending on public goods to prevent those outside the ruling group from also benefiting and getting stronger.

There is some empirical evidence to support this argument. Alesina, Baqir, and Easterly (1999), for example, analyzed the effects of ethnic diversity on public service delivery of city governments in the United States. They found that ethnic diversity in American cities reduces the performance of a city government in delivering a range of productive public services. La Porta et al. (1999), in turn, studied the impact of linguistic heterogeneity on government performance with a cross-country data set, and found that ethnolinguistic fractionalization is negatively associated with the provision of public goods. Their results indicate that in countries that are linguistically diverse, infant mortality rates and illiteracy are likely to be higher, and school attainment and infrastructure quality are likely to be lower. Betancourt and Gleason (1999) find that

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<sup>9</sup> See, for example, Meagher (1999). Social heterogeneity, in particular, ethnic heterogeneity has also been argued to hinder economic growth. Using a cross-country data set, Easterly and Levine (1998) found that ethnic diversity is correlated with slow economic growth. Collier (1998) showed that ethnic diversity is not necessarily associated with slow growth but the impact depends on the prevailing political system. His results suggest that only if political rights are lacking is ethnic heterogeneity associated with slow economic growth.

Indian districts with a higher proportion of Muslims and lower caste Hindus received lesser public services (measures by teachers, doctors and nurses per capita).

Second, social heterogeneity has been argued to make it **more difficult for people to work together and therefore for the political process to arrive at cooperative solutions to problems.** People with different ethnic or cultural backgrounds may sometimes have difficulties communicating with one another or acting collectively. As Denzau and North (1993) point out, since people have limited cognitive abilities, they adopt a variety of conceptual orientations to make sense of the world. These include values, norms, experiences and perceptions of the world that have been taught and ingrained in a community where one has grown up. Hence, people that have grown up in different communities may have different values, norms, and perceptions of the world that may in some cases hinder communication and collective action among them. This may make collective efforts to enforce government accountability difficult, as well as increase chances that the voice of some sections of the population will not be heard.

There are two important caveats to these arguments. First, the impact of social heterogeneity on public service delivery may depend on the prevailing political environment. For example, as Zucker and Darby (1999) point out, La Porta's et al. results about ethnolinguistic differences need to be treated with caution since countries differ in the degree to which language is allowed to enter into the governmental arena. This implies that it is critically important to study the impact of social heterogeneity in the context of the prevailing political system.<sup>10</sup>

Second, social diversity does not automatically mean that different social groups have narrow interests—that is, people do not necessarily identify themselves only with ethnicity, religion, or language. People are often members of more than one network (that is, clubs, associations, community and user groups) and membership in different networks may be overlapping across different social groups. Networks of civic engagement that cut across social cleavages nourish wider cooperation and tend to diminish conflict among different social groups. By contrast, non-overlapping social networks result in unequal opportunity to participate. This means that when assessing the impact of social heterogeneity on public service delivery, it is critical to pay attention to other networks and groups in the society and to the social heterogeneity of their membership. As Putnam (1993b) has shown, membership in horizontally-ordered groups may be positively associated with good government.

One interpretation of the effects of social heterogeneity and civil society on governance is that these social phenomena play a potentially important role in defining legitimacy. For example, if a nation-state or other jurisdiction is regarded as legitimate because of the shared history of its people or its long-standing cultural prestige, and if heterogeneous preferences and identities can be freely expressed and discussed, the extent of social heterogeneity may be relatively unimportant. In such a situation, it is possible that status groups based on ethnicity, clan, language, or religion would have

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<sup>10</sup> For example, Collier (1998) studied the impact of ethnic diversity on economic growth controlling for the political system.

relatively minor importance in the political arena. Diverse horizontal groups based on shared civic views and interests would then tend to be relatively more important in articulating interests and interacting with government.

By contrast, in states that are new, unstable, and/or repressive, the government's legitimacy is expected to be relatively low, and status-based groupings would tend to be more important (Meagher 1999). In other words, in such a situation, status group identity may fill a void of legitimacy and serve as a primary mechanism for mobilizing cooperative effort among members. The outcomes of social structure, it could be argued, are not simply a function of social heterogeneity alone, but reflect the *comparative legitimacy* of the state, of horizontal associations, and of status groups. Fractionalization and fragmentation, which appear to be associated with weak governance, mean that status identity takes precedence over loyalty to the political unit and interest affiliation as a principle of legitimacy and mobilization—as a result of prior history, racial antagonism, a failed or failing state, or some combination. Thus, both heterogeneity and relative legitimacy need to be taken into account in designing subnational jurisdictions (in principle, nation-states as well).

### 3.5.c *Economic Heterogeneity of the Population*

Economic heterogeneity of the local population with respect to income may also distort resource allocation and reduce the efficiency of public service delivery. Different economic groups are likely to have varying bargaining power and thus varying opportunities for participation. **Wealthier people are often better connected and can use their money and influence to steer the public policy and resource allocation.** The phenomenon of elite capture is well known in many countries (Schönwalder 1997, Tendler 1997). This behavior has a parallel among the “have nots,” who are sometimes able to lobby for special benefits such as contractual set-asides, or to create patronage networks that, for example, exchange votes in local elections for public employment and other favors that help improve the prospects of the lower class. In either case, economic status or class becomes an organizing principle and potentially a polarizing factor, frequently with detrimental effect on governance. Such effects are magnified when social and economic differences are correlated—e.g., when a particular ethnic group tends to be poorer than the others.

### 3.5.d *Trust*

The prevalence of trust among the local population, and between citizens and government has also been argued to influence public service delivery. Arrow (1972, 357), among others, has emphasized the importance of trust for economic activities as follows: “Virtually every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time. It can be plausibly argued that much of the economic backwardness in the world can be explained by the lack of mutual confidence.”

Trust has been argued to affect service delivery by decreasing the cost of acting collectively and, thereby, facilitating cooperation and collective action. Specifically, the



existence of trust between strangers has been claimed to be beneficial for economic performance (Fukuyama 1995, Knack 1999). The greater the level of trust between strangers, the greater the likelihood of cooperation within and across different social and economic groups has been said to be. Also, government bureaucrats have to cooperate on a daily basis with a large number of other bureaucrats and citizens. Trust can support this cooperation.

La Porta et al (1997) and Knack and Keefer (1997) provide empirical support for the view that trust is associated with government performance. Both papers use cross-country trust data from the World Values Survey. La Porta et al find the effects of trust on government performance, as measured by efficiency of the judiciary, corruption, bureaucratic quality, tax compliance, and civic participation, to be both statistically significant and quantitatively large. They also find that societies with high levels of trust have lower infant mortality rates, controlling for income. Knack and Keefer (1997) also conclude that trust is associated with confidence in governmental institutions.

As both Putnam (1993) and Fukuyama (1995) point out, trust depends on patterns of shared history and social identity. Hierarchical, familistic, and ethnically-riven societies tend to constrain the scope of trust to arenas that are much smaller than the political unit. Societies that are (or have traditionally been) relatively homogeneous (e.g. Germany, Japan) and those where social identity is shaped much more by civic association and economic interaction than status (e.g. the U.S., Northern Italy) tend to have relatively extensive trust. Trust, as analyzed by these authors, is the basis for successful cooperation, hence of effective governance.

### 3.5.e *Cultural Norms and Traditions*

Cultural norms and traditions may also affect the public service delivery and participation therein. Citizen participation is likely to be easier to organize and be accepted by the government, if it builds on a tradition of civic involvement in public policy. Also, cultural norms influence the effectiveness of citizen cooperation. For example, in Pakistan the cultural concept of *izzat*, which means honor, can in some instances hinder cooperation. One can acquire *izzat* only at someone else's expense, which implies that the success of one person is a threat to all others (Merrey and Wolf 1986). Merrey and Wolf (1986, 39) describe how this concept of honor has hurt the performance of some irrigation systems:

Men oppose or support decisions and programs based on their perceptions of their competitors' position. For example, even though all farmers suffered the exactions of a corrupt tubewell operator, they did nothing because, informants explained, if one man or group proposed petitioning his removal, others would oppose. This would be done not out of love for the tubewell operator but to prevent others from gaining some advantage from the issue or to pursue some long-standing grudge.

In this case, a norm that is detrimental to cooperation has become dominant. Other obvious examples are sexism and other forms of discrimination, and uncontrolled crime

and corruption. Social scientists and game theorists have attempted to model and explain the emergence of unpopular or dysfunctional norms as equilibrium outcomes. Theoretically, an exogenous shock or a hard core of dissent can render this equilibrium unstable (Bicchieri 1997, Huang and Wu 1994). In practice, this seems to suggest a strategy combining a rapid change in the rules of the game with the slow process of education and social evolution.

### **3.6 Capacity of Subnational Governments**

Subnational governments may have the political authority and access to financial resources, but unless they have the capacity to do the work, decentralization is unlikely to produce desired results. Inadequate capacity is often used as a counterargument in proposals for decentralization. Capacity refers to the ability, competency, and efficiency of subnational governments to plan, implement, manage, and evaluate policies, strategies, or programs designed to impact on social conditions in the jurisdiction (Shafritz 1986).

Following Fiszbein (1997), three key factors influence government capacity: human capital, physical capital, and incentive structures within government. Each of these factors will be discussed in more detail next.

#### *3.6.a Human Capital*

The quality of civil servants is the key dimension of capacity. Their quality is a function of their skills and knowledge, and the way these skills and knowledge are utilized within the government. Skills and knowledge are commonly measured by the level of education, training, and on-the-job experience. Aspects of the internal structure of the government that influence how well these skills are utilized will be discussed below.

According to Uphoff (1997), there are four general skill areas where subnational governments need to demonstrate capability: identification and analysis of local problems in order to plan appropriate responses; mobilization and management of resources; communication and coordination of policy implementation; and resolution of local conflicts. While subnational governments may possess some of these skills, they may lack the others. For example, they may have the needed information to assess local problems but they may not have the skills and knowledge to manage large projects and budgets or to coordinate policy implementation. This can be the case particularly in developing countries, where managerial capacity is often in short supply.

There is a concern that decentralization will lead to unequal distribution of skilled staff across subnational governments, in particular if subnational governments are allowed to do their own hiring. Variations in living conditions across jurisdictions has been argued to lead to a skewed distribution of human resources, as the best civil servants choose to live in the more developed areas. Therefore, according to some advocates, if skills are lacking at the local level, a unitary hiring system might be preferred to ensure that the necessary skills are present locally in all regions.

Since decentralization itself has been argued to build local capacity and skills, some people also claim that the initial level of skills and knowledge is not that critical for the success of decentralization. As Litvack and Seddon (1999, 47) state: “there is a growing appreciation that ‘management is a performance art’ better learned by doing than by listening.” However, there does not seem to be any rigorous evidence on this point.

### *3.6.b Physical Capital*

Even a high quality staff, however, is ineffective if it does not have access to the necessary equipment and **technology to carry out its work**. In particular, in developing countries phone lines may be inadequate, thereby hindering communication and coordination of government activities. The government may also lack transport equipment to visit the far-flung corners of the jurisdiction. Further, due to the lack of computers and proper computer systems, records may be kept manually, which is not only inefficient but also makes the records prone to tampering.<sup>11</sup>

### *3.6.c Incentive Structures*

In addition to infrastructure, the government needs to provide its staff with appropriate incentives to carry out their tasks competently and efficiently. Skills, knowledge, and access to equipment and technology alone do not ensure that the work gets done. How policies get implemented—and whether they get implemented as designed—depends on rules that govern the implementation process and behavior of civil servants.

Decentralization is closely related to the ability to provide incentives, because giving authority to a local official over local resource allocation allows the official to affect outcomes on the basis of which she can be rewarded. If a large team of officials at a central ministry is responsible for outcomes, then it is very difficult to design effective incentive schemes.

Civil servants, in many instances, have substantial discretion in the implementation of government programs. Often the reason for this is that it is difficult to fully account in advance for all contingencies, and thus some flexibility is needed in implementation.

As a result, however, moral hazard problems may arise, in particular, if the government and its staff have different objectives. The laxity of rules allows other factors, such as personal interests and the time horizon of civil servants, as well as civil servants’ relations with various interest groups, to influence policy implementation. In addition, some civil servants may simply be lazy and look for opportunities to shirk. As Frederick Taylor (1929), the father of scientific management, has written: “hardly a competent worker can be found who does not devote a considerable amount of time to studying just how slowly he can work and still convince the employer that he is going at

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<sup>11</sup> For example, Mookherjee and Das-Gupta (1999) discuss how computerization can increase the efficiency of tax administration and decrease tax evasion by making records more tamper-proof.

a good pace.” This represents a classical principal-agent situation where the agent and principal have differing individual objectives and the principal cannot easily determine whether the agent’s reports and actions are in line with the principal’s objectives or are self-interested misbehavior (Milgrom and Roberts 1992).

To limit these problems, the government needs to constrain the scope for individual discretion and make sure that there are mechanisms to monitor the actions and performance of civil servants (Milgrom and Roberts 1992). The aim of these mechanisms is to reduce informational asymmetries between the principal and agent that are a fundamental component of moral hazard. These mechanisms may be internal to the government—involving supervision, and periodic internal checks and reviews to control the actions of civil servants—or external. As discussed above, public disclosure of government budgets, expenditure programs, and procurement, as well as promoting citizen participation in public service delivery, permit external monitoring of government actions and performance by the local population. These external mechanisms can promote efficiency and accountability on the part of civil servants.

Further, there need to be clear rules about sanctions against misconduct and these rules need to be impartially implemented and enforced. If the sanctions are severe enough—that is, if the risk of sanctions outweighs the expected benefits from misconduct—they are likely to deter misbehavior. Penalties should vary according to the severity of the misconduct, and the loss of a job should be one of the options (Becker 1968). For example, systems where incompetent government workers can not be fired are unlikely to further the competence of the civil service, although obviously such firing must be subject to due process to avoid the emergence of political patronage.

Rules about promotion within the civil service also influence the effort expended by civil servants on the job. In many countries, promotions are granted on the basis of seniority. This may minimize discord among civil servants, but seniority is not necessarily the best indicator of a person’s productivity and competence (Rosenbloom 1986), and linking promotions to seniority provides little incentive for working hard and being accountable. By contrast, a system where promotions are based on merit is likely to enhance competence of the civil service by providing incentives for civil servants to improve their skills and do their jobs diligently and honestly.

To the extent that pay is a motivator—and typically it is an important one—governments need to seek to establish a clear link between an employee’s performance rating and his or her level of pay. In many developing countries, low civil service salaries are blamed for government inefficiencies. It has been argued that because government salaries are not adequate, civil servants need to resort to shirking and corruption to make ends meet. For example, according to Stevens (1994), a dramatic decline in real pay levels of government workers has partly led to corruption and low civil service productivity in Tanzania.

One option is to use incentive contracts that pay for output performance (Salanie 1998) or provide rewards for specific actions (Klitgaard 1988). However, outputs are

often difficult to quantify in the public sector. Also, there is a concern that performance pay schemes introduce an element of political control over a career civil servant, or provide an opportunity for favoritism. For example, project designs sometimes include pay supplements for civil servants charged with implementation, which can lead to bureaucratic competition for responsibility, inappropriate assignment of the project, and expectations of additional, sometimes illicit, benefits by the line bureaucrats. If monetary incentives are not feasible or appropriate, non-monetary incentives can be tried. These include challenging tasks, influential assignments, and public recognition.

The method of selecting civil servants also influences the competency of the civil service. Requiring a majority of civil servants to be selected through open, competitive examinations constrains the potential numbers of patronage appointments (Rosenbloom 1986). Selection through competitive examinations also has administrative logic, to the extent that the examination scores predict on-the-job-performance.

Finally, the government also needs to pay attention to the internal mobility of the staff. Long postings in the same place allow civil servants to develop corrupt relationships with clients. Rotation of staff may inhibit the development of these kinds of arrangements (Klitgaard 1988). Nevertheless, the rotation of central government staff in deconcentrated ministries also serves to retain their loyalty to the national-level administration and sometimes the national political party structure. Decentralization, to the extent it devolves such functions to autonomous subnational governments, can obviate such problems of over-centralization but it makes staff rotation for any reason more difficult.

Which way is decentralization likely to cut on all these issues? Depending on the institutional arrangements, it may improve incentives by reducing information asymmetries and the resultant potential for moral hazard, abuse, and corruption. On the other hand, unless careful attention is paid to the fiscal resources of subnational governments, which does not appear to be the case normally, human and physical capital constraints may become more severe with decentralization. The long-run hope is that improved governance, more rapid economic growth, and increased revenues at the subnational levels will more than offset the short-term problems. Once again, this prospect depends critically on the details of institutional design.

### **3.7 Other Factors**

Finally, a host of other factors are likely to influence the impact of decentralization. These include the quality of labor and land markets. The Tiebout (1956) argument that decentralization promotes resource allocation assumes that the mobility of labor is costless and responsive only to fiscal conditions. Hence, it assumes away a number of frictions such as imperfect information, moving costs, and land-use restrictions.

In practice, there are restrictions to the mobility of labor. Moving has a cost and in some countries there are also other restrictions on labor movements. Further, land markets are imperfect in many countries. There are zoning restrictions and other

regulations that hinder mobility (White 1975, Mills 1979, Epple and Zelenitz 1981). The land market imperfections are particularly relevant in economies dominated by agriculture. In addition to fiscal considerations, other factors such as the location of employment and family status influence the decision to move (Oates 1968).

One could also cite other factors, among them the average level of education of the local population. One could argue that the higher the level of education, the more actively people follow and participate in public policy since they are more likely to be aware of their rights and more vigilant of abuses of public trust. In addition, the level of initial natural resource endowments is likely to matter. Finally, the length of experience with decentralization is likely to influence the impact. Some of the effects of decentralization may take a long time to appear.

## 4 Conclusions

Decentralization is not a panacea. It has its advantages and disadvantages. The overall **impact** of decentralization on service delivery **depends critically on its design and prevailing institutional arrangements.**

This paper has reviewed the literature on factors that are likely to influence whether decentralization improves the efficiency of resource allocation, promotes cost recovery and accountability, and reduces corruption in public services. The literature suggests that **decentralization may work best, indeed may only be meaningful, if there is a local democracy; local democracy may work best in socially and economically homogeneous communities; and the devolution of the power to tax can create vertical externalities in terms of tax rates that are too high.** The most sensible form of decentralization may therefore be to create local democratic governments, match jurisdictional design to communal lines, and to primarily devolve expenditures rather than taxes (using transparent and formula-driven fiscal transfers). The review raises the question: what is the relative importance of these factors and what do they imply for the design of decentralized governance structures?

To assess the relative importance of various factors for the performance of decentralized service delivery and to identify what type of decentralization works and what does not in particular institutional settings, empirical work needs to be carried out. Data need to be collected from countries that have experimented with decentralization, and hypotheses need to be tested. That is the purpose of the next stage of the IRIS study.

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