SOME REMARKS ON FISCAL DECENTRALIZATION AND GOVERNANCE

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It is a great honor for me to participate in this conference. During my presentation, I would like to focus on the links between decentralization and governance. My remarks are based on my experience as a World Bank economist providing policy advice to countries of Eastern Europe, in particular Hungary. Furthermore I will draw on recent research on decentralization in which I participated (Dethier, 2000). I will thus draw on several ideas of friends and colleagues of mine and I would like to begin by acknowledging their influence.

There are two important issues that arise once the political decision to decentralize is made: the first is to design—or redesign—the institutional framework. All the laws of the country have to be redone; new systems have to be put in place; etc. to adapt tax policy, grants and transfers, tax administration, expenditure policies and budget management. Having well functioning institutions is a necessary, but not sufficient, condition for successful decentralization. The second important issue is sequencing. This is important to ensure that the overall incentive structure is correctly set up. It is important to learn from the experience of other countries what works and what does not: what functions should be decentralized to lower levels of government, which ones should come first, what financing mechanisms should be used and what mechanisms of administration should be to permit arms-length operations and ensure accountability.

I will weave three themes into my presentation: decentralization; democratic governance; and poverty reduction. A centralized government is presumably better able to internalize externalities, take into account economies of scale in the provision of public goods, and coordinate fiscal policy. However, a centralized authority does not have an unlimited ability to collect information and monitor agents, and local authorities are generally better informed - for instance on the revenue-generating capacity of local enterprises, or on the needs of local populations. The idea is to push decision making to the lowest possible level where peer monitoring can take place and where people can more directly control agents (Stiglitz 1999). Local providers of public goods have a better fit with locally diverse preferences (or get rid of uniformity constraints in provision that a centralized supplier is forced to adopt). Moreover, devolving responsibilities for expenditure management to the local level also has major advantages from the point of view of information. Putting decision making in the hands of those who have the information that outsiders lack gives them a strong incentive advantage. Local information can often identify cheaper and more appropriate ways to provide public goods (Bardhan 1997a). These incentive and information advantages make decentralization qualitatively similar to the advantages enjoyed by the market mechanism over the government, as Bardhan points out.

The second theme is that policy is largely about searching for appropriate incentives to internalize externalities, i.e., to take into account all the ramifications of individual actions. The concept of incentive should not be narrowly interpreted as monetary incentives, but more broadly, as any norm leading individuals to behave in a way that facilitates cooperation. The implicit or explicit social contract that complements the market economy - and the price system which underpins it - is made of formal or informal norms, or accepted standards of behavior, that can be conducive to various degrees of efficiency and equity. This social capital cannot be legislated by the government.

Finally, last but not least, there is the theme of democratic governance. The participation in the decision-making process by the individuals who have a stake in this process - stakeholders - may have a profound effect on the quality of life, which then can have a profound feedback effect on economic outcomes if the organization is made more effective. Education is an example. If parents are more active in ensuring that teachers and administrators are more effective, this will lead to positive outcomes for the children. Participation gives incentives to make an organization work. There is some evidence on this, for instance in the state of Himachal Pradesh in India (Probe 1999).

Participation, to be operational, requires a minimum of literacy, basic capabilities, and gender equality - which are often not present in very poor areas in developing countries. Participation requires empowerment of the people at the local level. But some political systems are such that those who are in power, or who control power, have few incentives to allow democratic decision making and participatory institutions to develop. Accountability is ultimately a question of democratic control of the government.1 The development of civil society and grass-roots movements, which can exercise important watchdog functions, as well as democratic competition between political parties and elections at the national and local level, represent important elements for the struggle to eliminate corrupt and nontransparent institutions.

The quantity and quality of public goods provided by governments, such as education or law enforcement, will be directly affected both by their allocation mechanisms and by their modes of governance. The allocation mechanisms that are adopted for public goods vary and depend, in part, on the nature of the goods themselves (i.e. the extent of excludability of benefits and of non-rivalry in consumption). Their modes of governance are characterized by their degree of centralization or decentralization; by the degree of participation of the stakeholders; by the transparency of the procedures adopted, and by the accountability of the agents involved.2 Generally, the agency funding the public good and the agency responsible for actually producing it are different. This is often the case for

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1 Participation and democratic decision making (e.g., through voting procedures) are separate issues.

2 Transparency involves the release by public or private organizations of information that is relevant to evaluating them (FLORINI 1999). It is always connected to the accountability of the agents managing these organizations. The purpose of transparency is to enable citizens, shareholders, etc., to hold agents accountable for the policies and performance of these institutions. These issues are inter-related. Accountability is hardly possible without transparency, and fiscal discipline is related to accountability.

local public goods (such as schools or hospitals) which are managed by agencies not responsible for their funding.

There is now an increasing amount of empirical evidence showing that outcomes—such as school achievements, or improvements in quality of life indicators or additional GDP growth resulting from public good provision—will be positively affected by good governance in the sense that decentralization to the appropriate level, participation and accountability will lead to improvements in efficiency. Whether good governance enhances welfare is largely an empirical issue. In part this is because the conditions under which decentralized organizations lead to Pareto-efficient allocations are restrictive (Stiglitz 1994). In part, it results from political economy considerations: even though in theory efficiency-increasing reforms allow winners to compensate losers, in practice institutional changes and the lowering of transaction costs may be to the disadvantage of some groups and affect the distribution of welfare in society, prompting some groups to react - in proportion to their political power - and demand changes in their rights.

Decentralization: The International Experience

There is a worldwide trend toward decentralization. This trend is a political reaction to the failures of centralized models of administration and economic management, whether Leninist or Keynesian. Decentralization worldwide is seen as a way to bring authorities in more direct contact with citizens. It is also seen - rightly or wrongly - as a way to improve the poor quality of public services, or to resolve the tensions arising from the unequal pace of growth and improvement in standards of living in different regions of the same country. As explained by Manor (1999), politicians see decentralization as a way to reconnect their regimes to social groups from which they have become increasingly divorced. Decisions to decentralize are not made because their usefulness has been proven by facts but because it helps politicians cope with a loss of confidence in the centralized state. This does not mean that centralism is preferable, but we still do not have enough evidence that decentralization works well.

The worldwide trend toward more decentralized governance - fiscal decentralization, political devolution of power and/or administrative deconcentration - is not easy to relate to other trends. Decentralization has been carried out by democratic and authoritarian regimes from the left and the right, often by governments that fear to lose control over international trade and telecommunications in an era of globalization. Decentralization takes place, as it were, in spite of globalization. The evidence does not seem to indicate that the increasing number of ethnic conflicts has directly influenced decentralization.

Is there a relationship between the tendency to undertake ‘good governance’ reforms and the need to ensure a certain share of tax revenue at the center? Historically, in some centralized states in Western Europe, democratic institutions developed through a process of bargaining of kings with bourgeois interest groups. The state was dependent for tax revenues on these interest groups, so they compelled the king to provide mechanisms through which their views could be represented (see e.g., North and Weingast 1989). What lies today behind the partnership between the central government and local grass-root organizations? Why do central rulers agree to decentralized modes of governance? Is it mainly for fiscal motives - to persuade these groups to provide revenues to the cente - or essentially for political motives, as a means of cultivating political support and to enhance the legitimacy of the regime and its capacity for non-coercive governance? This hypothesis, formulated by Manor (1999), needs empirical support but seems to fit well the present reality of countries like China.

Lessons can be drawn from the international experience with decentralization. These lessons are reviewed by Vito Tanzi (2000), by Bird and Vaillancourt (1998) and by several other publications. A first danger of decentralization is that it can exacerbate political tensions between regions if they have significantly different income levels. Second, since decentralization separates financing responsibilities from expenditure administration, problems of assignment of taxes and expenditures almost inevitably arise. Third, problems of expenditure control (more complicated in a decentralized than in a centralized system) can arise. A recent IMF volume reviewing the international experience (Ter-Minasian 1997) states that, from the point of view of macroeconomic control, there does not seem to be a need for major changes in expenditure assignments in most countries. In large countries such as China, India, and Russia, expenditure decontrol remains an issue, especially because of the danger of ‘soft budget constraint’ at local levels and implicit bail outs from the center. Local expenditures to counteract growing unemployment, the closure of loss-making enterprises, and other kinds of subsidies can get out of control, creating problems in restoring fiscal discipline at the macroeconomic level.

In a centralized system of governance, the government finds it difficult to commit itself not to intervene. Under “fiscal federalism,” the center may not be strong enough to resist financing the deficit of a lower level of government that bails out enterprises or otherwise engages in soft budget constraint practices. Credible commitment is accomplished by imposing limits on the amounts that can be borrowed by sub-national governments. However, these legal limits may not be operative when there are quasi-fiscal possibilities to finance the deficit (e.g., by state-owned banks). There are interesting discussions in the recent institutional economics literature on how institutions can endogenously lead the government to hold its promises regarding property rights. Such endogenous mechanisms include fiscal decentralization but also regulatory schemes (e.g., for telecommunications) and privatization.

Provision of Public Goods

The provision of public goods is both a political process and a budget process. At a theoretical level, the recent literature suggests that it is not possible to ensure incentive compatibility simultaneously with optimal allocation of resources and a balanced budget in the provision of public goods. In the absence of incentive constraints, an optimal fiscal system would equalize the marginal utility of taxation with the marginal utility of consumption of local and national public goods. But in the presence of incentive constraints, tax administration and public expenditure management is costly. The free rider problem has to be recognized as a second-best problem, imposing the requirement of incentive compatibility. The problem then becomes one of supply of public goods and optimal taxation in the presence of information constraints. In addition, the constraints imposed by the political environment have to be taken into account.

Our knowledge of the kind of governance structures for local public goods that are most likely to improve welfare outcomes is very limited. In many developing countries, institutions are weak, corruption rampant, and many laws go unenforced. In this kind of context, it is difficult to say whether schools, hospitals, road maintenance, etc. would be better managed by private firms or by government agencies. Hart et al. (1997) present an interesting model comparing provision by private agents or by government agencies. The model is based on incomplete contracts and assesses the tradeoffs between private and public provision of prisons, garbage collection, schools, and health care.[3] They conclude that the provision of public goods by public entities is superior when quality-enhancing innovations are unimportant, when corruption in government is a severe problem (outsourcing would increase the temptation for bribes) and when there are non-contractible cost reductions that have adverse effects on the quality of the public goods provided. Privatizing the provision of public goods is favorable when the reverse holds.

Attempts to ‘privatize’ the provision of some public goods—as part of the redefinition of the role of the state—can have serious implications for the poor. In very poor areas, the day-to-day livelihood of the vast majority of the poor depends on local commons such as fisheries, forests, or grazing lands that resemble more club goods than public goods. There are many recent examples of commons managed by specialized agencies, i.e., dedicated only to a single function - such as water agencies, or local irrigation organizations. When does community-level cooperation work and when does it not? Increasingly, all over the world, for irrigation, functions that used to be controlled by central irrigation bureaucracies are now being handed over to local units, such as local farmer organizations. So far the experience is mixed.

The Capture of the State

Decentralization and participation can increase accountability. There is some evidence that, by making local officials more accountable and placing responsibility for decision making and implementation in the hands of local stakeholders, the quality and the efficiency of public services, such as road maintenance and water supply improves (see the evidence cited in Bardhan 1997a and b). But decentralization is not ipso facto an accountability mechanism. There is, in fact, both empirical evidence and economic theory indicating that decentralization can increase corruption and reduce accountability (Rose-Ackerman 1997). Shleifer and Vishny (1993) show that decentralized corruption is a kind of free-for-all. Those taking bribes do not take into account the externalities of their own actions on the other potential recipients of bribes - while centralized corruption has a stake in not killing the goose that lays the golden eggs.

Using data from a large sample of countries in the mid-1990s, Treisman (1999) examines why federal states are perceived to be more corrupt. His findings are that the higher corruption ratings of federal states are related mainly to three factors. Their larger size implies, inter alia, diminishing returns in fighting corruption and regulatory ‘overgrazing’ by different level governments and agencies. They are also more likely to have separate police forces at both central and subnational levels, and have a greater propensity to have regionally elected upper houses of parliament with veto power, which can also increase corruption.

Capture of the state by interest groups is an important concept for political economy. The concept, however, is used in the economic literature in two different contexts. The first is the notion of “regulatory capture” discussed in industrial organization (see e.g.

3 The economic case for having some goods provided by private or by public organizations cannot be made if one assumes a world of complete contracts, as there is no difference between state and private provision of goods and services (Shleifer 1998).

Levine 1998). This strand of literature discusses what happens when a non-competitive industry captures its regulators. The second, more relevant for our topic, discusses how the allocation of public goods and the redistribution of transfers is affected by different voting procedures, political regimes, etc. Capture leads to problems of targeting of public expenditures. In the latter context "capture" is thus conceptualized as undue weight given to the rich in the welfare function that policy-makers are maximizing.

Bardhan and Mookherjee (1998) discuss the conditions under which centralized or decentralized systems of governance are superior for managing local public goods and poverty-alleviation programs, such as public works programs. They do not focus on allocation of taxing authority between central and local governments, but rather on information about local needs and local costs of services, including costs of supervision and monitoring programs. In a centralized system supplying public goods and services, bureaucrats have discretionary powers that may be used for corrupt purposes, and behave like unregulated monopolists. The bureaucrats are not accountable to the recipients of the programs and users of the public goods, but to the central authorities. However, the latter cannot completely monitor them for lack of information. In a decentralized system, the issue that arises is capture. Bureaucrats are accountable to the local government but the benefits of the program can be captured by interest groups that control the local government.

Capture leads to several problems in the delivery of local public goods, including excessive costs and black market problems. Corrupt bureaucrats will tend to overstate costs, to divert public goods to resell them to the non-poor on the black market, or to give priority to powerful socio-economic groups. Bardhan and Mookherjee compare the delivery of local public goods under decentralized and centralized modes of governance, and showed that there is no general answer to the question: which one is better from a welfare point of view? It depends on the political context, which is a parameter in the model. For example, if local capture by powerful interest groups is sufficiently large, decentralization may be worse from a welfare point of view, even when local agencies have more information about costs and the needs of the population.

It is, of course, worth making the point that both central and local governments are potentially 'capturable' by interest groups. This issue is discussed at length in Bardhan and Mookherjee (1999). However, there is generally more electoral competition between political parties at the national level than in local elections. As a result, policy making at the national level often represents a greater compromise among the policy platforms of different parties. Even in a non-democratic environment, it can be argued, that since there are economies of scale in organization and mobilization for interest groups, regional lobbies, etc., these groups will be forced to pool their resources and enter into strategic coalitions at the central level.

Fiscal Discipline and The Soft Budget Constraint

The 'soft budget constraint' phenomenon—i.e. the lack of fiscal discipline—is prevalent in the public sector of many countries.[4] It makes public expenditure

4 The most general definition of the 'soft budget constraint' is that the phenomenon take place in a context of an organization where the superior is led to relax financial discipline for the benefit of the subordinate. The phenomenon is not limited to the public sector and, indeed, is frequently encountered in the private sector. Both endogenous and exogenous explanations have been proposed for this behavior (KORNAI 1998).

management and macroeconomic control particularly difficult, because the state must be able to resist the pressure of interest groups, and greatly complicates the process of reforming the governance system. Expenditure control is an issue, especially because of the danger of soft budget constraint at local level and implicit bailout from the center. There are enormous pressures to increase local expenditures to counteract growing unemployment and the closure of loss-making enterprises, not to mention other kinds of subsidies to friends and cronies. Such pressures can create problems in restoring fiscal discipline at the macroeconomic level.

The prevalence of the soft budget constraint phenomena, as János Kornai has shown, tends to appear more extensively the bigger the state sector, the wider the bureaucracy’s sphere of action, and the greater the intertwining between politics and business. The soft budget constraint is linked to two factors. First is the tradition of pervasive central government intervention in economic activity and of state paternalism, which leads individuals to demand welfare benefits or compensation for welfare losses from the state. Second is fiscal pressure resulting from the economic transformation process itself, because social groups who are losers in this process lobby the state for compensation. The unemployed who lose their jobs when loss-making enterprises are closed; farmers who lose income when agricultural subsidies are withdrawn, and many other groups have claims on the budget. During a process of macroeconomic adjustment and movement toward a reduced government role in economic activity, as enterprises are separated from the budget, budgetary resources become more limited and deficit financing is reduced. It is not uncommon to find situations in which the government finds it difficult to resist the pressure. In some cases - e.g., when a bank agrees to refinance a bad project because the marginal benefits of refinancing exceed the marginal costs (since the loan that is not repaid is a sunk cost) - the phenomenon is the result, not of external pressure, but of the internal interests of the ‘softening’ organization itself (see, e.g., Bai and Wang 1999).

In large countries, the nature of the fiscal revenue-sharing arrangements as well as politics at the regional level have contributed to a persistence of soft budget constraint phenomena. The lack of budgetary discipline is often due to loss-making public enterprises bailed out by regional governments and by an inability - or unwillingness - of the central government to control the regional deficit. It is also caused by the need for politicians to gain support from their constituencies, which often includes many laid-off workers, farmers clamoring for subsidies, and other ‘vote banks’.

The recent literature (Kornai 1998; Maskin 1999) has pointed out that, when the behavior of the authority that tolerates the lack of financial discipline (for example, a regional government providing a subsidy to a loss-making enterprise) is endogenously linked to the internal interests of this ‘softening’ authority—i.e., when the marginal benefits of financing the deficit exceed the marginal costs if subnational authorities can pass on the cost to the next tier of government, the way out of this situation would be to credibly commit in advance not to finance the deficit. However, it is not always possible to put in place institutional arrangements of credible commitment.

Poverty Reduction

The extent to which the persistence or worsening of poverty is related to governance problems in the public sector is an issue that is only now receiving attention from researchers (see World Bank, 2000 and Dethier 1999b). There are many intervening variables in the development process, so that it is difficult to disentangle their individual effects and to distinguish between direct and indirect, or first- and second-order effects. Moreover, measurement is difficult because the various dimensions of governance captured by the indicators mentioned above, although they are conceptually distinct, are not statistically independent, and thus have a high degree of covariance.

It is widely recognized that policies that contribute to growth by improving the allocative efficiency of resource use (liberalization or adjustment policies) can help the poor, but that there are various reasons why, in spite of efficiency improvements, the poor could be excluded from the growth process. Income inequality is the main channel through which governance affects poverty,5 and inequality is related to political powerlessness. Two important factors that can explain why the benefits of growth do not trickle down to the poor in particular contexts, especially in countries with high and persistent inequality, are related to governance: the first is capture and the second is corruption. The former means that the interests of the rich are given more weight in the government welfare function than the interests of the poor. The latter perpetuates poverty by reducing growth, both directly and indirectly through lower social spending.

As stated admirably by the Governor of the Reserve Bank of India, ‘it can be argued, and correctly, that the ultimate causes of poverty are unequal asset distribution (e.g., land and capital) and unequal political power at the grassroots level. Growth rates, high or low, cannot ameliorate these basic causes of persistent poverty. However, it is also true that at any given distribution of the level of assets or political power, a higher growth rate is likely to generate more jobs and more revenue with which to help the poor. The social and political causes of poverty must be attacked directly, but this is not a reason for the neglect of the growth aspects of economic policy.’ (Jalan 1996).

The Example of India

Taxation and expenditure responsibilities for various kinds of public goods and transfers are usually not clearly assigned by the constitution or basic laws. Governance issues (for example, the extent to which any particular decision is decentralized or not) are also sometimes unclear and not fully specified by law. All that is specified is a broad framework for shared governance, for example, specifying that financial decisions on a particular activity should be centralized, but provision of the service itself decentralized. Sometimes local authorities are given power to make decisions, but the center needs to sign off. In practice, the agency funding the public good and the agency responsible for actually producing it are different. Public goods, such as schools or hospitals, are managed by agencies not responsible for their funding. Moreover some or all services are provided below cost or free of charge, and there is no reason to believe that the agency will minimize costs. Two issues arise: How should the grant mechanism from the center be designed? How does the authority (the principal) monitor the behavior of the agent, and what are the information and monitoring costs involved? Incentives that are inherent in own-revenue and transfers affect the ability to raise revenues as well as the ability to

5 It is not easy to estimate how the distribution of income is affected by economic growth, because it depends on a host of factors: the initial distribution of human and physical assets; the sectoral pattern of growth (often biased against the rural sector even though agriculture is clearly a ‘pro-poor’ sector in most developing countries) and the geographic pattern of growth; imperfections in markets; factor bias in technology, and, finally, government policies in particular on taxation and social welfare.

manage expenditures efficiently at the local level. It is at the local level that there is tax evasion for services for which people should pay and that the differential burden on taxpayers will be felt. Moreover many problems of capture and corruption take place at the local level.

In many countries decentralization is resisted by powerful interest groups. India provides an example discussed by Rajaraman (2000) and Drèze (2000). The 73rd Amendment to the Constitution in 1993 added a third tier of governance to the country's political structure. This constitutional change represents an important milestone in the history of democracy in India. It mandates regular elections at the local level, with special provisions to protect the rights of women and of scheduled castes/scheduled tribes. One third of the seats in panchayati raj (village councils) are reserved for women. Though the legal framework is in place, this does not mean that effective institutions of local governance exist. In rural areas in particular, local affairs are still run along authoritarian lines which, with very few exceptions, have not yet been replaced by more democratic and participatory institutions. On paper, fiscal responsibilities in many domains were transferred to the village panchayats by the 73rd Amendment. In practice, in most states, the panchayats have no meaningful involvement in these matters. They have neither the power nor the resources to get involved. For instance, in education, they cannot appoint auxiliary teachers, or authorize repairs or adjust school hours to the local agricultural cycle. For instance, a recent survey of primary education found that 73 percent of primary schools in north India have leaking roofs so that classes are interrupted for weeks at a time during the monsoon (Probe 1999). One of the reasons for this state of affairs is political resistance to decentralization, notably on the part of teacher organizations and the education bureaucracy. There has been not only resistance, but active dismantling of whatever decentralization existed earlier. Over time, the education system has become more and more centralized. For instance, in north India many schools used to be accountable to local bodies, but teacher organizations have pressed for transferring school management to the state government as they wanted all teachers to enjoy the same terms of employment and to be sheltered from local accountability.

By and large, panchayats have almost no incentives, in the present system, to increase local revenue. Local governments will have incentives to raise their own funds (and to enforce tax compliance) only if they are given powers to levy with associated responsibilities. If necessary, powers of collection may be withheld for any levies transferred from the state to local bodies until adequate local capability is built up. In their confrontation with powerful local élites, local bodies could receive legislative support in the form of a minimum obligatory levy rates and denial of all powers to grant ad hoc exemptions for these assigned functions. Efficiency of performance should result in more accountability to the electorate (provided free and fair elections are held) since the local jurisdiction would be paying the full tax price for these expenditures. Panchayats will only have a basis on which to establish credibility with their electorates and further expand their revenue-raising powers if local expenditures are funded from local resources.

Since the panchayats will clearly require a net transfer of funds, how should the mechanism of transfer from state governments be designed in order to avoid moral hazard and preserve incentives for local revenue effort? On the basis of the great diversity of local situations encountered in India, Rajaraman (2000) points out that "gap-filling" approaches (whereby state governments top up local resources) discourage local revenue efforts. Second, decisions about expenditure requirement should be made by the higher tier of government, not by the local body, if the higher tier funds those expenditures, especially in cases where higher tier resources contribute at the margin. Finally, to avoid corruption and misuse of funds, external determination of expenditure requirements must necessarily be accompanied by performance monitoring.

Concerning capture, Rajaraman points out that the right comparison is not whether local government is more susceptible to capture than higher-level government. The real issue is whether there is differential local capture - or differential propensity to choose club goods - between local expenditures funded from above and those funded from local revenues. If the local government is democratically elected and accountable, one would expect own-funded expenditure to be less susceptible to capture. The particular model selected for devolution of functions to the lower level should protect against the possibilities of capture in both streams.

Given that the fiscal functions of panchayats have remained virtually unchanged, while local elections have transformed the political incentive structure, one can legitimately whether the introduction of political incentives without the introduction of fiscal incentives have had an effect on the behavior of local governments and local politicians. Have there been visible changes in terms of transparency and public accountability? There are instances of increased accountability at village level. Drèze (2000) gives the example of Rajasthan where a non-governmental organization has managed to improve access to public records in some communities (see also Probe 1999). However, it is too early to track the effects of improvements in accountability, because local elections have taken place only recently.

Impact of Decentralization and Governance on the Welfare of the Poor

Outcomes of supply of and demand for education or health services - enrollment rates, mortality rates, etc - depend on both quantity and quality of services, and decentralization is likely to have an impact on both of these. A possible econometric approach using survey data to examine how governance variables affect human development outcomes would be to treat the quantity of services as pre-determined variables and focus on the quality of services, controlling for variables such as availability of facilities, household income, income inequality, and adult literacy. Mahal, Srivastava and Sanan (2000) have carried out such an exercise with data from a 1994 survey of 1,750 villages in 15 Indian states, covering 33,230 households, carried out by the National Council for Applied Economic Research. They test the hypothesis of whether increased decentralization and democratization have positively influenced enrollment rates and child mortality once the influence of socioeconomic circumstances, civil society organizations, and the capture of local bodies by elite groups are controlled for. They find that frequency of elections, presence of parent-teacher associations and other indicators of more democracy and participation generally have positive effects, although these effects are not always statistically distinguishable from zero. Further work is needed in two directions. First, it may be useful to model with more precision the impact of political regimes. The latter vary greatly across states so that it should be possible to examine, as Harriss (1999) has, the effects that politics may have had on poverty reduction. Second, to measure the impact of capture, it is necessary to make use of survey information on income (or asset) distribution, as participation can be expected to vary by income groups. Lanjouw and Ravallion (1999), using 1993-94 National Sample Survey data from rural India, estimate the marginal odds for individuals of different income categories to participate in school and anti-poverty programs. Their results suggest that the benefits of these programs are captured early on by the non-poor.

Capture leads to problems of targeting of public expenditures. Self-targeting in the provision of public goods, i.e., creating incentives that encourage participation only by the poor, such as public works programs, has been emphasized by the literature on development. In India, employment-oriented public works used to be organized centrally. Today, in most states, public works programs under the Jawahar Rozgar Yojana (JRY) scheme are organized at the village level. Money is transferred directly to the village panchayat, which is responsible for planning and implementing the works. As reported by Drèze, the record of these schemes is mixed. The choice of works to be implemented has improved because village communities are better aware of local priorities and have a stake in promoting the more productive works. The employment intensity of JRY for the unskilled, however, has greatly declined because local leaders have little interest in creating employment for landless laborers. They want to create productive assets and, from that point of view, their preference tends to be for works that are relatively intensive in materials and skilled labor. The JRY schemes are also plagued by corruption. In a recent survey of public works in five villages of Rajasthan, for instance, Drèze found leakages of at least 30 percent. Further, the fact that corruption is not smoothly institutionalized means that it often undermines the timely completion of works. This is a typical case of ‘decentralized corruption’.

Other examples of public goods that are relevant for the poor can be found in the area of physical and human infrastructure. These goods - whether a road, a school or a hospital - are typically locally provided public goods. The empirical assessment of income gains from infrastructure are plagued by a simultaneity bias problem: public decisions made about the location of the investment may be influenced by income level or growth rate between regions. Only a few studies have overcome this problem. They confirm that the poor derive large productivity gains from these public investments. How does governance affect the management of physical infrastructure such as irrigation or potable water systems? Local irrigation organizations, which used to be controlled by central irrigation bureaucracies, are now being handed over to local units such as farmer organizations. So far the experience is mixed. Pranab Bardhan cites his statistical analysis of 48 local irrigation organizations in six districts in Tamil Nadu (Bardhan 1999). He finds that inequality of land distribution is a significant variable in explaining low levels of cooperation. In highly unequal areas there is less cooperation. Cooperation (in the form of reciprocity or other mechanisms) works better among people who are relatively equal and have similar needs and resources than in hierarchical communities. One cannot generalize, however, and say that inequality hinders cooperation. The opposite kind of argument (that a certain degree of inequality is good for growth) can also be found in the literature.

It is recognized that heavily subsidizing health and education activities is likely to be pro-poor because, in developing countries, the income elasticity for those goods is greater than one, so that such policies promote a labor-intensive growth path. The argument rests on the assumption that the non-poor are satiated in their consumption of rudimentary social services, such as primary education or basic health care, because the poor have larger family sizes and the rich will shift into the private market for these services (Bardhan and Udry 1999). This assumption is, in part, confirmed by benefit incidence studies (measuring the utilization of these public goods) give some indication of the degree of capture by the rich of public programs which provide those public goods. The studies cited by Lipton and Ravallion (1995) show that such subsidies are, generally, moderately pro-poor. However, one recent study reviewing the benefit incidence of government spending on health in Africa presents evidence to the contrary (Castro-Leal et al. 1999). As it turns out, the richest household groups, as well as the poorest, rely heavily on publicly provided care in several African countries. Governance factors are a possible explanation for this form of capture of benefits.

One important issue is that health and education services differ greatly in quality, so that the non-poor are unlikely to be satiated for improved quality. As remarked above, at least in theory, the provision of public goods by public entities is superior when quality-enhancing innovations are unimportant, when corruption in government is a severe problem (outsourcing would increase the temptation for bribes), and when there are non-contractible cost reductions that have adverse effects on the quality of the public goods provided. The case of privatizing the provision of public goods is favorable when the reverse holds. T. Paul Schultz (1999), in a recent survey of health and schooling investments in Africa cites evidence from Kenya that improvements in the quantity of education favor the poor, while improvements in quality favor the rich, but notes that the evidence on this issue is not unambiguous.

When privileged groups exit from the system of public provision and set up private schools or health facilities of their own, this diminishes public pressure for efficient public services. The result is a divisive system that combines efficient but costly private provision for those who can afford it with dysfunctional public services for the rest. This pattern is quite widespread in India today, especially in urban areas, but increasingly in the rural areas as well, for example in Uttar Pradesh. By contrast, in Himachal Pradesh, government schools function relatively well, reflecting a sustained emphasis on elementary education in state policy as well as the relatively egalitarian nature of village communities (Probe 1999). As a result, there are few private schools in rural areas. This, in turn, keeps up public pressure for government schools of adequate quality. Interestingly, similar patterns apply to other local public services, from health centers to milk cooperatives and water supply. In these fields, too, Himachal Pradesh seems to have gained much from its relatively egalitarian social structure.

Privatization is not the only alternative to state provision of public goods and services. In the area of social insurance, there are community-based risk-sharing arrangements that work better than state-sponsored social security systems. They are less prone to moral hazard than state systems and more equitable because they are based on reciprocity. However these systems rely on informal norms and must be implementable without legally enforceable contracts. They are dependent on the modern banking sector (at least to accomplish ancillary functions such as accounting) and on the state. For these village- or region-based organizations to develop into national insurance markets with much larger coverage would require state support to enforce contracts.

In the majority of sectors that are of particular relevance for poverty reduction, a good case for shared governance - for complementarity between decision making at the local and central levels - can be made. In education for instance, some parts of the system (setting the curriculum, organizing examinations at the secondary school level, monitoring the quality of instruction, etc.) are best provided by central authorities with democratic control and oversight; for some tasks (such as fixing leaky roofs). It does not make sense for the center to get involved or to sign off on decisions; for other issues, it is best to share governance. Teacher absenteeism is such a case. Local communities have more information and a greater stake in monitoring teachers. At the same time, their own actions can be effective only if the education management structure itself responds to parental complaints. Alderman (1999), in a recent study of the social assistance system in Albania, notes that to take advantage of the presumed access to local information about needs that local governments have, there must be a corresponding flow of information to the center as well as an incentive to use this information. The increasing complexity of decentralized programs may raise the potential of improved delivery, but it also increases the chances for misallocation of funds at different nodes of the system.

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