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**Decentralization and the Provision
and Financing of Social Services:
Concepts and Issues**

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Decentralization and the Provision and Financing of Social Services: Concepts and Issues

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ABSTRACT

This paper is the fruit of an attempt to distinguish the elements, present in a fiscal decentralization process, that are likely to contribute to efficiency enhancement in the provision of social services in developing countries. From the methodological point of view, the paper makes an effort, whenever possible, to isolate the economic from the political in the arguments for and against fiscal decentralization. These two sets of arguments, economic and political, both equally important, are often intermingled in the literature. The distinction between them may improve our understanding of the advantages and limitations of the selection of a 'decentralized' provision of social services. Although nearly all the aspects of the fiscal decentralization process may be of some relevance in terms of the issue of equitable social service provision, the paper tries to stress the need to provide adequate incentives to local bureaucracies through the design of transfers and through community participation.

I INTRODUCTION

In recent years, many developing countries, as well as transition economies, have launched processes of state decentralization. In transition countries, decentralization is seen as the antithesis of the centralism which was once imposed. The public administrations in many of these countries used to follow the Soviet council type of system whereby all councils were part of the strict hierarchical structure of the state; therefore, the councils lacked any real decision making power. In the case of developing countries (for instance, those in Africa and Latin America) the state has historically been omnipresent and yet extremely weak. Most probably, the traditional role of the central government as exclusive provider of services has inhibited the self-reliance and development of civic institutions at the community level (Hommes 1995). In this context, decentralization is understood within the overall framework of institutional reforms aimed at rebuilding the state (Burki and Edwards 1996).

The experience of Western European countries in the decentralization of the state contrasts sharply with the experience of developing countries. In Western Europe intergovernmental fiscal relations and the assignment of responsibilities to different levels of government correspond to traditional links between communities and the national government. These mechanisms in developing countries are built from scratch most of the time. The timing is also different; governments in developing countries face strong pressure to solve fiscal imbalances and to alleviate poverty through the more efficient provision of social services.

Decentralization can be justified in terms of improvement in the efficiency of public expenditures, but it is not a panacea for the solution of problems in social service provision. Local governments are supposed to be more well informed about the local needs, preferences and financial capabilities of the community. However, none of the benefits (efficiency gains) usually attributed to a decentralized provision of key social services is automatic. Decentralization relies on the participation of the community in order to achieve a better match of expenditures with local priorities and preferences. Yet, by the same token, decentralization is a costly process, because fostering participation at the local level generates costs. Moreover, in order to be effective, participation requires an enabling environment created by the central government and local authorities. In other words, participation develops through the commitment of the actors in the

traditional socio-economic order: the authorities and the local elites. Therefore, decentralization is not a 'one size fits all' policy, and it should be understood as a process.

The theory of public finance provides some principles for decentralization, and the developed countries offer evidence on how well the application of these principles has fared. This paper is the result of an attempt to understand the mechanisms present in a decentralized setting that may allow authorities to overcome the problems of social service delivery and financing. From the methodological point of view, the paper makes an effort, whenever possible, to isolate the economic arguments from the political ones, whether for or against a decentralization process. In the literature these two sets of arguments, economic and political, both equally important, are often mixed up. The distinction between them may improve our understanding of the advantages and limitations of the choice of a 'decentralized model' for the provision of social services.

Although, because of the very nature of decentralization, nearly all the aspects of the process may be of some relevance in terms of equitable social service provision, we will focus mainly on the need to furnish an adequate set of incentives to local bureaucracies through the design of transfers and through community participation.

The second section of the paper puts the accent on definitions and the principles of decentralization. The third explains the issues and the complexities of the assignment problem. The fourth considers the role of transfers as a vehicle for granting incentives to local actors. The fifth examines the problems in social service delivery and discusses the mechanisms through which decentralization may or may not help to solve them. The sixth identifies two additional issues related to decentralized provision that require further discussion.

II WHAT DO WE UNDERSTAND BY DECENTRALIZATION?

The boundaries of the definition of decentralization are often blurred in practice. Constitutionally defined unitary governments such as those in Italy, the Nordic countries and Spain have achieved a fairly significant degree of decentralization. Even France has recently broken with a long history of centralism to delegate some functions to local authorities. One

might also highlight constitutional federal states like Canada, Germany and the US. Therefore, in order to facilitate the discussion, we need to clarify what we understand by decentralization.

There are two important dimensions of decentralization: fiscal decentralization and administrative decentralization. *Fiscal* decentralization exists when subnational governments have the power (through the constitution or particular laws) to raise some taxes and carry out spending activities according to clearly established legal criteria. *Administrative* decentralization exists when much of the money is raised centrally, but part of it is allocated to decentralized entities which carry out their spending activities according to close guidelines or controls imposed by the central government.

Using the typology of decentralization sketched by Rondinelli (1990), one could associate administrative decentralization to the notion of *deconcentration*, or the transfer of power to the local administrative offices of the central government. In the same way, fiscal decentralization could be associated to the notion of *devolution*, or the transfer of power to subnational political entities that involves the creation or the strengthening of the subnational units of government, the activities of which are outside the direct control of the central government.

In practice, this sharp distinction is not always possible or significant. Therefore, this paper investigates issues which, while applying to both types of decentralization, are more particularly related to fiscal decentralization, whereby local governments have can raise their own revenue through fees or taxation and enjoy a greater degree of autonomy.

In this paper 'central government' and 'federal government' are taken as being synonymous, so that the national authority is meant. Likewise, 'local government' and 'state government' are considered synonymous and are taken to mean any subnational level of authority.

III THE ASSIGNMENT PROBLEM

Conceptually, decentralization attempts to solve the so-called *assignment problem*. The assignment problem involves two equally important aspects of decentralization: expenditure assignment and revenue assignment. As

Boadway, Roberts and Shah (1994a) suggest, the assignment of powers and the optimal policies undertaken by each level of government depend upon the same efficiency and equity considerations that determine the rationale for government intervention in the economy (for example, externalities, public goods, economies of scale, absence of markets, imperfect information, etc.).

Provided that there are some functions which the public sector should perform, it is important to specify the responsibilities of each layer of government within the decentralized setting. In this respect, one might recall the three roles for the public sector as defined by Musgrave and Musgrave (1984), namely, the stabilization, distribution and allocation roles.

The macroeconomic stabilization function of the government includes measures taken by the government to obtain a high rate of economic growth and to address major economic imbalances, like the reduction of the fiscal deficit, so as to supply a stable economic environment for the private sector. This function should be performed by the centre.

The distribution function, by its very nature, limits the extent of decentralization. Here, the responsibility should also be undertaken at the centre. Any attempt on the local government side to address the issue of redistribution, through taxation, for instance, can induce inefficient migration because of the free mobility of economic factors – well-off households will seek to move to lower tax jurisdictions. The capacity of individual local governments to initiate redistributive policies is also likely to differ according to the differences in the fiscal capacities of these governments. The final outcome would be inequitable; poor people in a rich jurisdiction will be more well off than poor people in a poorer jurisdiction. This would also deepen regional disparities. Moreover, as Campbell, Peterson and Brakarz (1991) observe, in general, if local governments are left to their own devices, they tend to carry out less redistribution than the national government would do.

Instances in which the effectiveness of the stabilization and distribution functions have been undermined by poorly designed decentralization attempts are many. The case of Argentina in the late 1980s is an illustration of the negative consequences of decentralization on overall fiscal balance. A set of perverse incentives induced overspending at the

provincial level. At that time, provincial and national financial practices appeared to contribute to unsustainable public sector deficits and undermined national efforts to attain price stability. In 1986, the total fiscal deficit of the provinces before transfers was 6.2 per cent of GDP, higher than the combined deficit of state owned enterprises and the social security system (World Bank 1990).

More recently, the fiscal decentralization in China shows perverse features at the macro level that are documented extensively by Ma (1995: 68).

Local governments have undertaken *de facto* control over many policy instruments weakening the capabilities of the central government to achieve and sustain macro stability.

Statistics show declining trends in the ratio of government revenue to GNP and in the share of central government revenue in total government revenue in China over the period 1979 to 1992. This decline in central government revenue means that there are fewer possibilities to implement a re-distributive policy. As a consequence, poor regions are less well off than richer ones (Shanghai, Beijing, etc.), and the rural-urban gap has increased over the years (Yu 1997).

However, a decentralization process can also contribute to improvements in the spatial allocation of fiscal revenues, as in the case of Bolivia. The tax reform law which came into effect in 1993 is an important component of the Bolivian model of state decentralization (Galindo and Medina 1996). Within this framework, there has been an observed spatial redistribution of fiscal revenues that has two dimensions: (i) from the three richer departments – the so-called 'central axis' of La Paz, Cochabamba and Santa Cruz – to the rest of the country and (ii) from cities (department capitals) to other human settlements. Therefore, the tax reform law, together with the law on *participacion popular*, appears to be the correct tool to address the regional inequalities which have been characteristic in Bolivian history.

The allocation function is related to the process by which the total resources in an economy are divided between the private and public sectors according to level of government and to location. Furthermore, the spatial characteristics of public goods provide the basis for the *decentralization theorem* as formulated by Oates (1972). The theorem states that

centralization is costly if it leads the government to provide a bundle of public goods that diverges from the preferences of the citizens in particular areas. The organizational implications of the theorem are straightforward. The responsibility for public services should be assigned to the level of government the boundaries of which incorporate the beneficiaries (Dillinger 1994).

The main economic justification for the assignment of expenditures to local governments rests largely on allocative and efficiency considerations. These considerations have been summarized by Tanzi (1995).

- (i) Decentralization induces competition among jurisdictions. This is likely to produce the same kind of allocative benefits as a competitive market brings to the private sector.
- (ii) Decentralization allows experimentation in the provision of output. The outcome is also likely to be a quality improvement in the provision of services.
- (iii) Decentralization may generate a smaller public sector and a more efficient economy.
- (iv) Decentralization expands the possibilities for increased participation.
- (v) Decentralization promotes accountability through clearer and closer linkages between the benefits of local public services and the cost of these benefits.

Elements (i), (ii) and (iii) are analysed here below. Elements (iv) and (v) are examined in the section dealing with participation.

The idea of encouraging competition among localities is certainly an appealing one; nevertheless, the scope for competition can be very restricted even within a decentralized setting. For example, the delivery of social services implies that there is a large amount of sunk costs (both fixed and variable). These sunk costs, which determine the 'specificity of the asset' (Williamson 1985) to be provided, hinder the possibility of free entry into the market. This means that the market, or even local governments, cannot be left alone to furnish the asset. This fact, along with all the other attributes of a public good, reinforces the necessity of a co-ordinating agent (at a higher level of government) which can internalize the costs and the externalities. Co-ordination is also needed because of the

externalities and costs involved in service (product) development – curriculum design, new methods of teaching, etc. This is the equivalent of 'research and development' in the theory of industrial organization.

The idea of smaller government should be revisited. Under the same line of argument and on condition that competition is feasible, competition is costly.

Competition promotes product diversity and, by providing yardsticks, improves incentives. But there are costs to competition such as the 'duplication of fixed costs' (Tirole 1994: 15).

These fixed costs in the case of decentralization could affect the size of the bureaucracy as a whole, as is shown in the trends in public employment in Western Europe (see Table 1 in the annex). In the more recent experience of decentralization in Bolivia, the behaviour of municipal employment is also striking. In two years of operation, 17,000 permanent jobs were added to the structure of municipal governments (Galindo and Medina 1996). Although these numbers may be taken as a good sign in a context in which employment creation is badly needed, we subscribe to a more cautious approach, especially concerning the long-run effects of an increase in public employment (see section 6.2).

It is important to note also that the nature of the delivery of social services (education and health care) is multi-staged and requires co-ordination, at least in setting standards. Thus, primary education must follow the minimum standards so as to ensure that students, *ceteris paribus*, continue in school up to the level of higher education. In the case of health care, diagnoses must be sufficiently accurate to lead to appropriate treatments.

In other words, the efficiency gains which one attributes to the decentralization process can be achieved if and only if vertical co-ordination (among levels of government) and horizontal co-ordination (among localities), as well as some degree of centralized decision making, can be achieved.

3.1 Expenditure assignment

Expenditure assignment defines which functions or services will be performed by local government and which by the centre. Table 1 offers a list of the functions most commonly performed by local governments

around the world. This typology should be considered in the decentralization of government functions.

TABLE 1
TYPICAL EXPENDITURE RESPONSIBILITIES AT THE LOCAL LEVEL

Environmental services:

- Land use planning
- Transportation planning
- Environment protection
- Provision of roads and public transport
- Waste collection and disposal

Educational health and social services:

- Schools
- Higher education
- Hospitals and health care
- Social welfare services
- Provision of housing

Protective services:

- Fire service
- Police
- Consumer protection

Utilities:

- Electricity and gas
- Water and sewerage

Leisure:

- Sports facilities
 - Libraries
 - Cultural services
 - Tourism
-

Source: Hollis and Plokker (1995).

Within this framework, besides the main functions like stabilization and distribution presented in section II, the central government should also undertake functions like foreign affairs, defence, internal security, and justice. However, this does not mean that the central government does not have a role to play in the provision of social services. As we have seen while stating the limits of competition among jurisdictions, in the case of education, health care, infrastructure or environmental protection, the central government can be responsible for the establishment of the

regulatory framework, as well as the incentives and oversight mechanisms to ensure that the local authorities perform according to norms.

3.2 Revenue assignment

The other aspect of the assignment problem is revenue assignment. This concerns the nature of the decentralization process itself. The key question here is: Should local governments be allowed to raise their own tax revenue – to define the tax base and set the rates? An affirmative answer to this question implies the implementation of a process of fiscal decentralization.

Local governments must cover capital investment, as well as recurrent expenditures and debt servicing. In order to do this, they may have to rely on financial resources coming from local taxes, user charges, transfers from the central government and indebtedness. The importance of the sources may vary. However, as a general trend, central government transfers have been the main source of revenue for local authorities.

Regarding the revenue assignment problem at the local level, McMaster observes that revenue raising should not be merely sufficient, but also fair. 'Unfairness is itself an obstacle to revenue collection' (McMaster 1991: 23). Tax avoidance is an issue which arises from an individual perception of unfair treatment with respect to others, with respect to the level of services that citizens enjoy, or with respect to the ability of citizens to pay.

However, part of the controversy surrounding the decentralization process revolves around the fact that 'the reasons for decentralizing expenditures are completely independent from those in favour of decentralizing taxes' (Prud'homme 1995: 213). Yet, on pure efficiency grounds, expenditure assignment to lower levels of government can be justified, while the case for the decentralization of revenues is not very strong. There are two main explanations for this. First, local governments tend not to possess the institutional capacity to raise and administer tax revenue.¹ The second

¹ In many developing countries, central administrations have undertaken bold steps to modernize taxation systems by setting new rates, redefining the tax base and modernizing tax collection in order to minimize evasion and increase tax revenues. Therefore, the centre may not readily agree to give up part of the counting room in favour of local governments.

explanation relates to equity considerations and the distributive function reserved to the central government. Some taxes used for purely redistributive purposes should remain under the control of the central government.

Furthermore, the idea underlying the *assignment problem* (both revenues and expenditures) is that the government should avoid interfering with the efficiency of the *internal common market*, which means that there should be no barriers or incentives (imposed by subnational governments) to the movement of goods and services across political borders within a country. These barriers may be constituted by taxes and subsidies, by regulations, by preferential procurement policies or by the design of local public goods and services.

The principles of decentralization suggest that some taxes should remain central. Examples are the personal income tax, corporate taxes, capital gains taxes, payroll taxes, and taxes on trade. Other taxes, such as property taxes and excise taxes, including energy taxes, can be decentralized.²

The asymmetry between the assignment of revenues and the assignment of expenditures reinforces the need to build a system of transfers from the central government to subnational levels in order to facilitate the financing of activities which local governments are meant to perform. So-called *intergovernmental fiscal relationships* consist of the system for transfers from the central government to lower level governments and the set of arrangements for co-ordinating and sharing particular tax bases among different levels of governments.

A warning can be given at this stage. Many attempts to decentralize service provision have failed – they have been accompanied by user dissatisfaction – because local government expenditures have not been matched adequately by revenues, so that service delivery has been underfunded. In these cases, *ceteris paribus*, while the efficiency considerations favouring decentralization have still been valid, authorities have had to deal with discredited programmes.

² For an extensive discussion on revenue raising responsibilities in a federal setting, see Broadway, Roberts and Shah (1994b).

The literature on fiscal federalism argues that the assignment of responsibilities for spending must precede the assignment of responsibilities for taxation. However, experience suggests that, to the extent possible, it is desirable to decentralize taxation *at the same time as* one assigns spending responsibilities (Hollis and Plokker 1995). If local governments are not made responsible for generating at least part of their own revenue, they may have little incentive to be cost-effective (see below). Excessive reliance on transfers from the centre hinders accountability with respect to the local community. It also means less autonomy at the local level.

Like many other aspects of decentralization, the prerogatives of local authorities in raising revenues must be carefully monitored. For instance, local authorities in China influence tax rates, the tax base and the tax effort through the use of tax concessions and tax exemptions, although the central government has the legal responsibility for fixing the rate and the base of both central and shared taxes. Likewise, local authorities in China have increased the use of fees to generate the extra-budgetary funds which are earmarked for local use.³ Some calculations reported by Ma (1995) show that the ratio of extra-budgetary funds to budgetary funds rose from 66 per cent to 84 per cent between 1978 and 1990. Moreover, the effective tax burden on enterprises (including all additional fees) could be as high as 90 per cent. As a result, the central government has applied non-standard fiscal policy measures, such as borrowing from localities, revising the tax-sharing rules on an ad-hoc basis, and claiming ownership of well performing state-owned enterprises, that tend to encourage the efforts of localities trying to expropriate as much revenue as possible from the central government using discretionary means.

Meanwhile, the assignment of responsibilities to localities is not clear cut in China. In other words, revenues have been assigned, but not expenditures. There is substantial overlapping between the centre and localities in health care and education.⁴ For instance, the construction of health care facilities might be financed by the centre, the localities or city governments. In this context, the allocation of funds reflects the relative bargaining power of localities rather than the local needs. Thus, more well

³ Public utility surcharges, the retained earnings of state-owned enterprises, depreciation allowances, funds for technical transformation, and user fees are some of the sources of extra-budgetary funds.

⁴ This is also the case in productive sectors such as heavy industry.

off localities (with greater bargaining power) detour more revenue from the centre and diminish their own revenue raising effort.

IV THE ROLE OF TRANSFERS

4.1 Types of transfers

Local government financing in developing countries depends heavily on transfers from the centre as the main source of revenue. As Boadway, Roberts and Shah (1994a) point out, transfers represent 72 per cent of provincial revenues and 85 per cent of local government expenditures in Indonesia. In South Africa, transfers accounted for 85 per cent of provincial revenues in 1989-90.

The transfer system is an important part of intergovernmental fiscal relations. On the one hand, it helps to bridge the gap between revenue and expenditures at the local level and assures equity across jurisdictions. On the other hand, it is a powerful tool to help assure that some of the objectives of the central government are achieved.

First, transfers help to guarantee equity across jurisdictions. Fiscal capacity differs among local governments. Some local governments have a low tax base and high fiscal needs, while others have a high tax base and low fiscal needs. A system of transfers among these jurisdictions might therefore serve to reduce the differences.

Second, the central government can furnish a whole range of incentives through the design of transfers aimed at modifying the behaviour of local bureaucracies. In terms of an analogy with the 'principal-agent' theory, the central government would be the contracting entity (the principal), and the local government would be the contractor (the agent).⁵ This is known in the literature as the positive analysis of internal bureaucratic decision making (de Groot 1987, Cremer, Estache and Seabright 1994).

⁵ In the common form of the theory, the relationship between the two sides, the principal and the agent, is spelled out in a contract. The role of the principal is to provide a set of incentives to make the agent perform the actions which benefit the principal.

There are different types of transfers (Table 2). Transfers may be *conditional* or *unconditional*. In the case of conditional transfers, the funds are given to subnational authorities for specific purposes. The conditions may be very general, so that, for instance, the transfers must go towards spending in broad areas like health care, education, or environmental protection. If transfers are *sector specific*, they are called *categorical*. The use of conditional transfers is one of the main ways in which the central government can influence local governments to exercise their expenditure responsibilities in a way which is consistent with national efficiency and equity objectives (Boadway, Roberts and Shah 1994a). For example, Indonesia has a major programme of *block grants* that is designed to encourage reforestation, soil conservation and greening in environmentally critical areas. Funds are allocated on project-by-project basis. The allocation process includes an evaluation of the areas to be regenerated or protected (Parker 1995).

TABLE 2
TYPES OF TRANSFERS

	Conditional (Categorical)	Unconditional
Non-matching	Called <i>block grants</i>	Called <i>general transfers</i>
Matching	Called <i>cost-sharing</i> Open-ended Close-ended	

Source: Adapted from Shah (1994).

Transfers may also be *matching*, that is, their magnitude may be a proportion of local government expenditures of a particular sort. They may be *open-ended* (the magnitude depends on local government expenditure without any upper limit), or they may be *close-ended*. Open-ended matching transfers have an effect similar to that of a per-unit subsidy which boosts service provision (Winkler 1994).

A problem may arise when matching grants are applied in rural areas where the level of revenues which can be mobilized locally is very restricted. Parker (1995) describes a case in Zambia where a matching grant programme was initiated for rural development. It was quickly discovered that district authorities had no power to raise revenue, and they therefore had no resources to match with central government funds.

In the design of transfers, central governments must identify ways to distribute transfers among localities.⁶ To do this, central governments usually allocate funds according to a *formula*. The formula includes variables which reflect variations in need and cost among jurisdictions that depend on factors like population size (per capita transfers, which are called *capitation grants*), the average income of a locality, tax capacity (the size of a particular tax base), tax effort, the age structure of a population, degree of urbanization, measures of the cost of supplying particular local public services, or the relative need for local expenditures. An example of a capitation grant is the primary-secondary education grant in Chile. The central government determines according to a formula the amount of cash per student to be allocated to municipalities or private providers authorized to operate schools (Winkler 1994).

Revenue sharing mechanisms can be viewed as transfer systems and may take a variety of forms. They may be highly centralized, with the central government determining both the base and the rate structure for a particular tax source, collecting the tax, and turning over to local governments a proportion of the tax revenue collected.

Revenue sharing mechanisms vary considerably among countries. Complex allocation formulas are used in Brazil, India and Nigeria. The formulas rely on factors such as population, per-capita income and school enrolments. Other countries like Mexico, Pakistan, China and Malaysia employ *derivation* (point of collection) as the basis for resource allocation (Shah 1994).

4.2 Providing incentives through finance

Borrowings from the central government and transfers to local governments which are easy to obtain may lead to three undesirable effects: (i) a decline in the local fiscal effort (local tax revenue and other sources of revenue like user charges), (ii) overspending, and (iii) inefficient budgetary allocation. For instance, in Brazil in 1990 generous revenue-sharing provisions induced some municipalities to overspend by

⁶ The central government must also determine the proper growth rate for transfers over time. The growth rate might be calculated, for instance, on the basis of the GDP growth rate or of the growth rate of local expenditures for particular services.

raising public sector payrolls and wages and to reduce the fiscal effort by lowering local property taxes (Parker 1995).

How can a central government design an adequate system of intergovernmental fiscal relations that maximizes the potential of local revenue generation and at the same time induces local governments to comply with central government objectives?

Because of fiscal crises and the growing pressure on governments to rationalize expenditures that has resulted, central governments have recently become more concerned with tidying up their transfers to local authorities by linking them to problem and performance indicators (Tables 3 and 4). Some of these indicators are designed for the direct monitoring of the quality of the services delivered at the local level (for example, the proportion of infrastructure maintained above a minimum standard). The indicators are supposed to furnish a rough idea of feasible targets from one year to the next. Should a local government show an improvement in the indicators, it can qualify for the full amount of transfers or bonuses offered by the central government.

TABLE 3
POTENTIAL PROBLEMS WITH TRANSFERS

Problem	Problem indicator
i) Discourage local governments from using their fiscal capacity fully	i) Ratio of local tax revenue to local wealth (local fiscal effort)
ii) Induce local governments to overspend	ii) Ratio of total local revenues to current expenditures (self-reliance)
iii) Induce inefficient budgetary allocation	iii) [1- Ratio of overhead costs*]

* The ratio of indirect expenditures to total expenditures.

Despite the widespread consensus that it is desirable to consider these indicators explicitly in the creation of a transfer system, there is no evidence that governments, at least those in developing countries, are doing this in a systematic way. This is because the indicators, especially the ones measuring service quality, are difficult to obtain and require the establishment of a monitoring system. Some of the data needs for the estimation of selected indicators are outlined in Table 4.

TABLE 4
PERFORMANCE INDICATORS FOR AN EFFECTIVE TRANSFER SYSTEM

Performance indicator	Data requirements
Local fiscal effort	<ul style="list-style-type: none"> i) Local wealth base, measured as the value of physical assets plus local GDP ii) Local revenue collection
Self reliance in meeting current budgets	<ul style="list-style-type: none"> i) Total current expenditures ii) Local revenue collection
Growing real per capita revenue	<ul style="list-style-type: none"> i) Local revenue collection ii) Annual inflation estimates iii) Population estimates
Raising the growth rate of local revenue	<ul style="list-style-type: none"> i) Historical data on the amounts collected by local governments ii) Inflation estimates
Overseeing certain types of expenditures	Local government annual accounts
Meeting service delivery targets	Returns from monitoring systems
Targeting administrative behaviour	Returns from monitoring systems

Source: Adapted from McMaster (1991).

A word of caution must be offered concerning indicators which measure absolute values over time, as in the case of the indicator for local revenue per capita. Taken as a performance indicator, this measure may discriminate against poor localities, where local fiscal capacity is low by definition. Hence, the importance of targeting the *fiscal gap*, which is defined as revenue minus current expenditures.

Finally, the desirable characteristics of a transfer system are summarized by McMaster (1991) as follows.

- (i) The system should take into account the differences in the spending needs of local authorities in relation to a clearly defined set of responsibilities.

- (ii) It should compensate for differences in the ability of local authorities to finance their spending needs, that is, the differences in local revenue potential.
- (iii) It should provide incentives to authorities to improve local-revenue yields.
- (iv) It should be stable and predictable from year to year.
- (v) It should not encourage extravagance in the use of resources.

V DECENTRALIZATION AND THE PROVISION OF SOCIAL SERVICES

Decentralization implies the extension of a pool of revenues in order to finance a basket of social services that suits more closely the needs of a local population (see earlier). In this section two areas are analysed that are important for decentralization and social service provision and financing.

First, the question is addressed: What are the main problems concerning social service provision that decentralization is meant to solve? The second question examined is: What are the mechanisms present in a decentralized setting that allow authorities to overcome problems in social service delivery and financing?

For exposition purposes and in a schematic way, these two issues are summarized in Table 5.

TABLE 5
PROBLEMS IN SERVICE PROVISION AND THE ADVANTAGES OF
DECENTRALIZATION

Common problems in service provision	Advantages of decentralization
	i) Improves the flow of information
	ii) Increases the pool of local revenues through local taxation
i) Unfunded or nonexistent services	iii) Lowers costs and enhances economies of scale, provided that the services are supplied by the appropriate level of government
ii) Services are not relevant to the needs of a population	iv) Reveals the preferences of the community
iii) Urban bias	v) Boosts the participation of the community in decision making and financing
	vi) Fosters accountability
	vii) Improves monitoring
	viii) Enhances targeting
	ix) Facilitates privatization?

Source: Compiled by the author.

5.1 Problems with the current service provision schemes

Social service provision is key to human capital formation. Therefore, a lack of access to social services, or simply an inadequate system of social service provision, is one of the causes of the absolute poverty being experienced by more than one billion people today. Because social service infrastructure and provision tend to be centralized and urban based, it is difficult to exit from the poverty trap.

According to *Human Development Report 1996* (UNDP 1996), the share of the population in developing countries that enjoys access to services like health care, safe water and sanitation is much smaller in rural areas than it is in urban areas. This disparity in service access between rural and urban populations is wider in countries characterized by low to medium values in the human development index (see Table 2 in the annex). This suggests an urban bias in the provision of social services, and this bias has a significant impact on the extent of poverty in rural areas.

Governments in developing countries are faced with the challenge of improving the living standards of the population and especially of the poor. Yet, they must also be concerned about getting *the best value for money* in social services during these times of fiscal restraint. Despite recent gains in basic indicators – such as the infant mortality rate and the primary education enrolment rate – that gauge inputs to human capital, there is still much to be done to enhance the access of the poor to social services, especially in rural areas. In this context, the decentralization process may involve a spatial rearrangement in service provision that focuses on increasing the proximity of services to users. This is important in the identification of appropriate new investments in infrastructure, as well as in health care, education and farm support programmes which ameliorate the living conditions of the poor (Binswanger 1994). Decentralization can thus help to end the isolation and deprivation from which most of the rural poor in developing countries currently suffer.

5.2 In favour of decentralization: local participation

A crucial element in the enhancement of efficiency in a process of decentralization is participation. This section addresses three questions related to participation: (i) What is the meaning of participation?, (ii) What are the objectives of participation? and (iii) How can we assure that effective participation occurs?

Participation refers to the many channels for voicing and exchanging opinion – in voting, articulating preferences, providing advice and counsel, and channelling feedback from the public to the elected or appointed decision makers. In its largest sense, participation represents a fundamental link between government and governed (Campbell, Muñoz and Morgan 1993: 1).

World Development Report 1992 (World Bank 1992) states that people's participation has three main advantages: (i) it gives planners a more thorough understanding of local values, knowledge and experience; (ii) it wins support for project objectives and fosters community assistance in local implementation, and (iii) it helps resolve conflicts over resource use.

However, participation should be understood as more than merely a conduit for advice in the development of a project or for advocacy in favour of a planner's actions. Table 6 presents a *participation-*

empowerment index, in which level of participation is measured as the product of three separate 'dimensions': function, intensity and extent. Within each dimension are 'modalities' which have been given a value of '1' to '6'. The higher the score, the higher the level of participation. The 'participation empowerment index' is equal to the product of the three scores obtained (one per dimension). Noteworthy is the fact that the highest score, '96', is assigned to the situation in which households initiate the action and undertake the overall management of a particular activity.

TABLE 6
PARTICIPATION EMPOWERMENT INDEX

Functional participation	Intensity of participation	Extent of participation
Overall management (6)	Initiating the action (4)	All households (4)
Planning (5)	Decision making (3)	All interest groups (3)
Implementation (4)	Consultation (2)	Women's groups (2)
Maintenance (3)	Information (1)	Leaders only (1)
Distribution (2)		
Utilization (1)		

Source: Table 2 in Taal (1993).

This effort to quantify level of participation is useful. It provides several ways to define participation. However, the quantification can be misleading; it does not reflect entirely the full range of processes and choices in each category of participation, especially the category of the extent of participation (Taal 1993). For instance, a high index score due to a high rank for 'participation by interest groups' may mask the fact that the 'interests groups' in question are actually local elites. Also, the index does not capture, at least explicitly, the extent of participation in service financing, both monetary (user fees and taxation) and in kind (voluntary work and non-monetary contributions).

Community participation aims at five major objectives (Gow and Frankenhoff 1994): (i) efficiency in resource allocation, (ii) effectiveness in implementation, (iii) equity, (iv) the sustainability of benefits, and (v) accountability.

Efficiency: Services and investments should reflect the needs of citizens, and resources should be applied according to the priorities of the majority.⁷

Effectiveness: If services are implemented in consultation with the community, they will not only reflect user preferences more closely, but they are also more likely to incorporate local know-how and be more effective in meeting user needs.

Equity can be understood in two different ways: (i) on the basis of the equality in the contributions of individuals and (ii) on the basis of differences in the ability of individuals to pay.⁸ Ability and willingness to pay for services are more readily assessed at the local level because of the better flow of information and the proximity of local authorities to users.

The distinction between the ability to pay and the willingness to pay appears to be crucial in the effort to guarantee equitable access to social services. Gauging the ability to pay raises formidable methodological problems because of difficulties in the assessment of household priorities and household risk management (Watkins 1997). From this point of view, proximity to users may help to enhance the quality of the information available on the nature of user vulnerability and the responses of users to it. Such information is vital for any evaluation of the impact of cost-recovery programmes on the welfare of a population.

Sustainability: Experience in developing countries shows that the construction of schools and hospitals is often employed as a means to win votes. It is less clear that central governments are committed to cover recurrent costs and the maintenance of infrastructure, since fewer votes seem to be in the balance. Therefore, community participation may ensure the sustainability of the financing of recurrent expenditures for services and, in turn, the sustainability of the benefits of services.

⁷ However, there are dangers in following the wishes of the majority too closely. Poverty involves situations of exclusion. Therefore, one must make sure that the voice of the minority (those excluded) is taken into account.

⁸ These two points relate to the discussion about the desirability of providing universal access to social services, or of targeting the poor segments of the population. However, we wish to skip this discussion here. We just make the assumption that targeting is needed.

Decentralization might facilitate the accumulation of additional resources via user fees and non-monetary contributions to cover the recurrent costs of locally produced goods and services. These additional resources can help local governments overcome the fiscal constraints imposed by the central government, which may delegate responsibilities without supplying the required financial resources.

Community participation in the financing of local goods may generate other desirable outcomes.

(i) It pushes beneficiaries to play an active rather than a passive role. The beneficiary becomes a key decision maker. If the beneficiary does not contribute to the financing of the services in one way or another, the provision of services will cease.

(ii) It enforces accountability. The willingness of the community to become involved is boosted by the use of funds which have been generated locally, including local taxes.

(iii) It expands overall fiscal capacity. In centralized economies, tax revenue which is earmarked for local use, such as property tax revenue, generally represents only a marginal financial resource (Ebel 1995). The central government has little incentive to administer this resource efficiently, since it does not use this sort of tax revenue directly.

Accountability: In a centralized setting, the most common type of accountability is *internal accountability*, or accountability to the central government. Experience in developing countries shows that local governments usually act as 'agents', since transfers from the central government are the main source of their revenue. The central government acts as the 'principal' who determines the contract. Since accountability is internal (to the central government), the participation of users is restricted. Citizens are viewed as the passive recipients of government services.

An increase in people's participation in the financing of goods and services enhances *external accountability*, or accountability to voters and taxpayers. In other words, participation acts as the 'control mechanism' required by the theory of contracts in the provision of *ex-post* incentives. Both transfers, which provide the *ex-ante* incentives, and participation are necessary elements for the fulfilment of the contract.

This citizen participation broadens the scope of accountability and moves it out from the more conventional, vertical accountability to the centre, embedded within the existing administrative system, into something more democratic in theory at least, and horizontal, whereby office holders are accountable to their constituents and stakeholders as a form of political accountability (Gow and Frankenhoff 1994: 4).

5.3 Community participation in local affairs is not automatic

Ensuring citizen participation is crucial for the identification of user preferences and for the effective targeting of the poor. However, the mechanisms to foster participation must be created. Gow and Frankenhoff (1994) describe the following situation, which is often encountered.

- (i) Participation in local government simply does not occur;
- (ii) when it does, it is often unclear what it is supposed to be, and,
- finally, (iii) the results are counter-intuitive.

The second and third outcomes are not surprising given the complexity of the participation process. The first outcome reflects the political nature of the decentralization process. A successful decentralization process is, after all, the result of a well-conceived plan to share power. Therefore, in order to implement citizen participation, the traditional layers of power – the central government, local governments and local elites – should be engaged in the process.

The centre must establish an enabling environment for participation. The components of this enabling environment are rules and laws. A local government law must clearly define the participatory mechanisms. In some cases, the local government should periodically organize meetings open to the public. These meetings should also be held on the formal demand of citizens.⁹

Participatory mechanisms may also take the form of local neighbourhood associations which hold service providers and contractors accountable. Likewise, they may take the form of consultations open to the public,

⁹ For instance, see 'Ley Organica del Regimen Municipal de 1989'. *Coleccion de textos legislativos*, No. 10. Caracas: Editorial Juridica Venezolana, 1990.

workshops, referendums, broader local representation, municipal hearings, annual service sector reviews, and so on.

An example of an attempt at the institutionalization of participation in a broad sense is offered by the 1994 law on *participacion popular* in Bolivia. This law provides legal recognition for grassroots organizations (*organizaciones territoriales de base*) and entitles them to undertake investment projects using 'participacion popular' funds. It also permits the creation of surveillance committees (*comites de vigilancia*) in rural communities and neighbourhood associations in urban areas to oversee and eventually authorize or veto the use of 'participacion popular' funds.

5.4 The cost of participation and the risk of 'over-institutionalization'¹⁰

Adam Smith held that it is not the market which creates civil society, but civil society which creates the market.

The institutionalization of the participatory approach bears some costs in terms of the organization of people, the gathering of information, the calling of meetings, and the difficulties in reaching decisions. However, this is not the main issue in the current debate.

Participation and the creation of an enabling environment for participation have become so fashionable that the effort at institutionalization can get out of hand. The main advantage of participation as sketched out above resides in the fact that households benefit from being involved in local affairs by expressing their preferences, enforcing oversight mechanisms, and so forth. Nonetheless, in order to compensate for the isolation of people living in remote rural areas or for a vacuum in civil society that may have been created by decades of communism, donors and governments support the work of non-profit organizations, which in some cases act in place of the people as the local partner not only of the central government, but also of local governments.¹¹

¹⁰ In this section, we do not deny the necessity of enforcing and protecting community participation, but we do attempt to call attention to the tendency mechanically to associate community participation with NGO involvement in local activities.

¹¹ This phenomenon was first observed in the late 1980s in the *New Policy Agenda* (Edwards and Hulme 1996).

Many public sector agencies argue that, as service providers, non-government organizations (NGOs) are more cost effective than are governments. Also, some empirical evidence suggests that NGOs are more effective in reaching the poor. Therefore, these agencies prefer to reach agreements with NGOs for the delivery of urban and rural social services.

What is the nature of the participation of non-government, non-profit, organizations?

After gaining legal status, NGOs begin to play the role of both the representatives of users (their 'voice') and the providers (under subcontracts) of social services. This dual role raises several questions revolving mainly around two related matters: the legitimacy and the financing of NGOs.

The fact that bilateral and multilateral agencies work with NGOs does not mean that NGOs are less costly or more cost effective. In the absence of private philanthropy, the non-profit sector is typically financed by donors or by the state. Donor funding is usually directed towards big projects, and the more NGOs become involved in big projects, the more they risk becoming bureaucratic and inflexible.

It has also been found that, at least in former socialist countries, there is a tendency for non-profit organizations to become concentrated in large cities and therefore to exhibit a bias against rural areas.¹²

While many believe that greater NGO participation strengthens civil society, the issue of legitimacy remains a serious one. Voluntarism and self-reliance ought to be intrinsic features of NGOs and grassroots organizations. For this reason, it is difficult to justify the rapid emergence and growth of NGOs merely because funding suddenly becomes readily available (Edwards and Hulme 1996). Moreover, the service subcontracts act to render these organizations less accountable before ordinary citizens. Accountability thus becomes 'internal', that is, the organizations become accountable to the governments and donors which provide the funding, and citizens must once more play the passive role of service recipient.

¹² However, this problem is not necessarily related to the availability of donor funding.

State support for NGOs can be direct or indirect. Direct support consists of funding which is supplied through parliaments, line ministries and other public institutions. Indirect support is typically offered through tax exemptions.

Direct government financing represents a threat to continuity in service provision. While seeking community involvement in service delivery, government is trying to share out the service costs. However, by encouraging the participation of NGOs through the provision of direct financing, it does not really improve fiscal balance. Indeed, aside from the accountability and effectiveness issues, this NGO support may merely put off the problem, for, under conditions of fiscal distress, the funding may disappear, leading to renewed and perhaps even more serious restraints on service coverage.

Meanwhile, indirect state support through tax exemptions may encourage abuses, thereby discrediting the entire 'non-profit' sector, as has occurred in several countries in Eastern Europe. In this case, it becomes very obvious that enabling community participation is not the same as enabling the participation of NGOs. If indirect support is offered to NGOs, the legal framework must be clear so that abuses are prevented and cost-effectiveness in the non-profit sector is enhanced.

Other problems also inhibit the efficient participation of the non-profit sector in service provision. For instance, it is difficult to bring 'new blood' into the service sector through non-profit organizations. There seems to be a general shortage in leadership and managerial skills in the emerging democracies, as well as in the poorest countries. Qualified people, if they are at all interested in public matters, appear to be much more likely to accept government posts rather than devoting their energies to the non-profit sector, the status of which is still vague.

Finally, another problem area is the independence of NGOs with respect to local elites. Is the agenda of NGOs likely to be dominated by the concerns of local elites?

The desirability of participation rests on its effectiveness as a mechanism of checks and balances for the decentralization process. Governments and donors must be aware that, in spite of their non-profit nature, NGOs may still pursue their own interests. This may render them responsive to

performance incentives. Furthermore, in the absence of a profit maximizing objective, NGOs may exhibit a multidimensionality of goals similar to that characteristic of government agencies. Nevertheless, as Tirole (1994, pages 3-4) points out in reference to the behaviour of bureaucracies:

The multidimensionality *per se* does not hinder a creation of a powerful incentive scheme.... But the multidimensionality of goals often goes hand in hand with two difficulties. First, several dimensions of performance are, unlike profit or cost, hard to measure.... Second, and relatedly, the multiplicity of goals raises the issue of their weights... what is meant to be optimal depends on what the [agent] perceives to be its constituency.

5.5 Information should also flow from the top to the bottom

People must have a say so as to ensure that the provision of services fits their needs. However, information should also flow towards them. Local and central government authorities should establish communication channels to 'advertise' the role of new actors in service delivery and the newly available options resulting from the decentralization process.

Information is required in order to ensure co-ordination among actors. It is needed in order to build consensus around reforms. The most successful decentralization programmes have been accompanied by widespread public discussions and widespread understanding of the goals and the methods being used (Fiske 1996).

VI ISSUES FOR FURTHER ANALYSIS

6.1 A willingness to decentralize the state does not imply a willingness to decentralize services

Even if the political will to decentralize the state exists, the parties concerned with service delivery may not be interested in decentralized services or in assigning responsibility for services to local authorities.

Education offers a good example. As Fiske (1996) argues, the process of the decentralization of the provision of education cannot be understood

without an awareness of the interests of important stakeholders. Indeed, efforts to decentralize education have often failed because central governments have not established a consensus around the process and have not identified the interests of the real actors: political leaders, policy makers, ministry employees, teachers, and trade unions. Thus, for instance, while teachers and trade unions often oppose decentralization if it is likely to erode their bargaining positions, ministry employees may oppose the process if it threatens their jobs and their administrative power.

6.2 Decentralization and privatization: do they go hand in hand?

More and more frequently, the policy packages being recommended to developing country governments include decentralization and privatization. However, it ought to be pointed out that, in Western Europe, where the decentralization process has been going on for quite some time and which is often viewed as a model of the advantages of decentralization, the state exerts enormous influence as an employer. In fact, during the 1980s there was a sustained climb in the share of public employment in total employment (Table 1 in the annex).

What is the cause of this expansion in public employment? Is this expansion linked to the decentralization process? If so, is such an expansion likely to occur in developing countries? Once again, there is the problem of definitions. What do we mean by 'privatization' if not the establishment of a source of financing and employment creation separate from the state?

ANNEX TABLE 1
GOVERNMENT EMPLOYMENT AS A PERCENTAGE OF TOTAL EMPLOYMENT

	1960	1968	1974	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986
Total EEC	10.5	12.4	14.4	15.6	15.7	15.9	16.1	16.3	16.7	17.0	17.3	17.4	17.5	17.6
Total OECD - Europe	10.4	12.5	14.6	15.9	16.0	16.3	16.5	16.7	17.1	17.5	17.8	17.9	18.1	18.1
Total OECD - USA	9.6	11.2	12.9	13.8	13.9	14.1	14.2	14.4	14.6	14.8	15.0	15.1	15.1	15.2
Total OECD	11.3	13.3	14.3	14.9	14.9	14.9	14.9	15.1	15.2	15.4	15.5	15.4	15.4	15.4
Nordic countries		15.0	19.9	21.5	22.4	23.3	24.0	24.7	25.6	26.1	26.6	26.7	26.8	26.6
Denmark		15.2	22.2	24.0	24.9	25.8	26.9	28.3	29.8	30.8	31.0	30.3	29.8	29.4
Finland	7.7	11.0	13.8	15.8	16.7	17.5	17.7	17.8	18.4	18.9	19.4	19.7	20.3	20.8
Norway		15.2	18.7	19.7	20.1	20.8	21.3	21.9	22.5	22.9	23.7	23.9	23.9	23.3
Sweden	12.8	18.4	24.8	26.6	27.8	29.0	29.9	30.7	31.5	31.9	32.4	33.0	33.1	33.0
Continental Europe		11.8	13.6	14.4	14.7	14.9	15.1	15.2	15.5	15.9	16.1	16.4	16.6	16.6
France	13.1	13.2	13.9	14.7	14.9	15.2	15.4	15.6	16.0	16.4	16.8	17.3	17.8	18.1
Germany	8.0	10.9	13.2	14.2	14.4	14.6	14.8	14.9	15.2	15.6	15.9	16.0	16.1	16.1
Italy	8.7	11.3	13.7	14.4	14.8	14.9	15.1	15.1	15.3	15.6	15.6	15.8	15.8	15.7

Source: OECD (1988).

ANNEX TABLE 2
RURAL-URBAN GAPS

	1993 % Rural population	% of Population with Access to Services					
		Health		Safe water		Sanitation	
		Rural	Urban	Rural	Urban	Rural	Urban
High Human Development Index	33	74	91	55	78
Medium Human Development Index							
- with China	61	86	98	55	92	17	76
- excluding China	48	54	88	39	78
Low Human Development Index							
- with India	74	66	95	64	78	20	64
- excluding India	74	44	86	49	71	27	58
All Developing Countries	64	76	96	60	87	20	72
Sub-Saharan Africa	70	50	81	35	63	30	56

Source: UNDP (1996.)

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