

## Decentralized Governance

By

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The centralized state, on account of its many well-recognized failures, has lost a great deal of legitimacy everywhere, and decentralization of governance is widely believed to promise a range of benefits.

- It is often suggested as a way of reducing the role of the state in general, by fragmenting central authority and introducing more inter-governmental competition and checks and balances. (There have been, however, some strategic use of decentralization by central governments to 'divide and rule' regional power formations—examples from Uganda and Pakistan, where military dictators have used decentralization to consolidate central control).
- It is viewed as a way to make government more responsive and efficient, utilizing local information and initiative.
- Technological changes have also made it somewhat easier than before to provide public services (like electricity and water supply) relatively efficiently in smaller market areas, and the lower levels of government have now a greater ability to handle certain tasks.
- In a world of rampant ethnic conflicts and separatist movements, decentralization is also regarded as a way of diffusing social and political tensions and ensuring local cultural and political autonomy.

We'll take decentralization to mean:

The devolution of political decision-making power to local-level small-scale entities (like village or municipal governments), not just administrative delegation of functions of the central government to their local branches.

A central dilemma of governance

institutions in a poor country:

*a trade-off between commitment and accountability.*

On the one hand.....

One needs institutions of credible commitment to insulate the system from marauding special interest groups and partisan or faction politics. There are many instances of short-sighted political intervention in economic decisions.

In particular, long-term investment projects or economic policy decisions that have consequences over a prolonged period will not get off the ground without such commitment. (A major example is the lack of political commitment to implement adequate user charges, hurting long-term investment, domestic or foreign, in our power sector).

Even outside the economic sphere rule of law requires the system to display some degree of commitment that civil servants and the police are not at the mercy of ruling politicians.

In the macro-economics literature the credible commitment problem is usually emphasized in the context of central bank independence, but the problem is much wider and deeper.

On the other hand.....

Too much insulation often means too little accountability. This leads to high-handed arbitrary governance, leading to abuses and waste.

Even when the administration is benevolent, large-scale development projects directed from above by an insulated modernizing elite are often

- inappropriate technologically or environmentally
- far removed from or insensitive to local community needs and concerns
- failing to tap the large reservoir of local information, initiative, and ingenuity

These projects often treat poor people as *objects* of the development process, and end up primarily serving as conduits of largesse for middlemen and contractors, and also encourage widespread parasitism on the state.

In a country like ours where much of the economy is in the vast informal sector and dispersed in far-flung villages and small towns, the accountability mechanisms are particularly important at the local community level.

In some sense the dilemma of *commitment vs. accountability* is best resolved at the local level. If commitment is necessary for long-term projects, it may be easier to persuade the local people to make sacrifices for projects that are to benefit them in the long run.

- more transparency of benefits
- possibly more trust and peer monitoring
- resisting populist pressures may be easier to coordinate

In contrast, individuals and groups may perceive more uncertainty in the trickle-down from future growth arising out of large-scale centrally administered projects, and they may instead opt for the 'bird-in-hand' of current subsidies and short-term benefits

Accountability is also more direct at the local level, if the local democratic processes work. More local vigilance on issues where more local stake is involved ("it's our money you are wasting or stealing").

There are differential degrees of public vigilance over (or effectiveness of) different types of anti-poverty programmes, as Dilip Mookherjee and I (2006) have found in our study of the nature of leakage from anti-poverty programmes in West Bengal villages under the *panchayat* administration:

- In general in our statistical analysis of the panel data for 89 villages spread out over the whole of West Bengal we found that in the government distribution of 'private' goods like IRDP credit or agricultural 'minikits' of inputs, targeting was on average substantially pro-poor, and the leakages small.
- But in the use of more 'public' fiscal grants there is evidence of significant local elite capture (both in intra-village and inter-village allocations) and some effect of local political competition.
- Olken's similar findings in road projects in Indonesia

Decentralization of governance in the sense of devolution of power to local governments was constitutionally adopted in India around the same time as economic reforms. But this particular governance reform as yet remains largely on paper, except in 3 or 4 states.

A large number of local governments do not simply have adequate funds, or the appropriate delegated functions or competent functionaries to do the job properly, sometimes giving decentralization a bad name. Yet there have been some localized success stories.

Again, there is a major trade-off here.

Against the advantages of better local information and more local involvement, there are several problems decentralization has to grapple with

- local capture, as collusion of local elite groups or sectarian interests may be easier than at the central level
- sometimes more corruption
- because of agglomeration, more scarcity of administrative talent and technical expertise

But, hopefully, there is also learning by doing in local democratic processes.

Much, of course, depends on the initial levels of inequality (both social and economic), and how lop-sided the nature of political competition is at the local level. The West Bengal case is one where there has been a significant amount of land reform.

More empirical studies are called for in finding some pattern in the general determinants of how the trade-offs work out under different socio-political environments.

There is a large literature on decentralization, often referred to as “fiscal federalism,” mostly relating to the case of the United States.

But I want to stress the special issues that arise in decentralization in developing economies primarily because the institutional context (and therefore the structure of incentives and organization) are in some respects qualitatively different from that in the classical US case.

### ***Departures from the Fiscal Federalism Literature***

- **Much of the fiscal federalism literature focuses on the economic efficiency of inter-governmental competition, which often starts with a market metaphor that is rationalized by the well-worn Tiebout (1956) model.**
  - **In this approach, different local governments offer different public tax-expenditure bundles and mobile individuals are supposed to allocate themselves according to their preferences.**
  - **But the assumptions required for the Tiebout model are, however, much too stringent, particularly for poor countries:**
    - **The crucial assumption of population mobility (fully informed citizens 'voting with their feet' in response to differential public performance) often is not operative in poor countries.**
    - **In any case many of the public goods in question are community- and site-specific and it is often possible to exclude non-residents. Rural communities of poor countries, in particular, are often face-to-face, and social norms sharply distinguish 'outsiders' from 'insiders', especially with respect to entitlement to community services.**
- **The information and accounting systems and mechanisms of monitoring public bureaucrats are much weaker in low-income countries. In the standard literature on decentralization and fiscal federalism, the focus is on allocation of funds and *it is implicitly assumed that allocated funds automatically reach their intended beneficiaries*. This assumption needs to be drastically qualified in developing countries, where attention must be paid to special incentives and devices to check bureaucratic corruption -- and thus the differential efficacy of such mechanisms under centralization and decentralization.**
- **Even in the relatively few democratic developing countries the institutions of local democracy and mechanisms of political accountability are often weak. Thus, any discussion of delivery of public services has to grapple with issues of capture of governments at different tiers by elite groups more seriously than is the custom in the traditional decentralization literature.**
- **The traditional literature on decentralization, even though not impervious to issues of distribution, is usually preoccupied with those of efficiency in public provision. When a major goal of decentralization in developing countries is to effectively reach out to the poor (or to diffuse unrest among disadvantaged minority groups), often in remote**

backward areas, targeting success in poverty alleviation programs is a more important performance criterion than the efficiency of inter-regional resource allocation.

- In the traditional discussion of decentralization and federalism, the focus is on checks and balances, on how to restrain the central government's power, whereas in many situations in developing countries the poor and the minorities, oppressed by the local power groups, may be looking to the central state for protection and relief. Stepan (1999) has made a useful distinction between "coming-together federalism" like the United States, where previously sovereign polities gave up part of their sovereignty for efficiency gains from resource pooling and a common market, and "holding-together federalism" like the multi-national democracies of India, Belgium and Spain, where the emphasis is on redistributive or compensating transfers to keep the contending polities together.

- The fiscal federalism literature typically assumes that lower levels of government both collect taxes and spend funds, so localities can be classified as low-tax/low-service or high tax/high-service. This connection between local revenues and spending is rather tenuous.

In many developing countries there is a built-in tendency toward vertical fiscal imbalance. Income is often geographically concentrated, both because of agglomeration economies and initial endowments of natural resources and infrastructural facilities. Thus, certain local areas will find it much easier to raise significant tax revenue than others. In addition, there are limits to interregional tax competition.

The decentralization issues discussed in such a context are primarily about providing centrally collected tax revenue to lower levels of government, rather than seeking to empower lower levels of government to collect taxes. The focus is on public expenditure assignments, unaccompanied by any significant financial devolution.

- The decentralization literature typically assumes that different levels of government all have similar levels of technical and administrative capacity. This assumption is questionable for all countries, but particularly in poor countries, where the quality of staff in local bureaucracies -- including basic tasks like accounting and record-keeping -- is very low. As Bird (1995) puts it, information asymmetry thus works both ways: the central government may not know *what* to do, the local government may not know *how* to do it.

Of course, this problem is of differential importance in different services. Providing for street cleaning or garbage collection may not require sophisticated expertise, but power

production and transmission, bulk supply of clean water and public sanitation do. Decentralization to the local level will often work better in the former kind of services than the latter. It should also be recognized that there is learning by doing in local administration which improves the performance of local democracies over time.

In view of these departures from the traditional literature the recent work on decentralization and development has tried to grapple with the incentive and organizational problems that arise in situations of institutional failures and low political accountability.

Political accountability in poor countries is particularly affected by the likelihood of corruption or capture by interest groups and factions.

While local governments may have better local information and accountability pressure, they may be more vulnerable to capture by local elites, who will then receive a disproportionate share of spending on public goods.

On the other hand, the central bureaucrat who is in charge of the delivery of, say, an infrastructural service like electricity, telecommunication, or canal irrigation may be corrupt in a way that leads to cost-padding, targeting failures and generally an inefficiently low and inequitable service delivery. The problem for the central government which employs the bureaucrat is that it has very little information on the local needs, delivery costs and the amount actually delivered. Many programs in developing countries have thus a large gap between a commitment of resources at the central level and delivery of services at the local level.

Bardhan and Mookherjee (2006) develop a simple analytical framework that formalizes the trade-off between these conflicting aspects of centralized and decentralized delivery systems. It turns out that much depends on the particular financing mechanisms for local governments. User charges may be a useful compromise between the need for matching provision to local needs and avoiding an unduly heavy burden on the local poor following local capture by the elite.

User charges cannot, however, be used to finance anti-poverty programs (like targeted public distribution of food, education or health services) that by their very nature are

targeted at groups that do not have the ability to pay for the service (or pay bribes to the central bureaucrats). In such cases, as is shown in Bardhan and Mookherjee (2005), the extent of capture of local governments relative to that of the central government is a critical determinant of the welfare impact of decentralization.

Even though the extent of relative capture of governments at different levels is crucial in understanding the likely impact of decentralization initiatives, there has been very little work on the subject, either theoretical or empirical. For a theoretical analysis of the problem see Bardhan and Mookherjee (2000).

The extent of capture of local governments by local elites depends on

- levels of social and economic inequality within communities
- traditions of political participation and voter awareness
- fairness and regularity of elections
- transparency in local decision-making processes and government accounts
- media attention, etc.

These vary widely across communities and countries. Of course, central governments are also subject to capture, and it may be more than at the local level on account of

- the larger importance of campaign funds in national elections
- better information about candidates and issues in local elections based on informal sources.

On the other hand....

- particularly in large heterogeneous societies, the elites are usually more divided at the national level, with more competing and heterogeneous groups neutralizing one another
- At the local level
  - in situations of high inequality collusion may be easier to organize and enforce in small proximate groups (involving officials, politicians, contractors and interest groups)
  - risks of being caught and reported are easier to manage
  - the multiplex interlocking social and economic relationships among the local influential people may act as formidable barriers to entry into these cozy rental havens.

**At the central level in democratic countries**

- **More institutional mechanisms for checks and balances are usually at place**
- **more regular auditing of public accounts**
- **more vigilance by national media, etc.,**  
**much of which are often absent or highly ineffective at the local level.**

***Empirical Evaluation of Decentralized Delivery of Public Services***

**Even though decentralization experiments are going on in many of developing countries, hard quantitative evidence on their impact is rather scarce.**

**The main econometric problem is the commonly encountered endogeneity problem.**

**In claiming that decentralization brought about certain outcomes, it is worth considering that decentralization may have resulted from on-going political and economic changes that also affected these same outcomes.**

**Besides this econometric issue, there is the general problem, as we have indicated before, the impact of decentralization depends both on the context where it is implemented (particularly the political tradition that is germane to the functioning of local accountability mechanisms) and on the way it is designed (particularly as the design itself may be endogenous with respect to the underlying political economy). General presumptions that transcend institutional details are difficult to sustain, and the impact studies have to be very much context- and design-specific.**

**There exist in the literature a variety of case studies on the impact of decentralization initiatives, mostly based on 'before-after' comparison of service delivery outcomes. For a collection of such case studies in 8 countries (Brazil, Bolivia, Uganda, South Africa, Indonesia, Pakistan, China and India), see Bardhan and Mookherjee (2006).**

**In a more regular econometric study with a longitudinal sample of 89 West Bengal villages over 1978-98 Bardhan and Mookherjee (2006) examine the performance of local governments with**

respect to pro-poor targeting of credit, public distribution of agricultural inputs, and employment programs. We find that intra-village allocations were targeted quite well in favor of the poor, with only mild adverse effects of land inequality in the village and low caste status and illiteracy among the poor. In contrast inter-village allocations exhibited a substantially stronger and significant anti-poor bias. The results suggest that the accountability problems stem in this case more from political discretion at the upper tiers of government in inter-village allocations, rather than intra-village elite capture. One should, of course, keep in mind that West Bengal is one of the few states in India where village land reforms have been relatively successful. Intra-village elite capture is more likely in more unequal environments.

In a statistical analysis on the basis of village surveys and satellite and topographic data Somanathan, Prabhakar, and Mehta (2005) show that in the central Himalayas forests managed by village councils are conserved no worse, and possibly better, than those under state management, and at a cost that is an order of magnitude less per unit area.

There is hardly any household-level analysis in the literature of the comparative effects of centralized versus decentralized delivery.

One detailed study of targeting performance of a decentralized program using household level information in a developing country is that of Galasso and Ravallion (2005) studying a central government food-for-education program in Bangladesh where the identification of beneficiary households within a selected community was made typically by a local school management committee (consisting of parents, teachers, education specialists and school donors). Galasso and Ravallion use data from a 1995-96 Household Expenditure Survey to assess the targeting performance of the program. They find that the program was mildly pro-poor (i.e. taking all villages, a somewhat larger fraction of the poor received benefits from the program than the non-poor). But they also find some evidence of local capture.

There is some quantitative evidence on the impact of mandated representations of historically disadvantaged groups (like women) in leadership positions in local governance in India.

- Since 1998 one-third of all positions of *pradhan* in village *panchayats* in India have been reserved for women and the reserved *panchayat* is selected randomly. Taking advantage of this random assignment (thus avoiding an econometric problem in usual cross-section studies on this question that communities which are more likely to take women's needs into account may also be more willing to let them be in leadership positions), Chattopadhyay and Duflo (2004) have measured the impact of this political

- reservation policy on outcomes of decentralization with data collected from a survey of investments in local public goods made by 265 *panchayats* in West Bengal and Rajasthan. They find that the women leaders of *panchayats* invest more in infrastructure that is directly relevant to the needs of rural women (for example, drinking water supply), and that village women are more likely to participate in the policy-making process if the leader of their village council is a woman. (In other studies they have similar findings for location of public goods—like wells-- in their residential parts of the village when the leadership is reserved for disadvantaged castes).
- Besley, Pande, Rahman and Rao (2004) on the basis of their household and village survey in south India find that special group reservation of the position of *pradhan* in the *panchayat* improves the chance that a household in a disadvantaged social group (either 'scheduled caste' or 'scheduled tribe') would have access to some facilities (like private electricity or water connection) from a government scheme.

### ***Decentralization and Local Business Development***

Most of the cases of decentralization in developing countries examined in the theoretical and empirical literature relate to delivery of social services. But in recent years there has been an extension of the traditional literature on federalism to the case of the role of local government in promoting local business development, particularly in the context of transition economies, especially China and Russia, and this has potential implications for developing countries where so far public service delivery issues have been more prominent.

In Qian and Weingast (1997) and Qian and Roland (1998), for example, decentralization of information and authority and inter-jurisdictional competition have been considered as commitment devices on the part of the central or provincial government to provide market incentives, both the 'positive' incentive rewarding economic success at the local level and the 'negative' incentive in terms of punishing economic failure.

The local government-run township and village enterprises (TVE's) which served as the engine of growth in China in the 80's and 90's have been cited as a major example of the outcome of a successful 'market-preserving federalism'. In terms of 'positive' market incentives the TVE's had full control over their assets and they were largely left alone (as a residual claimant) to 'get rich gloriously', and the limited knowledge of the upper-tier governments about the 'extra-budget' and 'off-budget' accounts of local governments acted as check on the formers' interventionism.

In contrast, as we can see from an econometric study of the fiscal relations between local and regional governments in Russia by Zhuravskaya (2001) on the basis of a panel dataset for 35 large cities, local governments could retain only about 10% of their revenues at the margin, thus providing only weak incentives to foster local business development and thus to increase their tax base.

In terms of the 'negative' incentive, Chinese upper-tier governments by denying bail-out to many failing TVE's enforced a dynamic commitment. Having no access to state banks and facing mobility of capital across jurisdictions raised the opportunity costs of local governments for rescuing inefficient firms, thus leading to the endogenous emergence of a hard budget constraint.

Without denying the importance of these market incentives, it is possible to argue, however, that the case of market-preserving federalism is institutionally underspecified in the studies. Depending on the political-institutional complex in different countries the same market incentives may have different efficacy.

As Rodden and Rose-Ackerman (1997) have pointed out in a critique of market-preserving federalism, whether political leaders of a local government respond to highly mobile investors or instead pay more attention to the demands of strong distributive coalitions dominated by owners of less mobile factors depends on the institutional milieu. Owners of capital vary widely in the specificity of their assets and institutional incentives facing political leaders may vary even for the same jurisdictional competitive pressure. Even in a democracy, not to speak of authoritarian systems, electoral competition does not necessarily punish local leaders who fail to respond to exit threats of mobile asset owners and are instead more responsive to coalition-building and the 'voice' of well-organized lobbies.

The problem of local capture by the oligarchic owners of immobile factors of production like land in many parts of rural India

In the Chinese case the lack of such strong rural lobbies (owing largely to the egalitarian land distribution) may have made a difference in the local governments' vigorous pursuit of rural industrialization. Equitable distribution of land in the 1978 land reform program provided a basic safety net for workers in the inevitable displacements of fast industrial growth.

In Russia many have pointed out that over much of the 1990's local governments have shown features of being captured by erstwhile rent-holders and old firms which sometimes blocked the rise of new firms that could compete away their rents. There is a great deal of evidence on collusion between large firms and local governments (sometimes at the expense of federal tax compliance)—see Slinko, Yakolev and Zhuravskaya (2004).

It seems jurisdictional competition is not enough to explain the emergence of endogenous hard budget constraints for local governments without a lot more specification of the local political process.

In conclusion, it is important to keep in mind

- Cases when beneficiary control does not work
  - Elite capture or elite 'exit'
  - Need for demand-side interventions (when community monitoring is not enough). Large contingent transfer programs, rare in India, seem to have been quite successful in Mexico and Brazil (Oportunidades/Progresá in Mexico, Bolsa Família in Brazil).

The literature on decentralization in the context of development is still in its infancy.

- On the theoretical side, perhaps the key challenge is to find better ways to model the complex organizational and incentive problems that are involved, in a situation with pervasive problems of monitoring and enforcement.
- On the empirical side, there is a great deal of scope for rigorous work in evaluating the impact of on-going decentralization initiatives, using detailed household and community surveys, comparing it with the experience with centralization or some other counterfactual. Separating decentralization from its political and economic causes and contexts, so that decentralization is not just a proxy for an ill-defined broad package of social and economic reforms or the outcome of the characteristics and the institutional details of a more broad-based and progressive community, is a delicate and challenging problem.