

Decentralization and the Provision of Public Services:

Framework and Implementation

Aehyung Kim

The World Bank
Development Economics
Capacity Building, Partnership, and Outreach Team
January 2008



Abstract

This paper discusses decentralization (administrative, fiscal and political) of government in public service provision. It aims to facilitate understanding among practitioners, policy makers, and scholars about what decentralization entails in practice compared to theory. A review of the empirical literature and experience of decentralization is presented. The paper highlights issues that policy makers in developing and transitional countries should be aware of when reforming government, considering their unique political and economic environment.

The author argues that decentralization produces efficiency gains stemming from inter-jurisdictional

competition, enhanced checks and balances over the government through voting at the subnational level, and informational advantages due to proximity to citizens. By contrast, arguments against decentralization include the risk of an increased level of corruption, coordination problems stemming from multiple layers of government, low capacity of subnational government, and unproductive inter-jurisdictional competition.

Decentralization itself does not render increased government effectiveness in public service provision. Instead, the effectiveness of government largely depends on the quality of human capital and institutions.

This paper—a product of the Capacity Building, Partnership, and Outreach Team, Development Economics—is part of a larger effort in the department to disseminate research findings pertinent to development. Policy Research Working Papers are also posted on the Web at <http://econ.worldbank.org>. The author may be contacted atakim3@worldbank.org.

The Policy Research Working Paper Series disseminates the findings of work in progress to encourage the exchange of ideas about development issues. An objective of the series is to get the findings out quickly, even if the presentations are less than fully polished. The papers carry the names of the authors and should be cited accordingly. The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors. They do not necessarily represent the views of the International Bank for Reconstruction and Development/World Bank and its affiliated organizations, or those of the Executive Directors of the World Bank or the governments they represent.

**Decentralization and the Provision of Public Services:
Framework and Implementation**

Aehyung Kim

Acknowledgements

I am indebted to many individuals. I would like to thank Michael Bell, Martin Lardone, Garbor Peteri, Rémy Prud'homme, Vito Tanzi, and Serdar Yilmaz for their insightful comments on earlier drafts, and I am also grateful to Pranab Bardhan, Robert Ebel, Boris Pleskovic, Steve Webb, Roland White, and Howard Wolman for their helpful discussions in developing the framework of the paper. All remaining errors are mine and this paper's findings, interpretations, and conclusions are entirely those of the author and do not necessarily represent the views of the World Bank.

Introduction

Decentralization has been gaining increasing attention as a means of improving the provision of public goods and services¹ as reforming public-service delivery has moved to the forefront of the current policy agenda.² The main economic reason behind this increased interest is the prospect of improving citizens' welfare through efficiency gains (Tanzi 1995). In other words, welfare is maximized if each local government provides the Pareto-efficient³ level of output for its constituents through benefit pricing (Oates 1972, p. 34-35). The argument is that local government is more efficient to provide public goods and services tailored toward the preferences and tastes of individual residents, so as to achieve an increased level of satisfaction for them.

At the same time, experience shows that decentralization has often been motivated by political reasons (e.g., dealing with a mounting budget deficit) rather than economic rationale (e.g., efficiency gains, increase in employment, economic stabilization, equity). For example, an overburdened central government may try to delegate or pass on the responsibility for the provision and maintenance of public goods and services to local government, but without ensuring adequate institutional and financial provision. In this case, decentralization neither improves welfare or the quality of life for residents nor increases the efficiency of the public sector.

High expectations from decentralization seem to stem partly from recent experiences of failed centralized states under planned economic and political systems.⁴ Strong pressures for the restructuring of the public sector are present today, and have been before in countries at differing stages of economic development. It has been argued that fragmenting central authority and introducing more "Tieboutian" intergovernmental competition (e.g. "voting with feet") can generate a range of benefits including making government more efficient and responsive.⁵ Some economists and political scientists also have questioned the effectiveness of central government in improving the distribution of income and stabilizing the economy, while advocating a smaller public sector by giving markets and local jurisdictions more power. These arguments have been put forward along with support for privatization to improve the efficiency of the public sector,⁶ although it is not evident that decentralization can improve income distribution

¹ See John G. Head (1974) for discussion on public goods and welfare.

² See the World Bank publications for discussion on reforming public service delivery: World Development Report (2004); Berlin Workshop Series (2004); Annual Bank Conference on Development Economics-Europe (2005) and Besley and Ghatak (2003).

³ Pareto-efficiency refers to the situation when nothing could be done to make at least one person better off without hurting someone else. The implication is that no one needs to be made worse off, while at least one person will have an increased level of welfare.

⁴ The World Development Report 1997 (World Bank) argues that development requires an effective state that plays a facilitator role in encouraging and complementing the activities of private businesses and individuals versus reducing government to a minimalist state. Governments with both centrally-planned and mixed economies are shrinking their market role because of failed state interventions.

⁵ Charles M. Tiebout (1956) argues that the Musgrave-Samuelson analysis, which is valid for federal expenditures, need not apply to local expenditures.

⁶ Vito Tanzi, 1996, "Fiscal Federalism and Decentralization: A Review of Some Efficiency and Macroeconomic Aspects," in *Annual World Bank Conference on Development Economics 1995*, pp. 296.

and macro management. Cai and Treisman argue that “decentralization is sometimes presented as almost a functional equivalent of privatization.”⁷

This paper examines the conceptual framework and experience surrounding decentralization. It aims to shed light on the effectiveness of decentralization in improving the provision of public services. First, it begins by presenting definitions of decentralization. Second, it discusses some of the arguments for decentralization, with allocative efficiency one of the main economic rationales for improving public welfare. Third, issues related to the implementation of decentralization are addressed. These include economic factors influencing the assignment of expenditure and revenue responsibilities. Some of the major revenue sources are also discussed including own revenue and intergovernmental transfers. Fourth, the potential impact of decentralization and its implications for developing countries are reviewed by examining experience with decentralization. Finally, the conclusion highlights the main points of each of these sections.

What Is Decentralization?

When discussing decentralization, it is implicitly assumed that countries have different levels of government (central, regional/state, municipal/local) with different degrees of decision-making power. Some political scientists argue that each level of government in a federal system should have independent authority: on this definition, only a few countries would be considered to operate in a federal system (e.g., US, Canada, Switzerland). Meanwhile, the literature on decentralization does not uniformly agree on what decentralization entails.

The following are some definitions of decentralization that are broadly coherent, but have different emphases:

1. Wallace E. Oates argues that a federal system of government is the most promising form for organizing the public sector in resolving the allocation, distribution, and stabilization problems. There are two near polar forms of government:
 - *Complete centralization* (a unitary form of government): in the absence of other levels of government, the central government assumes full responsibility for the three economic functions of the public sector.
 - *Total decentralization*: the opposite direction of centralization on the spectrum of governmental forms that would presumably represent a state of anarchy. A highly decentralized system in which the central government is almost completely devoid of economic responsibility. In this case, a system of small local governments would perform virtually all the economic tasks of the public sector. But this would be highly unrealistic.

Oates sees that a unitary government has a comparative advantage in resolving stabilization and distribution problems (including externalities of collective goods) while

⁷ Cai, Honbin and Daniel Treisman, “Did government decentralization cause China’s economic miracle?” *World Politics*, forthcoming, pp.35.

a decentralized government has comparative advantages in satisfying varying preferences of the residents of the different communities by providing public goods and services whose benefits are *limited to a specific subset of the population*. Oates argues that federalism combines the advantages of these two polar forms and avoids the most serious shortcomings of each.⁸ In a federal system, each level of government makes decisions concerning the provision of certain public services in its respective geographical jurisdiction: *each does what it can do best rather than attempting to perform all the functions of the public sector*.

Oates argues that economists might be interested in which “different levels of decision-making do exist, each of which determines levels of provision of particular public services in response largely to the interests of its geographical constituency” (Oates 1972, pp. xvi). Thus, economists’ central concerns are the allocation of resources and the distribution of income within an economic system. By this definition, any fiscal system/government at least possesses federal elements. In that decentralization (fiscal decentralization) has compelling advantages for *some* functions over a complete reliance on centralized decision-making.

In Oates’ view it makes little difference to the economist whether or not decision-making at a particular level of government is based on delegated or constitutionally guaranteed authority in contrast to the conception of federalism in political science. Thus *federalism should be treated not in absolute but in relative terms, in degrees rather than in kind*.

2. Prud’homme (1994) suggests a typology that distinguishes between three types of decentralization: spatial, market and administrative. *Spatial decentralization* is defined as a process of diffusing urban population and activities away from large agglomerations; *market decentralization*, economic liberalization, is defined as a process of creating conditions in which goods and services are provided by market mechanism; and *administrative deconcentration* is defined as the transfer of responsibility for planning, management, and the raising and allocation of financial resources from the central government and its agencies to field units of government agencies, or subordinate units or levels of government.

According to Prud’homme, administrative decentralization can be subdivided into three types: de-concentration, delegation, and devolution.

- *De-concentration* is the redistribution of decision-making among different levels within the central government;
- *Delegation* is the transfer of responsibilities from the central government to semi-autonomous organizations not wholly controlled by the central government but ultimately accountable to it; and
- *Devolution* is the transfer of powers from the central government to independent sub-national governments. However, this typology does not

⁸ Oates interprets Kenneth C. Wheare’s definition of federalism: a political system provided by the constitution that protects the autonomy of different levels of government, “...the method of dividing powers so that the general and regional governments are each, within a sphere, co-ordinate and independent (Oates 1972, pp.16).” A political study of federalism is concerned with the division and use of power, by excluding from the federal category a system in which the power of sub-national governments is exercised solely at the convenience of the central government: delegation.

seem to hold always: the word “decentralization” is often being used for a synonym for “devolution.”⁹

3. Vito Tanzi (1996) describes decentralization in two broad categories:
 - *De-concentration*: implies only a delegation of administrative control to lower levels (sub-national governments in the administrative hierarchy) and
 - *Decentralization*: genuine possession of independent decision-making power by decentralized units.

4. Richard M. Bird and Francois Vaillancourt (2006) consider three types of decentralization:
 - *De-concentration*: giving regional or local offices of the central government decision-making power previously held in the central offices in the capital;
 - *Delegation*: making a sub-national government responsible for carrying out a function for which the central government retains responsibility; and
 - *Devolution*: transferring responsibilities from the central government to sub-national governments.

5. James Manor (1999) considers three types of decentralization: de-concentration or administrative decentralization, fiscal decentralization, and devolution or democratic decentralization.¹⁰
 - *De-concentration/administrative decentralization*: refers to the dispersal of agents of higher levels of government into lower level arena. However when de-concentration (even with fiscal decentralization) occurs in isolation without simultaneous democratization, it still enables the central authority to penetrate more effectively into lower level arena without increasing the influence of interests at those arena. This could be especially true in developing countries.
 - *Fiscal decentralization*: refers to downward fiscal transfers to lower levels influencing over budgets and financial decisions. Fiscal decentralization in isolation without democratization would face the same problems mentioned above (e.g., central control) although it is less prone to these tendencies than de-concentration.
 - *Devolution/democratization*: refers to the transfer of resources and power (and tasks) to lower level authorities which are largely or wholly independent of higher levels of government, and which are democratic in some way and to some degree.

6. Cai and Treisman illustrate three types of decentralization based on examination of common usage.
 - Administrative decentralization occurs when subnational agents are permitted by national authorities to make certain policy decisions, subject to review.

⁹ Rémy Prud'homme (1994) pp. 2.

¹⁰ Manor excludes other three types of decentralization, namely, decentralization by default (when government institutions become so ineffective, fail to influence lower level arenas), privatization, and delegation (of responsibilities for development programs or projects to para-statal agencies).

- Political decentralization occurs when either: (1) subnational governments have the right to make certain policy decision not subject to being overruled by higher levels, or (2) subnational officials are chosen by local residents.
- Fiscal decentralization implies various forms of fiscal allocation to subnational governments depending on a specific government.

In summary, three general types of decentralization are presented: administrative, fiscal, and political.

- *Administrative* decentralization takes place when funds are allocated to decentralized units that carry out their spending activities even if most taxes are raised centrally.¹¹ It should be noted that in many developing countries, subnational governments act as agents of the central government according to guidelines imposed by the central government rather than making independent spending decisions.
- *Fiscal* decentralization exists when sub-national governments have decision-making power, authorized by the constitution or legislation, to raise revenues (taxes) and perform spending activities.¹²
- *Political* decentralization exists when public officials (e.g., governor, mayor, council member) at sub-national governments are elected by secret ballots, and sub-national governments are given independent power for decision-making by constitutional or legislative authority.

Table 1: Types of decentralization and their characteristics

Type	Administrative	Fiscal	Political
Characteristics	Independent decision-making by subnational governments on spending activities	Independent decision-making power by sub-national government for raising revenues and allocation of financial resources	Free election in selecting officials (e.g., mayor, council) of subnational governments by secret ballots

In practice, decentralization is often used with interchangeably devolution, and de-centralization with delegation. It also should be noted that decentralization, in a theoretical sense (and in an ideal world), requires the simultaneous occurrence of all these three types of decentralization (administrative, fiscal, and political) in order to realize the full potential benefits. However, in the real world (and more so in developing countries) each of these can occur in isolation, or any two (or all) can occur simultaneously to different degrees.¹³ Thus, decentralization can be better described as an evolutionary

¹¹ Italy could be considered as an administratively decentralized country where local entities raise a small amount of total revenue but spend a relatively large portion of total net expenditure (Vito Tanzi 1996, pp. 297).

¹² Examples of fiscal decentralization include Argentina, Australia, Brazil, Canada, India, Germany, Nigeria, Switzerland, and the United States (Vito Tanzi 1996, pp. 297).

¹³ James Manor (1999).

process for allocating administrative, fiscal, or political power to subnational governments, rather than being defined precisely by these specific features.

For example, in measuring fiscal decentralization, the most widely used indicator is the population weighted average share of subnational expenditure and revenue in the total public sector, as reported in the Government Finance Statistics (GFS) of the International Monetary Fund. The average expenditure and revenue shares of subnational governments in twenty-eight countries have been increasing steadily over time since 1980. However, GFS is not an ideal data set for measuring fiscal decentralization: although it provides a breakdown of expenditures by function and economic type, it lacks information on the degree of expenditure autonomy. On the revenue side, GFS does not provide information on whether taxes are collected through shared taxes, piggy-backed taxes, or locally determined “own-source” taxes, or what proportion of intergovernmental transfers is conditional or unconditional (Ebel and Yilmaz 2002).

Another effort is underway by the Organization for Economic Cooperation and Development (OECD) to measure the degree of subnational autonomy over expenditure decisions as well as own-revenues and grants (see Bell and Ebel 2006). Roy Bahl sums up that “fiscal decentralization refers to an intergovernmental system where the balance of power moves more toward the subnational government sector than has been the case.”¹⁴

Why Decentralization?

In recent years, many countries around the world have begun to undertake decentralization in response to “government failure” in delivering public goods and services. It is viewed as a way to make government more efficient, responsive, and accountable. These perceived benefits of decentralization have attracted a diverse range of supporters¹⁵ that favor small government, free-markets, and a bottom-up approach, while privatization is encouraged as a way to advance decentralization (Tanzi 1996, Bardhan 2002). Before discussing the rationale for decentralization, a brief note on efficiency regarding the provision of public services is in order since the government’s resource allocation policies (e.g., revenue and expenditure) influence it. First, two dimensions of efficiency are discussed: productive and allocative. Second, arguments for improving welfare through government allocation are considered.¹⁶

Productive efficiency is when the economy is working on its production possibility frontier: this is when production of one good is achieved at the lowest cost possible, given the production of the other good(s).¹⁷ In other words, it is the highest possible output of one good, given the production level of the other good(s). Meanwhile, ***allocative efficiency*** is the market (in this case the public sector) condition whereby

¹⁴ Bahl (1999, pp. 4)

¹⁵ Pranab Bardhan calls them “anarcho-communitarians” (2002, pp. 186).

¹⁶ Allocation function is one of the three major economic functions of government identified by among others, Musgrave (1956), Oates (1972); the other two functions are the distribution function and the stabilization function.

¹⁷ A production possibilities curve (PPC) or “transformation curve” is a graph that shows the different quantities of two goods that an economy can produce if it uses its limited productive resources efficiently. Points along the curve describe the trade-off between the two goods. This curve shows the possibilities open for increasing the output of one good by reducing the output of another.

resources are allocated in a way that maximizes the net benefit attained through their use. Allocative efficiency refers to a situation in which the limited resources of a country are allocated in accordance with the wishes of consumers. An allocatively efficient economy produces an "optimal mix" of commodities. Resources are used allocatively efficiently if they are spent for producing the right mix of goods for the right people at the right price. That is to say, in a situation where society produces goods and services at minimum cost that satisfy the preferences of consumers, resources are allocated efficiently.

A set of rules devised¹⁸ in welfare economics if fulfilled will give rise to a Pareto Optimum, i.e., no one can be made better off without someone else being worse off. In other words, if somebody could be made better off without making any other person worse off, then clearly welfare is not maximized, and therefore resources are not allocatively efficient. If an economy is perfectly competitive, it is assumed that equilibrium exists, i.e. Pareto-efficiency, based on individual welfare.

However, Pareto-efficiency does not ensure socially desirable objective such as equity. In addition, Pareto-efficiency based on individual welfare may not also be efficient because of externalities since individuals take account only direct effects on themselves, not the effect on others. Furthermore, a competitive economy may not ensure a Pareto-efficient allocation of resources due to "imperfect information." The role of government is thus to ensure the correct supply of public goods while its intervention in markets is justified on the ground of correcting "market failures."¹⁹

Furthermore, unlike the private sector which has the single goal of maximizing profits for its share holders, the public sector's goal is to increase the benefit of the public at large—even though preferences are diffuse and welfare may be hard to measure. In this sense, Bergson (1983) suggests that a "Pareto-improvement" should be concerned with "normative efficiency" in formulating optimization criteria.²⁰

In the context of decentralization, a Pareto efficient allocation of resources alone may not necessarily lead to the optimal allocation of resources to meet the collective interest of citizens in a particular jurisdiction. Because Pareto efficiency does not necessarily produce public goods and services that reflect the desirable characteristics of these services, simply that no one person could be made better off without making some other person worse off. There is no consideration, for example, for equity. Thus, allocative efficiency occurs when the public sector produces public goods and services *most valued by society*. This means scarce resources are allocated to the production of goods and services so that citizens' wants and needs are met in the best way possible.²¹

As alluded before, the role of the public sector is to achieve a welfare optimum by allocating resources efficiently and facilitating economies i.e., through providing necessary public goods and services in *promoting job growth, fair income distribution,*

¹⁸ The basic theorems of welfare economics require that the economy is perfectly competitive and there is a full set of markets (e.g. identical marginal rate of substitution in consumption, identical marginal rate of transformation in production) and a number of market conditions (e.g. asymmetric information, externalities, natural monopoly, and principal and agent problems) may not lead to inefficiency.

¹⁹ See Joseph Stiglitz (1980) for detailed discussion.

²⁰ For further discussion see: Abram Bergson (1954, 1983) for social welfare; John Rawls (1971) for "max-min" utility function concerning equity and social economic justice; Amartya Sen (1984) for equity and poverty.

²¹ See Joseph Atkinson, A. B. and Joseph Stiglitz (1980) for detailed discussion on issues of efficiency and the economics of the public sector.

and *efficient allocation of resources* (Musgrave 1959, Oates 1972). Although these three functions are conceptually distinctive, they are fundamentally interdependent and moreover, at a policy level, any public problem will have an impact on the attainment of all three of the objectives of public policy.²²

However, there exist different levels of decision-making in a federal structure²³ of the public sector; each of which determines the provision of particular public services in responding largely to the interests of its *geographical* constituency (Oates 1972). An ideal case, “the optimal form of federal government to provide the set of n public goods would be one in which there exists a level of government for each subset of the population over which the consumption of a public good is defined.”²⁴ Oates calls this ideal case “*perfect correspondence*” in the provision of public goods in which a perfect match exists between the jurisdiction of each government unit and the group that collectively consume the goods.²⁵ For example, special districts in the U.S. reflect this concern such as fire, sewerage, and water districts. However, it should be noted that it is implicitly assumed that the costs of providing each level of output of the good²⁶ in each jurisdiction are the same for the central or the respective local government.

For example, central government tends to be better equipped at dealing with stabilization and distribution problems (e.g., monetary and fiscal policy) in maintaining the economy at the national level, while local governments are constrained in their capacity to regulate the aggregate level of economic activity. On the other hand, local governments may be more efficient, for example, in providing public goods of a local nature (e.g., refuse collection) for their constituency. They have comparative advantages over central government to provide the mix of public goods and services that best reflect the preferences of individuals in the jurisdiction since they have better access to information on local affairs. While a centralized government might not be well informed about them or ignore the difference, and would thus tend to supply a uniform package to all residents, and does not deliver the Pareto-optimal level of satisfaction for them. Thus the main economic argument for decentralization is largely based on *allocative efficiency* grounds (Tanzi 1994).

According to Oates, “it will always be more efficient (or at least as efficient) for local government to provide the Pareto-efficient levels of output for their respective jurisdictions than for the central government to provide any specific and uniform level of output across all jurisdictions.”²⁷ The argument is that welfare is maximized if each local government provides the Pareto-efficient output for its constituency based on the principle of “*perfect correspondence*.” Olson (1969) also argues that there is allocative efficiency where the boundaries of a government and a collective good it provides

²² Wallace E. Oates, 1972, *Fiscal Federalism*,

²³ Oates (1972) argues that “any fiscal system is federal or at least possesses federal elements” and “it is not surprising, for decentralized finance has such compelling advantages for *some* functions that one would not expect to find a total reliance on centralized decision-making on fiscal matter (pp. xvi).”

²⁴ Oates (1972) pp. 34.

²⁵ Oates (1972) pp. 34.

²⁶ If this is not the case, for example, if the central government can realize important *economies of scale* (*scope*) in the provision of the good that are not available to the local government individually, centralization may be desirable despite the decentralized character of the consumption of the good (Oates 1972), pp. 37.

²⁷ Oates (1972) pp. 35.

coincide. “There is a need for a separate governmental institution for every collective good with a unique boundary, so that there can be a match between those who receive the benefits of a collective good and those who pay for it (pp. 483).”

In addition, the incentives for decentralization are likely to be greater the more varied the efficient levels of output across jurisdictions; for the more pronounced will be the divergence of any uniform level of output from the efficient level in most localities. For a given population size, the welfare gain from the decentralized provision of a particular local public good becomes greater as the diversity in individual demands within the country as a whole increases and as each geographical grouping of consumers becomes more homogeneous in terms of their demands for the good (see appendix for graphical presentation).

At the same time, the “*subsidiarity principle*”²⁸ argues that the efficient provision of public goods and services requires that the government satisfy citizens’ needs and preferences as much as possible. Taxing, spending, and regulatory functions should be exercised by lower levels of government unless a convincing case can be made for assigning them to higher levels of government. This principle is the opposite of the residuality principle applied in a unitary country, where local governments are assigned functions by the central government. Thus the subsidiarity principle and decentralization in federalism should produce the optimal allocation of resources and consequently maximize welfare.

Implementing Decentralization

As shown from experience in decentralization, it is rarely the case all of the three types of decentralization occur simultaneously. Instead, it is more common to see one or two aspects of decentralization implemented in many countries; when governments decentralize they are often really deconcentrating or delegating rather than devolving responsibility (Martinez-Vazquez, McLure, and Vaillancourt 2006). At various degrees and scopes of decentralization, countries around the world have attempted to expand the role of sub-national governments in providing public goods and services for their citizens.²⁹ Most subnational governments deal with fiscal activities for generating revenue and making decisions on spending (expenditure) for the provision of public goods and services.

a. Assigning Functional and Expenditure Responsibilities

As mentioned in the previous section, the division of expenditure and revenue responsibilities and revenue sources is largely determined by how government activities are assigned to different levels of government. At the same time, assignments of functional responsibilities depend on the relative competence of different levels of government for carrying out a particular functional area. The three major functions of government include: *macroeconomic stabilization*, *income redistribution*, and *resource*

²⁸ Martinez-Vazquez et al (2006, pp. 18) states that “this is put forward as a key principle in the proposed European constitution (Article 1-9).”

²⁹ Roy Bahl (1999) does not see “true fiscal decentralization” would be viable in developing countries at least in the short run, given their very limited tax base at the local level.

allocation. Four criteria can be used to assess the assignment of functional and expenditure responsibilities.

Four Criteria. At the same time, each level of government is responsible for activities based on four (not exhaustive) criteria: economies of scale; the presence of externalities; heterogeneity of preferences and of circumstances; and emulation.³⁰

- *Economies of scale:* vary across goods and services and size of jurisdiction. For example, the unit cost per good drops as the quantity of the good increases. The existence of significant economies of scale constitutes an argument for a higher level of government to provide a particular good or service.
- *The presence of externalities (negative or positive):* provision of a good or service may have spill-over effects beyond a particular jurisdiction. The presence of external effects is a consideration in determining the optimal-sized group to serve a particular good. For example, the smaller the group, the less the external effects are likely to be internalized. The greater the externalities (as aggregate welfare gain or loss becomes larger), a higher level of government provision is desirable.³¹
- *Heterogeneity of preferences and of circumstances:* when there is the existence of heterogeneous preferences among geographical subsets of the total population, welfare would be maximized if each local government satisfies the unique preferences of its citizens by providing a particular good or service tailored to citizens' preference (e.g., quality) instead of uniform provision of a good across the region or country by the central government.
- *Emulation:* refers to competition, which facilitates introducing best practices in government, requires two or more jurisdictions involved in a given activity; an argument for decentralizing government activities.

b. Two Major Sources of Subnational Government Revenue: Local Taxes and Intergovernmental Transfers

Governments carry out their responsibilities through spending. Expenditures should be matched by revenues. Revenues basically consist of three sources: local tax revenues, intergovernmental transfer, and to some extent, borrowing. Borrowing is certainly another option, but recent studies (Tanzi 1996; Rodden, Eskeland, and Litvack 2005) suggest this may be problematic because of the lack of hard budget constraints imposed on subnational government in most developing countries (and in many OECD countries). Central government bail-outs are rather common and the weak enforceability of hard budget constraints of subnational governments puts macro-economic stability at risk (Tanzi 1996, Bardhan 2002, Tommasi 2006). This is particularly a problem for developing countries, except perhaps for a few wealthy metropolitan cities.

³⁰ Martinez-Vazquez, McLure, and Vaillancourt (2006).

³¹ Oates (1972, pp. 46) adds "free-rider" problems when the provision of the good elsewhere can serve a substitute for local provision of a good. Then there will be an incentive to engage in "free-rider" behavior (accentuates with a large number of small jurisdictions of consumers).

However, only two sources will be discussed in this paper. Local tax revenues typically include income taxes (piggy backed to federal income taxes in many developing countries due to collection difficulties), property taxes, user fees, license, excise fees. Intergovernmental transfer (reflecting disparities between central and subnational governments and across different subnational governments) can be conditional (e.g. matching grants) or unconditional (revenue sharing) grants from the central government. Depending on the degree and scope of decentralization, sub-national governments either have autonomy deciding on what to and how to spend money on goods and services or they have to follow guidelines imposed by the central government. However, it should be noted that in most countries subnational governments have very limited tax bases and capacity to set tax rates and administer the collection of taxes. As a result, the central government determines the tax base and rates as well as collecting centrally. Thus, intergovernmental transfer is the most important resource for subnational government.

b-1. Own Revenue Sources of Subnational Government

The Principle of Benefit Taxation. Subnational governments raise their own resources from various taxes and fees. If subnational governments are to achieve true fiscal decentralization, they must control their own sources of revenue. Thus important questions are which revenue sources can and should be assigned to subnational levels of government and how these assignments will be carried out. The principle of benefit taxation³² represents that to the extent possible, goods and services provided by the government should be financed by fees and taxes. Olson refers to “*fiscal equivalence*” in which there is a match between those who receive the benefits of a collective good and those who pay for it (1969). Tax payments should reflect the costs and benefits of public goods and services. This is fair and efficient in the sense of encouraging responsible use of the nation’s scarce resources. Such taxes levied on motor vehicles and fuels are some of the examples of benefit-related taxes used for the construction and maintenance of roads.

The assignment of taxes should match the benefits derived from spending based on assigned responsibilities and expenditures of each level of government. Approaches to assigning revenues to subnational governments differ in the degree of fiscal autonomy in terms of *the ease of compliance and administration, the fairness and neutrality they can likely produce, and the degree of interjurisdictional redistribution they can accommodate*. According to Martinez-Vazquez et al (2006), four aspects of revenue assignment can be distinguished: (1) which level of government chooses the taxes from which subnational governments receive revenue; (2) which level defines the tax base; (3) which level sets the tax rates; and (4) which level administers the taxes. For the view of subnational fiscal sovereignty, the authority to set rates is the most important of these because the choice of rates is what allows subnational government to choose the level of public services. However, excessive subnational latitude in the choice of tax bases and in tax administration can cause unacceptable administrative burdens and distortions in the allocation of resources.

³² The principle of benefit taxation refers that within the context of the just distribution of income, consumers finance the cost of public goods and services by payments in accordance with benefits received.

Approaches for Subnational taxes. In general three approaches are practiced. Under a first approach, subnational governments have fiscal autonomy provided by independent subnational legislation and administration in choosing taxes they levy, tax bases, setting the tax rates, and administering the taxes. This approach is practiced in Canada, Switzerland, and the United States. Under a second approach, a higher level of government defines the tax base and collects both its own and surcharges set by subnational governments. With this approach, subnational governments retain the attributes of fiscal sovereignty in the tax field by setting the tax rate rather than retaining the ability to define the tax bases and administer taxes. Under a third approach (tax sharing), subnational governments receive fixed fractions of revenues from particular national taxes originating within their boundaries. However, this approach restricts subnational governments' fiscal autonomy even if they have authority over spending a given amount of revenue (see Tommasi 2006 for extensive discussion on tax sharing in Argentina during the 1990s).

Based on the traditional theory of fiscal federalism (easy to administer locally and mainly imposed on local residents), subnational governments are usually given a limited tax base such as property tax, taxes on vehicles, and user charges and fees. These limited sources of revenue impose difficulties on subnational governments in financing necessary public services. For example, property tax is not sufficient to meet major social expenditures in most cases; in addition, it is costly and difficult to administer.³³ Richard Bird (2006) argues that good subnational taxes should satisfy two main criteria: (1) they should provide sufficient revenue for the autonomous fiscal units, at least for the richest subnational units; and (2) good subnational taxes should impose fiscal responsibility at the margin on subnational governments by allowing them to establish their own tax rates with respect to at least some major taxes.

Major Tax Sources for Subnational Government. The following are the major tax sources for subnational governments (local and regional).

- *User charges:* these are based on the principle of “willingness to pay” rather than the principle of “ability to pay.” Citizens should value what the public sector supplies, at least at its marginal cost. It is a way to assess the true demand for the goods or services the public sector supplies, thus the economic efficiency in allocating resources can be enhanced. However, the importance of user charges is greater in principle than the relatively small amount of revenues collected from this source in most countries.
- *Property taxes:* in spite of difficulties in assessing the value of property and administrative costs, a low-rate and uniform property tax is important in financing local governments in most countries. Subnational governments usually finance “hard” services such as local roads and garbage collection out of property taxes. However if these governments are to expand their roles into “soft” services such as education and health, then they will need to have access to more elastic revenue sources.
- *Excise taxes:* while the property tax is the pre-eminently local tax, excise taxes (on alcohol and tobacco) could be a significant source of subnational

³³ Bell and Bowman (2005) explore a way to extend local property taxation into communal lands in rural South Africa.

revenue. Excise taxes are relatively easy to administer and lend themselves to regionally-differentiated rate determination. In addition, a general benefit argument can be made for some regional excises, for example, on alcohol and tobacco to the extent that subnational governments are responsible for health expenditures and on vehicles and fuel to the extent that they are responsible for regional and local roads.

- Other potential sources of taxes include personal income taxes, payroll taxes, sales tax, and business taxes. Except user charges to some extent, most of these taxes (including property and excise) are not likely reduce local and regional disparities between jurisdictions.

To implement fiscal decentralization, three principles are suggested for subnational taxation (Bird 2006): (1) attention should be paid to matching expenditure and revenue needs; (2) an effort should be made to ensure that all governments bear significant responsibility at the margin for financing the expenditures for which they are politically responsible; and (3) subnational taxes should not unduly distort the allocation of resources. In many developing and transition countries, however, problems related to subnational taxation would largely remain unsolved in the foreseeable future even if there are major reforms of subnational tax regimes, due to limited tax bases and administrative capacity at the subnational level. That is why many transition countries have opted for shared taxes.

b-2. Intergovernmental Transfers

Regarding intergovernmental transfer, several experts (Oates 1972, Bhal 1999) argue that unconditional grants are preferable to conditional grants in promoting decentralization. In the case of *conditional grants*, the central government defines to some extent, the objectives for which sub-national governments are to use the grants in promoting positive externalities across regions (e.g. education, health programs, inter-regional transportation network). On the other hand, with unconditional grants, subnational governments can employ the grants according to their own set of priorities and objectives. But, there is an indication that conditional grants (e.g. matching grants) that earmark to infrastructure are more likely to promote infrastructure investment (Oates 1972) more than non-conditional grants. It might also be desirable if the central government wants to promote positive externalities generated by multi-jurisdictional infrastructure projects through this kind of subsidies (“Pigovian” subsidies). Then, the central government may want to use conditional grants as a policy tool in creating certain incentives for sub-national governments.

Unconditional grants, to some extent, imbed an element of the welfare optimum involving both allocative efficiency and an equitable distribution of income (Oates 1972, pp. 78). In Australia, Canada, and several European states, the central government makes substantial unconditional grants to subnational governments containing significant equalizing features.³⁴ At the same time, a national program that distributes income

³⁴ Based on equal per-capita grants to all states, the grants are usually financed by the progressive federal income tax which wealthier jurisdictions would pay in a larger sum per capita to support the grant program although they receive the same per-capita grant as poor states.

among individuals, not among jurisdictions, is the preferred alternative to achieve a just distribution of income among individuals in a country. Unconditional grants are also used for the promotion of horizontal equity (the equal treatment of equals)³⁵ among jurisdictions. The central government seeks to equalize the fiscal capacity of all jurisdictions by instituting a transfer program of unconditional grants to poorer localities. For example, grant per capita can vary inversely with the level of per-capita income in the jurisdiction.

Most countries use both conditional and unconditional grants to more decentralized levels of government. The former are typically used to encourage spending on such items as education, health, highways, and regional roads, which involve significant interjurisdictional positive externalities, in addition to support explicitly redistributive programs. The major conditional grant programs intend to achieve two primary objectives: (1) the achievement of national minimum levels of certain basic public services; and (2) an equalization across jurisdictions of the “fiscal effort” required to provide these minimum program levels. It is to ensure that every individual has access to a sound program of public services within his chosen locality at a cost in line with what he would pay elsewhere.

Moreover, these intergovernmental grants in general involve equalizing provisions (e.g., horizontal equalization) so that poorer jurisdictions receive more generous support by incorporating provision to account for the particular expenditure requirement, or “need” of each jurisdiction in addition to its “fiscal capacity” to meet that need. Intergovernmental transfer thus can be interpreted as a policy tool by the central government in achieving one of its prime responsibilities in achieving income redistribution. In addition a good intergovernmental transfer system should provide fiscal incentives for local governments to economize on expenditures and to raise their own resources.

Challenges and Potential Impacts and of Decentralization with Implications for Developing Countries

Policymakers, researchers and the public have long been interested in ways to increase the effectiveness of the public sector. The core of the debate lies in how government can improve the welfare of its citizens through adequate provision of public services, from opportunities for education and employment to the provision of clean water. Decentralization has been seen by a wide range of advocates as a way to increase the efficiency and enhance the accountability of the public sector, i.e. improving the governance of the public sector. These potential benefits have engendered an enthusiasm for decentralization in both developing and developed countries. Developing countries are turning to decentralization to escape from the traps of ineffective public sectors, while developed countries look for effective tools to reorganize the government in order to efficiently provide public services in the “post-welfare state” era (Bennett 1990; World Bank 1997; Bird and Vaillancourt 2006).

³⁵ Musgrave (1959) argues in *The Theory of Public Finance* (pp. 160) that “perhaps the most widely accepted principle of equity in taxation is that people in equal positions should be treated equally.” Grants are also provided to alleviate vertical fiscal disequilibrium between different levels of government by assessing the needs based on such indicators as population, urban density.

However, decentralization is neither good nor bad. “It is a means to an end, often imposed by political reality (World Bank 1999, pp. 107).” In addition, it is increasingly clear that the benefits of decentralization can easily be undermined by potential costs such as increasing indebtedness, high deficits, and procyclical finances of subnational governments and regional disparities (Wolman 1994; Prud’homme 1994, 1996; Tanzi 1996; Rodden, Eskeland, and Litvack 2005; Bardhan and Mookherjee 2005; Tommasi 2006). At the same time, the potential allocative efficiency gains of decentralization stemming from satisfying unique preferences of citizens in jurisdictions may not be realized as assumed in theory. Because in most developing countries, the problem is not in satisfying fine differences in preferences between jurisdictions but to meet basic needs.

a. Accountability

Regarding public sector accountability, it is argued that the accountability of the public sector will be improved because ineffective local officials would be voted out from their office because the taxpayers will express their preferences in their votes. However experience shows that local elections are often dictated by personal loyalties or political party loyalties. Even if taxpayers vote based on their preferences, it is often the case that voters have limited access to relevant information (“asymmetric information”) and often limited capacity to digest the information (see Sappington and Stiglitz 1987 for asymmetric information; Downs 1957 for voting in democracies³⁶). Devarajan et al (2007) show that the “missing link” between citizens and local government officials in the provision of public services is due to the lack of enforceability of local officials’ accountability. This problem tends to be more severe in developing countries.

At the same time, there is no guarantee that locally elected officials will fulfill their obligation to satisfy the revealed preference. Incentive systems are such that the officials may satisfy a number of influential people in business and political communities (“local elites”) instead of their constituency in order to be re-elected. In particular if re-election depends largely on the influence of local leaders and interest groups rather than on the local performance of public services, as it usually takes longer than the election cycle to produce tangible benefits with policy changes. Thus “local capture” can easily undermine the benefits of decentralization by incurring new costs (e.g. poor subnational tax collection, distortionary subnational taxation, inefficient provision of local public goods).

Experience on decentralization also points to the effects of corruption at the local level although there is no conclusive evidence whether centralized or decentralized government creates higher costs related to corruption (see Bardhan, Pranab and Dilip Mookherjee 2005 for a detailed survey on corruption). Several studies warn that corruption is costly in terms of allocative efficiency and production efficiency. For example, bribes and kickbacks from suppliers would lead to an oversupply of services.

³⁶ Downs (1957) argues that the empirical observation of the economic theory of a democracy suggest that democracy is an imperfect political system as the government is chiefly motivated to maximize the most votes instead of maximizing the social welfare of the society. This imposes continuous challenges to governments and citizens alike as to what degree we can collectively ensure a relatively equal society where the will of people and the public interest are represented relative to the proportion of the population and not relative to the endowment of resources, to help ensure economic and political stability.

At the same time, productive efficiency would be undermined when cost-saving technologies and policies are not adopted.

b. Regional Disparities and Economic Development

Decentralization can also increase regional disparities between jurisdictions. Prud'homme (1994, 1996) argues that decentralized redistribution is likely to lead to different treatment of similar individuals in a country. For example, jurisdictions with higher per capita income would be able to provide higher levels of public services than those with lower per capita income. Residents in wealthier jurisdictions could even be levied at lower tax rates for higher levels of public services than those in poor jurisdictions.

Moreover, political fragmentation could hamper the promotion of regional economic performance and worsen the disparities within it. For example, local metropolitan governments compete with each other as locations for employers so as to improve their tax base. This need not increase the aggregate level of employment in metropolitan areas, it merely redistributes employment. Local governments have incentives to exclude high cost residents and are reluctant to invest in improving the skills of the poor. Fragmentation tends to encourage a “beggar thy neighbor” policy (Wolman H. et al 1992). Therefore equity between localities and individuals should be a concern when considering decentralization. In many developing countries where income distributions between jurisdictions and individuals are skewed, equity and fairness should be an important consideration in designing decentralization.

Experience on decentralized government in the U.S. also raises an issue related to public policy in promoting development through state enterprise zone programs. Peters and Fisher (2002) argue that excessive competition between states and localities to attract business and firms through enterprise zone programs has not produced any noticeable positive impacts on either job growth or tax revenue. Front-loading incentives for attracting business through tax rebates and infrastructure provision have failed to provide any sustained investment growth; instead the venture has wasted tax revenues of the subnational government. Although subnational governments should take an active role in promoting economic growth within their jurisdictions, the fragmented government structure does not seem well equipped to implement coherent economic development strategies for long term economic growth.

C. Local Capacity

Although their decentralization experience has not resulted in the macroeconomic instability associated with Latin America, White and Smoke (2005) observe that East Asian countries face the major challenges in decentralization. One of them is the poor accountability and weak capacity (both financial and human resources) of subnational governments. The other two relate to the sound assignment of functions among different levels of government and concerns for the sufficient allocation of own-source revenues to subnational governments to ensure the adequate provision of services.

At the same time, Yilmaz, Hegedus, and Bell (2003) emphasize that in order to realize the full potential of decentralization, the availability of necessary information at

the local level is critical. In many developing countries, as local governments take a more active role in the provision of education and health services (which help reduce poverty), weak statistical capacity at the subnational level to produce the household data needed to identify potential beneficiaries and monitoring progress in poverty reduction prevents full realization of decentralization.

Bardhan (2002) also highlights the need to strengthen the local capacity of information and accounting systems and mechanisms of monitoring the performance of public bureaucrats in developing countries. For instance, attention should be paid to special incentives and devices to check bureaucratic corruption, thus the differential efficacy of such mechanisms under centralization and decentralization can be evaluated. In many developing countries, one of the major goals is to effectively reach out to the poor—targeting success in poverty alleviation programs is treated as an important criterion, rather than the efficiency of interregional resource allocation. Thus, redistribution to disadvantaged groups or regions at the subnational level can improve the potential for productive investment and human resource development on the part of communities long bypassed by the local elite.

Conclusion

Musgrave (1956) argues that a federal structure for the public sector has the greatest potential for resolving the stabilization, distribution, and allocation problems while Oates emphasizes that all forms of government in one way or another share the characteristics of federalism, regardless of degree of centralization or decentralization. Theories of federalism and empirical studies suggest that there tends to be an inverse relationship between centralization and income level, population size, and diversity (cultural, ethnic, regional, racial). At the same time, many developing countries are searching for an alternative to the ineffective provision of public services by the central state. Thus, it is likely that many countries are likely to face issues of decentralization as countries grow in terms of income and population, and to improve the efficiency of provision of public goods and services.

First, this paper discussed several definitions of decentralization. It showed that devolution is often used interchangeably with decentralization, while delegation is often substituted for de-concentration. In general, decentralization refers to the independent decision-making authority of subnational government in its administrative, fiscal, and political affairs. But in reality, most countries are likely to simultaneously deal with issues related to these two dimensions (e.g., delegation and devolution) of decentralization, not just one or the other.

Second, the paper presented efficiency arguments for decentralization, by examining theories of federalism where each level of government has a comparative advantage in the provision of particular public services. For example, the central government might be more efficient in dealing with macrostabilization and redistribution policies. However, subnational government is able to more efficiently provide public services of a local nature within its jurisdiction, because it has better access to relevant information and is more accountable for satisfying the preferences of its residents. Thus, decentralization of certain public services will improve the welfare of a country's citizens at the aggregate level.

Third, in discussing implementing decentralization, it was argued that the proper assignment of functional responsibilities depends on the relative competence of different levels of government for carrying out a particular functional area (e.g., macroeconomic stabilization, income redistribution, and resource allocation). Four factors (externalities, economies of scale and scope, heterogeneity of preference, and emulation) are considered for assigning functional responsibilities. It is argued that certain types of economic parameters influence the structure and operation of the public sector, although the structure of a particular country is largely the result of the unique political and social history of that nation. At the same time, the assignment of government activities determines the division of expenditure and revenue responsibilities.

Expenditures are financed through subnational own sources of revenue and intergovernmental transfers. Subnational government's own sources of revenue include user charges, fees, and excise and property taxes. These taxes are based on "the principle of benefit" that users should pay for services provided. Other potential sources of revenue are retail sales taxes, income taxes, and value added taxes. But these taxes are usually collected centrally and shared between different levels of government in most developing countries. Intergovernmental transfers are the other major source of revenue for subnational government in most countries, due to limited tax bases and weak administrative capacity in setting tax rates and collecting and administering taxes. In addition, borrowing is another option, but recent studies (Tanzi 1996; Rodden, Eskeland, and Litvack 2005; Bahl and Martinez-Vazquez 2006, Tommasi 2006) suggest this may be problematic because of the lack of hard budget constraints imposed on subnational government in most developing countries (and in many OECD countries). Broadway and Shah (2007) argue that subnational governments are almost never self-sufficient financially—regardless of the political or constitutional definition of the nation—and have to rely on financial transfers from the central government. Thus, at least in the short term, a key issue is how to design an effective intergovernmental transfer that ensures the adequate provision of public services.

Finally, the paper examined challenges and potential impacts of decentralization, along with their implications for developing countries. In recent years, many developing countries have taken a keen interest in decentralization to address the problem of an inefficient public sector. But, experience shows that the negative impacts of decentralization can undermine the benefits. Some of the challenges for decentralization include the limited capacity of local government, corruption of local officials, and imperfect democratic systems. These imply that decentralization may not fully deliver the intended objectives of improving public sector management and efficiency of resource allocation in the provision of public services.

However, there is growing pressure to find an alternative to the ineffective centrally controlled provision of public services in many developing countries even if decentralization is not a panacea for correcting inadequate provision of public services. In order to fully take advantage of the potential benefits of decentralization, Bahl (1999) suggests twelve rules that need to be in place for the viable implementation of fiscal decentralization.³⁷ For the first rule, Bahl argues that implementation should begin with a design of a comprehensive system and be prepared to deal with the transition problems during phase-in. In addition, he considers that political autonomy is the most

³⁷ See Bahl (1999) for detailed discussion on twelve rules for implementing fiscal decentralization.

crucial element of a decentralized system, along with a significant set of expenditure responsibilities and a substantial amount of taxing powers, budget making autonomy, transparency, and a hard budget constraint. At the same time, it is crucial for many developing countries to improve institutional design in order to reshape existing forms of organization of the public sector and improve the provision of public goods and services. Therefore, issues of accountability and incentives are as important as issues of optimal taxation, tax incidence, and so on.

References

- Atkinson, A. B. and Joseph Stiglitz. 1980. *Lectures on Public Economics*, McGraw-Hill Education.
- Bahl, Roy. 1999. *Implementation Rules for Fiscal Decentralization*, Georgia State University, Atlanta, Georgia.
- Bahl, Roy and Jorge Martinez-Vazquez. 2006. *Sequencing Fiscal Decentralization*, Policy Research Working Paper, no. WPS 3914, the World Bank.
- Bardhan, Pranab. 2002. "Decentralization of Governance and Development," *Journal of Economic Perspectives*, Fall, Vol. 16, No. 4, pp. 185-205.
- Bardhan, Pranab and Dilip Mookherjee. 2005. "Decentralization, Corruption and Government Accountability: An Overview," in *Handbook of Economic Corruption*, edited by Susan Rose-Ackerman and Edward Elgar.
- Bartik, J. Timothy. 1991. *Who Benefits from State and Local Economic Development Policy?* pp. 202-211.
- Bell, Michael E. and John H. Bowman. 2005. *Implementing A Local Property Tax When There Is No Real Estate Market: The Case of Commonly Owned Land In Rural South Africa*.
- Bell, Michael E. and Robert D. Ebel. 2006. *Statistical Capacity Building in Tanzania and Uganda: Identifying and Measuring Own-Source Subnational Revenue Autonomy*.
- Bennett, Robert J. 1990. "Decentralization, Intergovernmental Relations and Markets: Towards a Post-Welfare Agenda?" in Bennett (editor) *Decentralization, Intergovernmental Relations and Markets: Towards a Post-Welfare Agenda*, Clarendon Press, Oxford.
- Bergson, Abram. 1954. "On the Concept of Social Welfare," *The Quarterly Journal of Economics*, Vol. 68, No. 2, pp. 233-252.
- . 1983. "Pareto on Social Welfare," *Journal of Economic Literature*, Vol. 21, No. 1, pp. 40-46.
- Besley, Timothy and Maitreesh Ghatak. 2003. "Incentives, Choice, Accountability in the Provision of Public Services," *Oxford Review of Economic Policy*, Vol. 19, No. 2
- Bird, Richard M. 2006. "Fiscal Flows, Fiscal Balance, and Fiscal Sustainability," in *Perspectives on Fiscal Federalism*, edited by Bird and Vaillancourt, World Bank.
- . 2006. "Local and Regional Revenues: Realities and Prospects," in *Perspectives on Fiscal Federalism*, edited by Bird and Vaillancourt, World Bank.
- Bird, Richard M. and Francois Vaillancourt. 2006. "Introduction and Summary," in *Perspectives on Fiscal Federalism*, ed. by Bird and Vaillancourt, World Bank.
- Broadway, Robin, Sandra Roberts, and Anwar Shah. 1994. *The Reform of Fiscal Systems in Developing and Emerging Market Economics: A Federalism Perspective*, Policy Research Working Paper 1259, the World Bank, Washington, D.C.
- Broadway, Robin and Anwar Shah. 2007. "Overview," in *Intergovernmental Fiscal Transfers: Principles and Practice*, ed. by Robin Broadway and Anwar Shah, the World Bank.
- Cai, Honbin and Daniel Treisman. forthcoming. "Did government decentralization cause China's economic miracle?" *World Politics*.

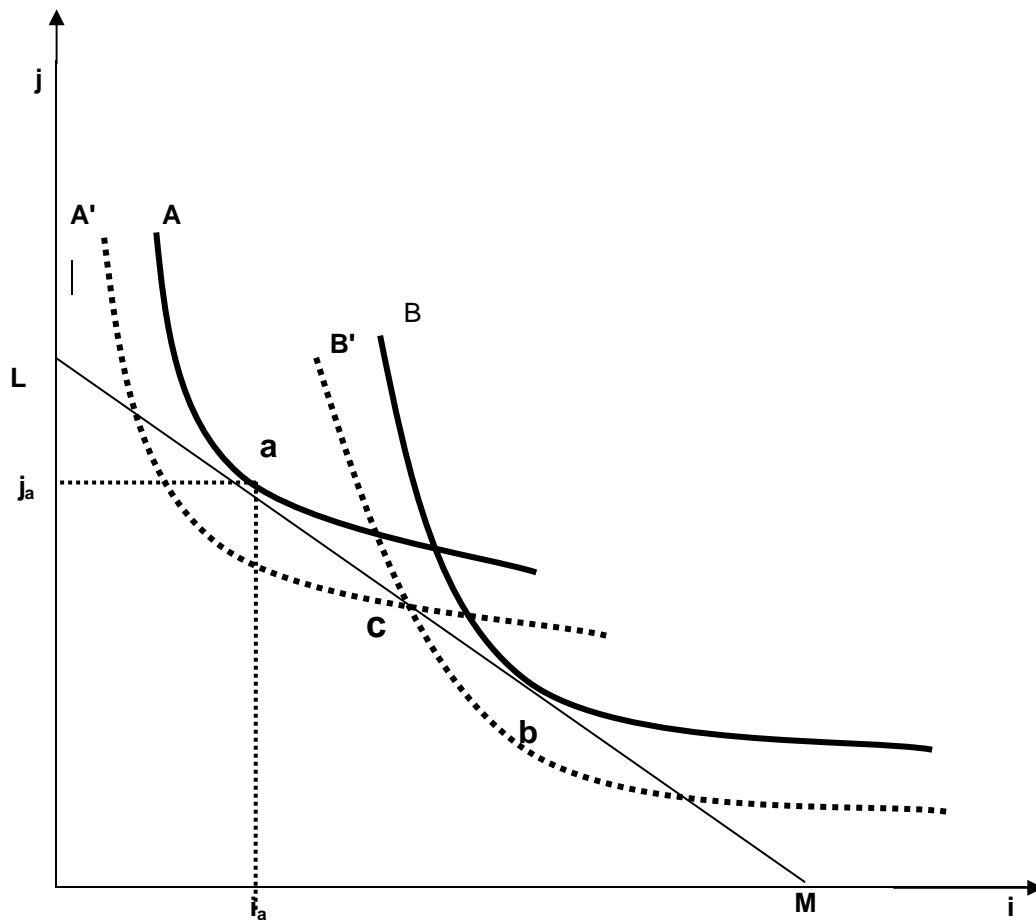
- Cremer, Jacques, Antonio Estache, and Paul Seabright. 1994. *The Decentralization of Public Services: Lessons from the Theory of the Firm*, Policy Research Working paper 1345, World Bank, Washington, D.C.
- Devarajan, Shanta, Stuti Khemani, and Shekhar Shah. 2007. *The Politics of Partial Decentralization*, the World Bank.
- Downs, Anthony. 1957. *An Economic Theory of Democracy*, Harper and Brothers.
- Ebel, Robert D., Serdar Yilmaz. 2002. *On the Measurement and Impact of Fiscal Decentralization*, World Bank.
- . 2002. *Concept of Fiscal Decentralization and Worldwide Overview*, Working Paper No. 30346, World Bank.
- Head, John, G. 1974. "Public Goods and Public Policy," *Public Good and Welfare*, John G. Head (ed.), Duke University Press.
- Manor, James. 1999. *The Political Economy of Democratic Decentralization*, World Bank, Washington, DC.
- Martinez-Vazquez, Jorge, Charles McLure, and Francois Vaillancourt. 2006. "Revenues and Expenditures in an Intergovernmental Framework," in *Perspectives on Fiscal Federalism*, edited by Bird and Vaillancourt, World Bank.
- McLure, Charles E. Jr. 1995. "Comment on 'Fiscal Federalism and Decentralization: A Review of Some Efficiency and Macroeconomic Aspects,' by Vito Tanzi," Bruno, Michael and Boris Pleskovic (editors), *Annual Bank Conference on Development Economics 1995*, World Bank.
- Musgrave, Richard. 1959. *The Theory of Public Finance*, (New York; McGraw-Hill).
- Oates, Wallace E. 1972. *Fiscal Federalism*, New York: Harcourt, Brace, Jovanovich.
- Olson, Mancur. 1969. "The Principle of 'Fiscal Equivalence': The Division of Responsibilities Among Different Levels of Government," *American Economic Review*, vol. 59 (May).
- Peters, Alan and Peter S. Fisher. 2002. *State Enterprise Zone Programs*, pp. 1-14, 217-237.
- Prud'homme. Remy. 1994, *On the Dangers of Decentralization*, Policy Working Paper 1252, World Bank, Washington, D.C.
- . 1996. "Comment on Conflicts and Dilemmas of Decentralization by Rudolf Hommes," Bruno, Michael and Boris Pleskovic (editors), *Annual Bank Conference on Development Economics 1995*, World Bank.
- Rawls, John. 1971. *A Theory of Justice*, The Belknap Press of Harvard University Press, Cambridge, Massachusetts, London, England.
- Rodden, Jonathan, Gunnar Eskeland, and Jennie Litvack. 2000. *Fiscal Decentralization and the Challenge of Hard Budget Constraints*, World Bank.
- Shah, Anwar, and Sana Shah. 2006. "The New Vision of Local Governance and the Evolving Roles of Local Governments," in *Local Governance in Developing Countries*, edited by Anwar Shah, World Bank.
- Sappington, David E. M. and Joseph E. Stiglitz. 1987. "Privatization, Information and Incentives," *Journal of Policy Analysis and Management*, Vol. 6, No. 4, 567-582.
- Sen, Amartya K. 1970 (1984). *Collective Choice and Social Welfare*, Elsevier Science Publishers.

- . 2000. "Social Justice and Distribution of Income," in Atkinson and Bourguignon (editors), *Handbook of Income Distribution*, Elsevier Science Publishers.
- Stiglitz, Joseph. 1998. "The Private Uses of Public Interests: Incentives and Institutions," *Journal of Economic Perspectives*, Vol. 12, No. 2, Spring (1998), 3-22.
- Tanzi, Vito. 1996. "Fiscal Federalism and Decentralization: A Review of Some Efficiency and Macroeconomic Aspects," Bruno, Michael and Boris Pleskovic (editors), *Annual Bank Conference on Development Economics 1995*, World Bank.
- Tiebout, Charles. 1956. "A Pure Theory of Local Expenditure," *Journal of Political Economy*, vol. 64 (Oct.).
- Tommasi, Mariano. 2006. "Federalism in Argentina and the Reforms of the 1990s," in Wallack and Srinivasan (editors), *Federalism and Economic Reforms*, Cambridge University Press, New York, 2006.
- White, Roland and Paul Smoke. 2005. "East Asia Decentralizes," in *East Asia Decentralizes: Making Local Government Work*, ed. Roland White, the World Bank.
- Wolman, Harold. 1994. "Decentralization: What Is It and Why We Should Care," in Robert J. Bennett (ed.), *Decentralization, Local Governments, and Markets*, Clarendon Press, Oxford.
- Wolman, Harold, et al. 1992. "National Urban Economic Development Policy," *Journal of Urban Affairs*, Vol. 34.
- World Bank. 1997. *World Development Report (WDR) 1997 – the State in a Changing World*, World Bank
- . 1999. *World Development Report (WDR) 1999/2000 – Entering the 21st Century: the Changing Development Landscape*, World Bank.
- . 2004. *World Development Report (WDR) 2004: Making Services Work for Poor People*, World Bank.
- . 2004. *Berlin Workshop Series 2004: Service Provision for the Poor— Public and Private Sector Cooperation*, World Bank.
- . 2005. *Annual World Bank Conference on Development Economics- Europe: Are We on Track to Achieve the Millennium Development Goals?* World Bank.
- Yilmaz, Serdar, Jozsef Hegedus, and Michael E. Bell. 2003. "Implementing Fiscal Decentralization Data Needs and Availability," in *Subnational Data Requirements for Fiscal Decentralization: Case Studies from Central and Eastern Europe*, ed. By Serdar Yilmaz, Jozsef Hegedus and Michael E. Bell, the World Bank.

Appendix

This efficiency argument can be represented graphically by figure 1, in which i and j are the per capita quantities of two local goods to be provided. LM is a budget constraint showing the quantities of i and j that can be produced. A and B are (families of) indifference curves for local governments A and B respectively. In a centralized system, the central government will settle on c , on indifference curves A' and B' . A' and B' are indifference curves inferior to indifference curves A and B . In a decentralized system, local government A will settle at point a (producing i_a and j_a), on indifference curve A ; and local government B will settle at b , on difference curve B . Thus, decentralized provision implies a welfare gain compared with central provision.

Figure 1. Welfare Benefits of Decentralization



Source: Remmy Prud'homme (1994), pp. 6.