FIGHTING POVERTY THROUGH FISCAL DECENTRALIZATION

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EXECUTIVE SUMMARY

Fiscal decentralization is an important reform initiative in many –if not most- developing and transition countries. The goal of many decentralization reforms is to empower local communities through their local governments; to provide a more equitable allocation of resources; and to assure improvement in the delivery of key services, such as education and health care. In the context of lesser developed economies, assuring equity –in the form of policies designed to alleviate poverty- take on even greater significance.

Yet, despite its obvious importance, relatively little is known about the overall impact of fiscal decentralization policies on poverty reduction. In many ways, the decentralization literature has not seriously tackled the nature and effects of the linkages between poverty and decentralization. Likewise, the poverty literature has largely ignored the role that local governments and decentralization play in poverty reduction strategies.

This study brings together the current state of knowledge of how fiscal decentralization –including the assignment of expenditure responsibilities, the assignment of revenue sources to subnational governments, intergovernmental fiscal transfers, and local government borrowing- can affect poverty levels. Based on a better understanding on how these two thematic areas intersect, the study provides specific suggestions and recommendations on how development agencies and international financial institutions can support fiscal decentralization reforms in a more pro-poor manner.

1. INTRODUCTION

Fiscal decentralization is an important policy reform initiative in many –if not most- developing and transition countries. While different goals are pursued with decentralization reforms in different countries, decentralization reforms generally aim to improve the delivery of key services, such as education and health care; to democratically empower local communities through their local governments; and to increase the transparency and equity with which public resources are allocated across the national territory. In the context of lesser developed economies, improving public service delivery and assuring that services are delivered in an equitable manner -including programs and services designed to alleviate poverty- take on even greater urgency.

Despite the obvious importance of understanding the exact impact (and interaction) of fiscal decentralization on poverty reduction, relatively little is known about the intersection of these two topics. In the traditional public finance literature to date there have been only a few serious attempts to systematically consider the impact of the different dimensions of fiscal decentralization on poverty reduction. In turn, the traditional literature on poverty has largely ignored the role that local governments and decentralization play in poverty reduction strategies. In fact, poverty reduction and economic development in developing and transition countries have traditionally been approached exclusively as a central government challenge.

The tension between the centralist poverty reduction agenda and (fiscal) decentralization reform continues to characterize today's international practice. Although the notion of community-driven development –which embraces the view that poverty is local and that poverty alleviation requires involvement at the local level- is increasingly gaining followers among policy practitioners and in the development literature, donor-supported development activities and poverty reduction programs have traditionally been centrally driven and top-down. Even when the recognition is made that community involvement and ownership is needed for sustainable economic development and poverty alleviation to take hold, many community-driven development programs purposely circumvent local government authorities, who are seen as inefficient, corrupt, and prone to elite capture.

The overarching goal of this study is to bring together the current state of knowledge of how well designed fiscal decentralization–including the assignment of expenditure responsibilities, the assignment of revenue sources to subnational governments, intergovernmental fiscal transfers, and local government borrowing- can support poverty reduction policies, and at the same time uncover how poorly designed decentralization programs may be harmful to the objective of fighting poverty.

We start by reviewing the concepts of poverty and decentralization, and considering the strengths and shortcomings of the ways in which these concepts are measured and quantified. In our conceptual discussion, we seek linkages via the direct and indirect impacts that decentralization may have on various components of well-being (private income, basic needs, security, and so on). Based on a better understanding of how decentralization and poverty reduction intersect, the study seeks to provide specific conclusions and recommendations on how national governments, bilateral development agencies and international financial institutions can both design fiscal decentralization reforms in a more pro-poor manner and how poverty reduction strategies can embrace a proactive solid role for subnational governments.

2. POVERTY AND DECENTRALIZATION: RELEVANT AND RELATED CONCEPTS

Both poverty and decentralization are concepts commonly used and heard in the international development community. Although these terms have distinct meanings that are quite different from each other, these concepts share several traits. First, neither concept is as easy to define as might be believed at first glance; in fact, the definitions used to capture these concepts have changed over time as our understanding of poverty and decentralization has evolved. Second, as a corollary, neither concept is as easily quantifiable as might be believed. Third, and more substantively, both concepts concern themselves with empowerment: in the simplest terms, decentralization deals with empowering citizens through their local governments while poverty reduction concerns itself with empowering a group of these citizens: the poor. If the increasingly accepted wisdom that “all poverty is local” is correct, then decentralization policy and poverty reduction strategies could be closely intertwined and have synergetic positive effects on each other.

2.1 MULTIDIMENSIONAL DEFINITIONS OF POVERTY AND DECENTRALIZATION

DEFINING POVERTY

In its most basic form, poverty connotes a condition of low income and failure to satisfy basic needs. Based on this definition adopted in the 1970s, the global poverty problem is still staggering: there are 1.1 billion people in the world living on less than one dollar per day (UNDP, 2004).[1]

> Poverty connotes a condition of low income and failure to satisfy basic needs. Yet poverty is about more than a lack of resources: poverty is about risk, uncertainty about the future, vulnerability, powerlessness, lack of voice, representation and freedom

In the debates of the 1980s and 1990s, the concept of poverty gradually evolved from the notion of “minimum level of subsistence” to the notion of “relative deprivation,” which defines poverty as the failure to maintain the standards prevailing in a given society. More recent debates have added other elements to the poverty definition, including such intangibles as ‘capabilities’, dignity, autonomy, vulnerability, voice, empowerment and participation. [2]

Accordingly, the measurement of poverty has been broadened to include, in addition to income, a broad set of non-income basic needs, like primary education, basic health, and access to social services. In this respect, the Human Development Index (HDI) measures the average overall achievements in human development in a country based on life expectancy, educational attainment, and GDP per capita.[3] The incidence of this broader concept of poverty is reported by the mapping in Figure 1, which shows the inverse of the human development index levels (1-HDI). While extreme poverty is increasingly concentrated in Sub-Saharan Africa, poverty continues to be a global concern.

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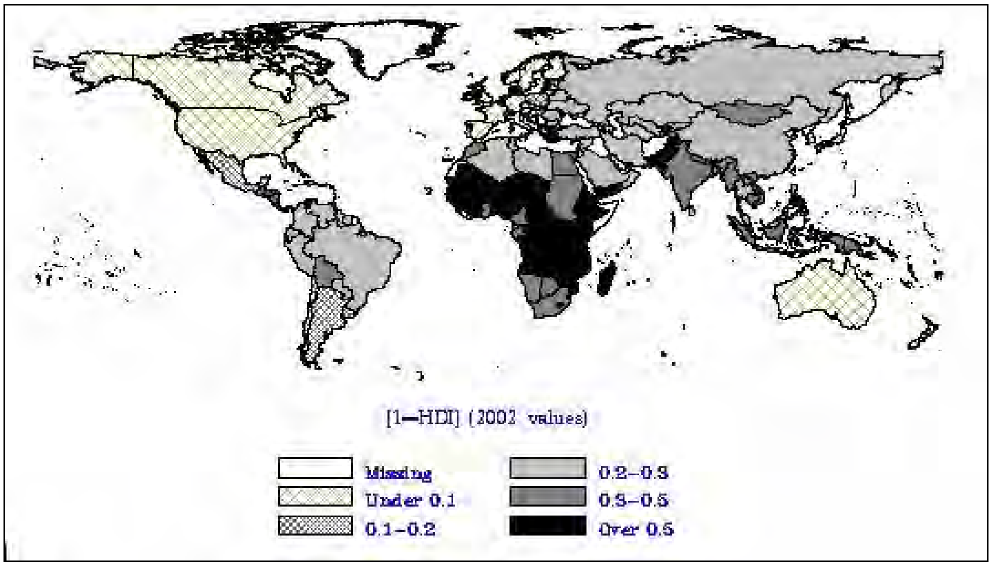
1 Note that this measure of poverty is based on consumption ability. The “one-dollar-a-day at purchasing power parity at 1985 ($1 a day-1985 PPP) was developed by World Bank analysts in an attempt to link poverty line and poverty measures across countries. It was first used in the 1990 World development Report.

2 See, for example, Sen (2000) and Sachs (2005).

3 The United Nations Development Program (UNDP) issued its first Human Development Report in 1990.

FIGURE 1: PATTERNS OF POVERTY AROUND THE WORLD, MEASURED BY (1 – HDI)



Source: Based on Human Development Report (UNDP, 2004).

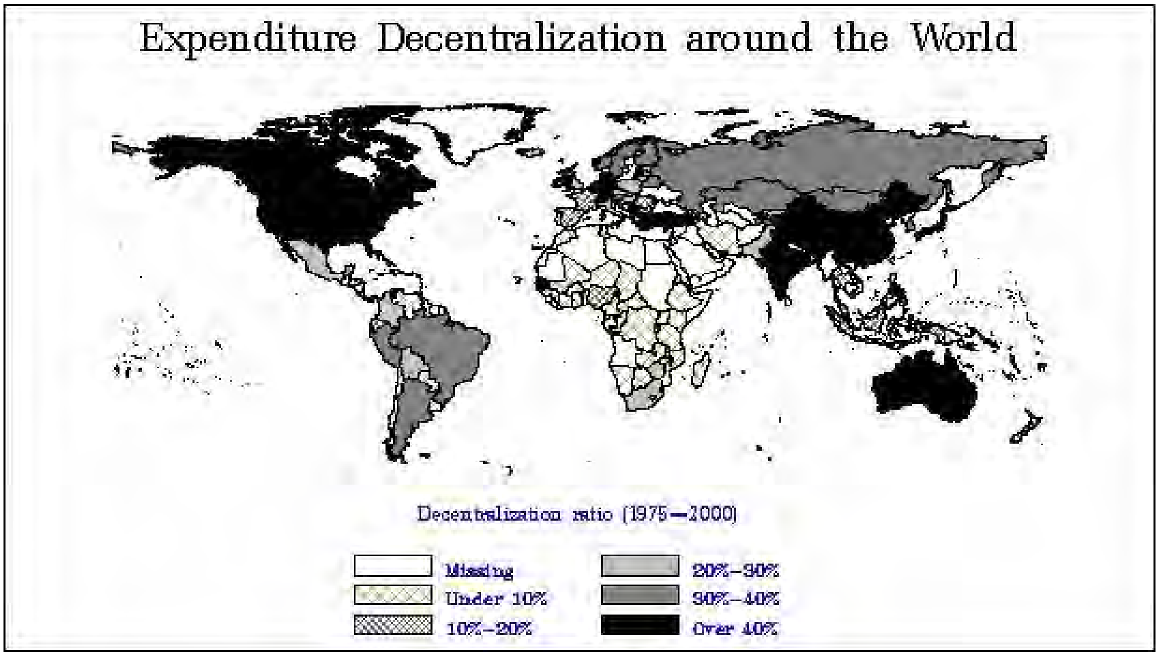
The discussion above illustrates well that the concept of poverty is likely to be multi-dimensional, encompassing both monetary and non-monetary aspects. An important implication is that any attempt to define poverty by focusing only on one aspect of this concept runs the risk of underestimating its richness and complexity.

DEFINING FISCAL DECENTRALIZATION

The importance of decentralization as a policy reform theme in countries around the world cannot be easily overstated. Some 95 percent of democracies now have elected subnational governments, and countries everywhere—large and small, rich and poor—are devolving political, fiscal, and administrative powers to subnational tiers of government (World Bank, 2000). In fact, the past decade has seen a series of countries engage in high-profile reforms of their intergovernmental fiscal relations in order to accommodate new political and economic realities, including Indonesia, the Russian Federation, South Africa, and Uganda.

Reliance on subnational governments for spending the country's public resources ranges, as shown in Figure 2, from virtually nil in some countries to over 50 percent in others. Although the level of decentralization is conventionally measured by the share of total public expenditures or revenues at the subnational level, the success of decentralization reforms probably depends less on these measures of decentralization than on the level of genuine autonomy exercised by local governments in their revenue and expenditure decisions and by the integrity of the system's design. Yet it is difficult to properly capture or quantify these aspects related to the existing autonomy in fiscally decentralized systems in a single measure.

FIGURE 2: PATTERNS OF EXPENDITURE DECENTRALIZATION AROUND THE WORLD
PERCENTAGE OF PUBLIC SPENDING BY SUBNATIONAL GOVERNMENTS



Source: Based on IMF Government Finance Statistics (2001)

Decentralization is commonly defined as the transfer of authority and responsibility from the central to local governments and the empowerment of the people to run their daily affairs through their local governments.[4] The economic literature identifies several distinct attributes of government authority, each of which can be separately assigned among the levels of government and therefore should be evaluated separately. Essentially, governments operate through regulation, financing, administration, and delivery of public goods (Philip, 1954).

> Decentralization is commonly defined as the process of transferring decision-making powers to subnational tiers of government.

Therefore, we can observe different extents of decentralization for each of the four components (or attributes) of government power. On the revenue side of the budget, subnational governments may exercise autonomy by being able, in any combination, to introduce their own taxes, modify the structure of existing taxes, and collect their own taxes. Thus, no single-dimensional measure can capture the true degree of decentralization. Approaches to measuring the extent of fiscal decentralization have been long debated in theoretical works and, more recently, in empirical studies focusing on the link between fiscal federalism and various fiscal and economic outcomes.[5]

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4 See Bahl (2005) and Litvack and Seddon (1999) for examples of different definitions of decentralization.

5 For a thorough discussion see Riker (1964, p. 51-84), Oates (1972, p. 196-99), and Bahl and Linn (1992, p. 390-91). Econometric applications can be found in Oates (1972), Oates (1985), Nelson (1986), Grossman (1989), Shah and Huther (1999), Jin *et al.* (forthcoming), Davoodi and Zou (1998), Zhang and Zou (1998), Woller and Phillips (1998), Eberts and Gronberg (1990), Panizza (1999), Stein (1999), Akai and Sakata (2002).

The bottom line is that there is no one single best measure of decentralization. The choice of an appropriate measure has to be determined with the particular aspect of decentralization that is being studied. Moreover, while studying the impact of one particular aspect of decentralization, we need to control for differences in other aspects of decentralization and for general institutional and economic background. One of the reasons for inconclusive results of existing empirical studies (reviewed later in this paper) is their vagueness on what aspect of decentralization they are actually studying. It should not come as a surprise that studies actually focusing on different aspects of decentralization show opposite impacts on the same variable of interest such as poverty.

2.2 WHAT THE LITERATURE SAYS

Although there is a large number of studies and research papers that have considered the impact of specific aspects of fiscal decentralization and decentralized service delivery on poverty reduction, surprisingly there have been very few attempts to bring the two sets of issues together in a comprehensive manner. The existing literature has approached the interaction between decentralization and poverty from a number of different angles, each of which has its particular strengths and weaknesses.

Economic theory. The traditional public finance literature dealing with fiscal decentralization has not dedicated much attention to studying the impact of fiscal decentralization on poverty. The few relevant studies are based on Musgrave's (1959) classical discussion of the role of government, arguing that income redistribution functions should be assigned exclusively to the central government.[6] According to this argument, not only would local governments be disinclined to engage in income redistribution at the local level, but doing so would also be inefficient. This is so because factor mobility (particularly labor) will make attempts by subnational jurisdictions to change the distribution of income self-defeating as the poor migrate to areas of high redistribution, while the rich cluster in areas of low redistribution.

A few empirical studies have analyzed the impact of decentralized financing on poverty reduction efforts in developed countries by estimating migratory response to differentials in support to the poor (e.g., Brown and Oates, 1987). The tentative conclusion of these studies is that this migration potential depresses levels of assistance, such as the Aid to Families with Dependent Children (AFDC) in the US. However, central financing and design of welfare programs does not rule out local government's involvement in implementation and targeting programs to the intended population. Also, factor mobility, the largest theoretical constraint on subnational redistribution functions, may not be as large a concern in developing countries.

Conceptual papers and descriptive case studies. The bulk of the current literature on decentralization and poverty consists of conceptual studies or reports, commonly supplemented by anecdotal evidence and/or descriptive case studies. While some of these studies are published in peer-reviewed academic journals, a majority of these studies comprise policy reports, working papers and consultants' reports; accordingly the depth of these studies varies greatly. A common feature shared by many of these studies is the lack of meaningful empirical evidence either in favor or against the specific policy positions that are being argued.

[6] However, there is on the other hand a large and growing literature in public finance that studies the roles and practices of subnational governments in income redistribution. See, for example, Bahl, Martinez-Vazquez and Wallace (2002).

In many conceptual discussions of decentralization that are based on the theoretical literature on local government finance and "fiscal federalism" (Tiebout, 1956; Oates, 1972), decentralization is simply assumed to empower local communities and help improve the overall efficiency of government services.[7] Presumably, these expected outcomes can also improve the situation of the poor; however, this is not immediately clear or obvious (Rao, 2000). However, other scholars essentially argue the opposite position -that expenditure decentralization is essentially a poor policy response for poverty reduction- either based largely on anecdotal evidence and qualitative observations (e.g., Crook, 2003) or based on fairly complex theoretical models of local political capture (e.g., Platteau and Gaspart, 2005).

We certainly do not mean to imply that there is no place for conceptual arguments, theoretical models, case studies, and anecdotal evidence in arriving at a better understanding of the relationship between decentralization and poverty reduction. However, caution should be taken in accepting such discussions or argument without the appropriate context as conclusive evidence either in favor or against one position or the other.[8] At either extreme, largely unsubstantiated platitudes on the benefits of "bringing government closer to the people" on one hand and the detriments of entrusting poverty reduction to "weak and unaccountable local governments that are captured by local patronage politics" on the other hand are unlikely to be helpful in advancing our knowledge on the issues or contributing to a constructive policy dialogue.

Empirical studies. While their numbers are relatively limited, there are a number of empirical studies that explore the direct relationship between decentralization and poverty alleviation using country-level data sets. In general terms, the approach of these studies has been to use regression analysis to estimate the impact of different measures of (fiscal) decentralization on some national poverty indicator. Shortcomings of this approach include limitations caused by the incomplete nature of the measures used for both poverty and decentralization; the challenges of constructing a data set with comparable data across countries; as well as the difficulty of dealing adequately with endogeneity and simultaneity issues; for example, both decentralization and the incidence of poverty incidence may be driven by the level of economic development. These weaknesses of the cross-country panel dataset analysis limit somewhat the validity of the findings. In addition the results have not always been clear cut. For instance, von Braun and Grote (2000) conclude that decentralization does indeed serve the poor, although the impact depends on the interaction of political, administrative and fiscal decentralization systems, and in addition the sequencing and pace of the different types of decentralization seem to play an important role on the final outcome.

Similarly, mixed results are found in studies of decentralization outcomes in terms of quality of specific pro-poor services. For example, Khaleghian (2003) concludes that decentralization appears to improve the coverage of childhood immunization in low-income countries but that the opposite holds for middle-income countries. At the same time, in the middle-income group, democratic government mitigates the negative effects of decentralization, and decentralization reverses the negative effects of ethnic tension and ethno-linguistic fractionalization.

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[7] Probably the most comprehensive attempt to date within the public finance literature to capture the intersection between decentralization and poverty reduction is the volume *Development, Poverty, and Fiscal Policy: Decentralization of Institutions* (Rao, 2002).

[8] A subset of policy studies and reports draws policy conclusions on the link between decentralization and poverty based on a review of country experiences (e.g., Jütting et al., 2004). While the quality of such studies can vary tremendously, the conclusions of such studies may again be diminished to the extent that the underlying sources rely on subjective, qualitative or anecdotal evidence.

State of the literature. It would be fair to conclude that the current state of the literature on the topic is its infancy and that the findings so far are inconclusive as to the overall impact of fiscal decentralization policies on poverty alleviation. Taken together, the available evidence suggests that while the experience of the last 15 years shows that fiscal decentralization has the potential to affect political stability, public service performance, equity, and macroeconomic stability, there is neither a consistent positive or negative relationship between decentralization reform and poverty reduction. Perhaps in a way the state of the literature is not only a reflection of the scant work that has gone into this area but also a reflection of the wide variance in the quality and depth of fiscal decentralization reforms. While poorly designed fiscal decentralization reforms can hurt economic growth and worsen poverty, well-designed fiscal decentralization reforms can improve overall efficiency, economic growth, and provide an effective tool in poverty alleviation.

Before discussing separate elements of decentralization policy, immediately below we summarize all potential linkages via the direct and indirect impacts that decentralization may have on various components of poverty. This analytical framework will allow us to systematically explore the interactions between each dimension of fiscal decentralization and various aspects of poverty in subsequent sections.

3. (HOW) CAN FISCAL DECENTRALIZATION AID IN ACHIEVING POVERTY REDUCTION

3.1 LINKAGES BETWEEN DECENTRALIZATION AND POVERTY REDUCTION

Although a full exploration of the root causes of poverty and its solutions (including geographical location, addressing the scarcity of economic resources or the failure of the economic system to combine resources in productive ways) fall beyond the scope of the current study, fiscal decentralization may affect a country's poverty reduction efforts in a number of ways. Because poverty is best defined as deprivation of various aspects of well-being, it is logical to seek conceptual linkages via the direct and indirect impacts that decentralization may have on these well-being components: private income, basic needs, and security. In the subsequent sections, the review of separate elements of decentralization suggests that satisfaction of the basic needs of the population is the area of poverty reduction where most benefits of decentralization are likely to occur. However, in an indirect way, decentralization also affects generation and redistribution of income, empowerment and participation of the poor and their vulnerability to external shocks.

BASIC NEEDS OF THE POPULATION

There are several potentials ways in which decentralization may affect basic needs of the population through the provision of services in areas such as primary education, basic health and other social services. These public services affect the quality of life for all people and therefore are an important ingredient for poverty reduction. The following benefits are commonly attributed to decentralized provision of public services:

- *regional differences in needs and preferences can be better taken into account*: Local governments are better positioned than the national government to administer and deliver public services as a result of informational advantage regarding local preferences and costs. Local governments have a more institutionalized linkage with beneficiary communities, improved information, and the incentive to use this information; therefore, local governments are better placed to identify the poor, to respect local social identities, and to respond more efficiently to local variations in conditions, tastes, standards, affordability, location requirements and so on for services or infrastructure. Community participation can improve the information flow leading to improved project performance and better targeting.[9] In contrast to deconcentrated branches of central ministries, local governments may ensure horizontal coordination of line department staff, budget and activities at the local level.

- *population mobility narrows the gap between local government policy and local communities' preferences*: Decentralization of expenditure responsibility and tax authority breaks uniformity and thus enriches the choice of bundles of public goods and taxes that can be offered. Through self-selection of individuals, their preferences can be matched with bundles that different governments offer.

- *competition among local governments favors efficiency and organizational and political innovations*: Mobility of labor and capital between localities rewards governments who better serve

[9] For evidence on community participation improving program targeting on social safety net programs for the poor see Baland and Plateau (1996), Isham et al (1995), La Ferrara (1999) and Narayan et al (1997).

residents and businesses via the expansion of the tax base. Competition among subnational governments can be also a source of innovation, leading to improved quality and lower costs in the production of public goods.

- *more efficient and responsive governance as citizens have more influence*: Accountability relationships between local authorities, citizens, providers and the center are strengthened, as decentralization can bring greater citizens' voice, information, responsiveness and monitoring. Since local residents can monitor local government better than the central government, they are more likely to hold local officials accountable for delivery of services at some acceptable quantity and quality. If voters are dissatisfied with public services, they no longer vote for the offending officials.

The aforementioned benefits of decentralization can make a difference at the various stages of government action aimed toward satisfaction of the basic needs of the poor. Clearly, decentralization policies can affect the level of public resources that are allocated to these expenditure areas; it can affect how these expenditures translate into government programs and how these programs are implemented; finally decentralization can also affect whether these program actually reach the targeted population groups.

More generally, decentralization can bring an improvement at each stage of the budget process by promoting good governance. Good governance has been found to improve a variety of outcomes, such as school achievement, quality of life indicators, or even GDP growth (Kaufmann et al. 2000). Decentralization and good governance are in many ways symbiotic and reinforcing processes, especially when political decentralization (with local elections and participation) is present (Martinez-Vazquez and McNab, forthcoming 2005; Blair, 2000; Manor, 1999). To the extent that decentralization and better governance improve local services and outcomes that are related to the wellbeing of the poor, reductions in absolute poverty should follow. Relative poverty may also be reduced if the improvements in the quality of services are in those areas that are more than proportionally consumed by the poor.[10]

EMPOWERMENT AND SECURITY

In an indirect manner, good governance and accountability are obvious important precondition for assuring a pro-poor, pro-growth economic environment in which government services are delivered in an efficient and effective manner. In addition, fiscal empowerment of local governments in a way that brings government truly closer to the people may provide an even more direct benefit to the poor, by strengthening their voice, representation and basic freedoms. Thus, decentralization can empower the poor through the creation of institutions that promote greater voice and participation of the poor. Decentralization can enable voice mechanisms for citizens to express their views to government bodies, potentially empowering the poor to make their needs known and making their voices heard in shaping policies that affect their lives. In addition, decentralization creates opportunities for citizens to participate in the administration, budgeting and delivery of public services.

Improved representation and empowerment of the poor can also reduce their insecurity and vulnerability to external shocks. External shocks, such as economic turmoil, tend to affect the poor more directly because of their higher vulnerability due to the lack of financial cushions and personal assets, diminished access to safety nets, and so on (Skoufias, 2003). Also, civil conflicts are associated with a rise in poverty due to population displacement and destruction of infrastructure.

[10] Note that even Pareto-improving growth can increase inequality and thus measures of relative poverty, despite the fact that income for the poor has increased (see Ravallion, 2004).

Because poor households mostly rely on informal insurance arrangements through their extended family and community, they are insecure in the face of a crisis affecting the entire community. Moreover, the kind of coping strategies they have to rely on in those circumstances can entrench poverty and transmit it to other generations (selling productive assets, reducing healthcare and nutrition for their children, reallocating their time from schooling to earning income, etc). Also, depreciation of currency associated with an economic crisis can increase the relative price of staple foods, which usually account for a large share of poor household budget. Moreover, fiscal retrenchment pursued by the government during an economic crisis usually involves cuts in social programs, which are critically important for the poor. Finally, there are theoretical arguments and empirical support to the notion that inflation hurts the poor relatively more than the rich (Easterly and Fischer, 2001).

Potentially decentralization can reduce vulnerability of the poor to such external shocks (Spoor, 2004). Improved representation and organization of formerly excluded groups through decentralized governance can enable the poor to have better access to safety nets and social security schemes, reducing their vulnerability and insecurity (Jutting et al, 2004). Also by establishing grounds for political consensus in ethnically divided societies, decentralization can reduce instability, to which the poor are most vulnerable (Bird et al., forthcoming).

ECONOMIC OPPORTUNITIES FOR THE POOR

Besides better satisfaction of basic needs of the population and reducing their vulnerability, potentially decentralization can also enhance economic opportunities for the poor. There are four ways in which decentralization may affect private income.

First, decentralization can enhance economic growth though the level and quality of economic infrastructure (roads, ports, and so on) as we explain in section 4. Local governments are critical to providing an enabling environment to ensure local economic growth, both by providing capital infrastructure as well as by promoting human capital development. Economic growth is ultimately the key to sustainable reduction of income poverty at the local level. It is unlikely that central government bureaucrats situated in a distant capital are able to accurately identify the most productive infrastructure investments in a local community. Therefore, a pro-poor investment strategy may require extensive local involvement.

Second, decentralization may facilitate economic growth through its impact on macroeconomic stability (Martinez-Vazquez and McNab, 2005; Agenor, 2004). Macroeconomic recessions decrease the probability of finding new employment and the level of earnings for those already employed.

Third, decentralization can promote the inclusion of poor people in the growth process by removing constraints and empowering them to take control of their own development (through better education and health) and to take advantage of existing economic opportunities (Stern et al, 2005).

Finally, private income can be affected through more efficient redistributive policies via equitable allocation of public resources. We further develop these themes in subsequent sections of this study devoted to sectoral expenditures and revenue assignments.

3.2 SPECIAL RELEVANCE FOR THE INTERNATIONAL DEVELOPMENT COMMUNITY

While decentralization can play a fundamental role in poverty alleviation in developing and transition economies around the world, the link between poverty reduction and fiscal decentralization takes on additional significance in two groups of countries. First, a special relationship exists between fiscal decentralization and poverty reduction in so-called failed, failing, and fragile states. Ethnic and religious conflicts around the world are among the most visible contributing factors for centrifugal forces and the generation of poverty themselves. Such conflicts are often the exponent of (or compounded by) regional economic disparities and regional concentrations of poverty. A quick review of recent civil conflicts around the world, suggests that calls for independence or autonomy are often the strongest where poverty -or the gap between the rich and the poor- is the greatest or where ethnic and religious minorities are not allowed the means for self-government. That list could include –among others- the conflicts in Chechnya in the Russian Federation, the autonomous enclaves in Armenia and the Republic of Georgia, northern Sri Lanka, West Papua in Indonesia, or the Kurd region in Turkey. In many of these cases, fiscal decentralization reforms and regional targeting of poverty reduction efforts might have contributed to removing some of the underlying disparities that fed the conflicts (Bird and Ebel, 2005). Currently, the possible success or failure for democratization and peace in countries such as Afghanistan, Iraq, and Sudan may be determined in large part by the system of intergovernmental fiscal relations that each country will choose to pursue and the resulting distribution of wealth and poverty across their national territories.

A second group of countries that needs to be borne in mind in considering the relevance of this study for the international development community is the role of fiscal decentralization on poverty reduction in large, populous countries. It is relevant to note that while poverty alleviation in Africa has received top priority in the international development community, about half of the world's total population –and almost the same share of the world's poor- lives outside of Africa in one of the six most populous developing countries (notably China, India, Indonesia, Brazil, Pakistan and Bangladesh). The challenge of improving the delivery of public services and achieving poverty reduction in the context of these large, populous countries is distinctly different from the poverty challenge faced by smaller, less populous nations. Not only is it unlikely that these countries will be able to address their poverty issues without decentralization, but also effective decentralization efforts in these countries will require much greater attention to the regional-local dimension of intergovernmental fiscal relations.[11]

3.2 RISKS OF DECENTRALIZATION AND INSTITUTIONS MITIGATING THEM

Decentralization, as we have seen above can be quite instrumental in the fight against poverty. However, if decentralization is not done right, there is the risk that those potential benefits not only will not materialize but also that it will tend to aggravate the poverty problem. On the macroeconomic side, a "botched up" decentralization process can easily lead to economic instability, an inefficient allocation of resources, and slower economic growth. On the microeconomic service-delivery side, decentralization can fail to translate into better services for poor people at any stage of the budget process: governments may misallocate budgets by spending resources on the wrong groups of people; even when resources are allocated correctly, they may not reach their intended destinations if organizational and incentive problems in public agencies lead to misappropriation or theft; even when resources reach a school or health clinic, providers may have weak incentives, motivations, or capacities to deliver services effectively (see Keefer and Khemani, 2004).

As suggested by Bardhan and Mookherjee (1998), the benefits of decentralized service delivery can depend critically on the level of capture by local elites and on the level and nature of local inequality. If there is local capture and the interests of the local political elites are not aligned with those of the

[11] For example, some authors have interpreted the difficulties of China and India decentralized systems with basic service delivery at the local level, and therefore with fighting poverty, as being associated with the failure of those two systems to genuinely decentralize beyond the intermediate level of government, the provinces in China and the states in India. See Martinez-Vazquez (forthcoming) and Bahl et al (2005).

local poor, decentralization may work against the wellbeing of the poor.[12] Similarly, in situations with pronounced inequality in local relations of power and authority, decentralization, and in particular the decentralization of poverty programs in such contexts can worsen local inequality and reproduce or entrench local power relations (Conning and Kevane, 2002; Galasso and Ravallion, 2005).[13]

These risks become more eminent, of course, as the particular decentralization design deviates from the maxims of local discretion, voice, and accountability. On the other hand, the risks are minimized when certain institutional conditions, such as political freedoms, adequate human and physical capital bases, or free information flows are present.

Many empirical studies, some of which are surveyed in this paper, show that practically all countries in which decentralization has had a positive impact on poverty can be categorized as “free,” following the Freedom House index.[14] Also countries in which decentralization has had a positive impact on poverty have a literacy rate of over 70 per cent, in sharp contrast with the bad performers, where the rate lies below 50 per cent (Jutting et al, 2004).

To be effective, political accountability requires public access to information. Besley and Burgess (2001) find that in India, states that are more responsive to food shortages tend to also be those with higher levels of newspaper circulation, electoral turnout, and literacy. In contrast, these authors also find that richer states do not tend to be more responsive than poorer states. In Uganda, when evidence of leakage of public school resources emerged following the implementation of “expenditure tracking” exercises, the central government launched an information campaign.[15] It began publishing monthly transfers to school districts in newspapers, broadcasting them on radio, and requiring primary schools to post the information. As a result the information on leakage became a powerful driver of public action, and the level of leakage fell significantly (Reinikka and Svensson, 2004).

A number of decentralization practitioners (for example Prud’homme, 1995 and Tanzi, 1996) have pointed out several other institutional factors that may affect the outcome of fiscal decentralization:

- *the accountability of subnational governments to constituents:* In many countries, local officials are not elected by popular vote, but are appointed. In this case, voters may not express their preferences through elections, and may not replace those who do not represent their views. This institutional prerequisite is often referred to as “political decentralization.”

- *the possibility for people to choose where to reside:* This enables people to “vote with their feet,” but requires developed housing and labor markets.

[12] Inherited social institutions might conflict with the participation of excluded groups. The literature shows that pro-poor decentralization programmers in some countries (e.g. Malawi, Sri Lanka) have been compromised by the existence of traditional power structures and the presence of local patron-client relationships that have been perpetuated after the implementation of reform programs.

[13] Note that democratic governance does not guarantee by itself the implementation of pro-poor policies at the local level. This would require the majority of local population to favor pro-poor expenditures and to participate in the political process at least by voting. However, the poor are less educated and have a lower propensity to vote or to register to vote, and generally to participate in political process.

[14] An exception may be China, where decentralization may also have had a somewhat positive impact on poverty despite being “not free.” See Jutting et al. (2004).

[15] Public expenditure tracking surveys are being widely used across different countries such as Chad, Ghana, Honduras, Mozambique, Papua Guinea, Peru, Rwanda, Senegal, Tanzania, Uganda and Zambia. For more on this topic, see Dehn et al (2003), and Ablo and Reinikka (1998) for a case study in Uganda.

- *social capital:* If local social customs entrench economic backwardness of some groups (e.g., women), decentralization might make things worse. Also, transitional countries have extremely atomized societies after decades of citizens' passivity prevailing under the communist regime. It will take some time and experience of civic participation for local residents to build social capital, including positive beliefs about their neighbors and local community, and willingness to cooperate in order to improve the community.

- *a certain degree of independence of the subnational governments from the national government:* Local governments should have some freedom to choose how they will allocate their revenue resources among competing expenditure demands. This is not always the case. Compensation rates for public employees are often fixed and beyond the control of local governments. In some countries, local governments must seek approval of their budgets from higher level governments. All this is related to the central government's regulatory powers over local affairs (or "administrative centralization" as often referred to in policy literature).

- *the availability of qualified and integral staff at the local level:* It is argued that skilled fiscal managers are too scarce in developing countries to be shared between the central and local governments.

- *a minimum of fiscal management and budgeting institutions:* Clear rules of financial accounting and budgeting at all levels of government ensure some transparency of public finances and thus accountability to constituents.

Other preconditions for a successful impact of decentralization on poverty are in the realm of fiscal institutions. For example local governments might be unable to act on their superior knowledge of local needs and costs if they are bound by financial regulations imposed by the central government. Moreover, citizens may be more reluctant to engage in local budget issues if local governments are not delegated enough fiscal autonomy. We provide further discussion of these risks and conditions necessary to mitigate them in subsequent sections focusing on designing particular aspects of decentralization.

4. POVERTY REDUCTION AND LOCAL EXPENDITURE RESPONSIBILITIES

While both the revenue and expenditure sides of budgets affect the distribution of income among households, it is generally admitted that effective income redistribution to improve the status of the poor has to mostly come from the expenditure side of the budget (Martinez-Vazquez, 2001). This is especially true in developing countries, where tax systems may not have a large impact on the distribution of income, because the overall tax effort as a percent of GDP tends to be rather small. At the same time, government expenditures even in the poorest countries tend to be quite large by comparison to the income received by the poorest groups of the population (Selowsky, 1979). Therefore, changing the benefit incidence of public expenditures does have a significant potential for changing the welfare of the poor: i.e., increasing the level and quality of certain services (education, health and clean water), which have been proved to be critical to lifting people from endemic poverty.

Fiscal decentralization may have an effect on pro-poor expenditures if it is true that decentralization brings government decision-making (setting priorities, designing plans and implementing budgets) closer to the intended beneficiaries. In that case, decentralization can make the public sector more responsive to the population, and hopefully to the poor. While local citizens should be able to exert more effective pressure on government when decision-makers are physically accessible, local decision-makers should have access to information on local problems and opportunities which allow them to tailor plans and budgets in a way the central government could not (Foster et al, 2002).

Local governments' familiarity with local conditions gives this government level an advantage in the implementation of certain programs that intend to target certain population groups. Thus, local governments are more likely to be responsive to the concerns of the user groups, including the poor. In addition, local governments may be better able to monitor and control the agencies involved in program delivery (Boadway and Shah, 2002). The fact is that local governments may have a distinct advantage compared to central authority in identifying the poor within their communities and understanding the needs due to their proximity to the people. Local governments may be able to ensure more efficient service delivery not only through better information but also through closer oversight, monitoring, and control of service staff (teachers, health care workers, etc.), potentially decreasing absenteeism. On the other hand, if the devolution of expenditure responsibilities is pursued in the absence of strong accountability relationships; if there is significant elite capture -either at the central or local government level-; or if the poor are not politically empowered, then it is equally likely that decentralized expenditure assignments will contribute very little, if any, to poverty reduction efforts.

The potential advantageous positioning of the local government leads to the "subsidiarity principle", which is considered the guiding principle in determining expenditure assignments between different government levels. This principle suggests that government services should be provided at the lowest level of government that is capable of efficiently providing this good or service. This principle leads to outcomes where, as much as possible, the area where the benefits of a government service are enjoyed coincides with the government boundaries at each level of government. Proximity gains should be weighed against efficiency losses from small scale of operation and deficiencies of local institutions such as quality of staff. In addition, in accordance with the subsidiarity principle, the central government will continue to play a major role in poverty reduction activities that are implemented at the local level, as the central government should play an important role in providing resources to the local government level in order for local governments to fund poverty reduction activities.

Provided that there is no single best assignment of expenditure responsibilities and that there is no absolute best way for deciding which level of government should be responsible for a particular public service, the adequacy of any expenditure assignment has to be judged in terms of how well it achieves the goals or objectives pursued by the government in its decentralization strategy. As such, governments need to analyze whether their assignment of expenditure responsibilities in all its dimensions (i.e., regulation, financing, provision) is indeed assigned to the respective levels of government with the comparative advantage in performing each function. To the extent that poverty reduction is an important strategic policy objective in many developing countries, expenditure assignments would have to achieve the efficient delivery of public services in an equitable manner – both to poor and non-poor households alike- in a way that encourages participation and creates proper links of accountability to the communities that are being served.

Even though the results of studies on the impact of decentralized expenditure decisions and service delivery to the poor are still mixed, international experience shows that when the devolution of expenditure functions is clear, stable and well-designed, fiscal decentralization can support pro-poor outcomes. This growing strong evidence creates a great promise for improving public service delivery to the poor through decentralization. However, as we discuss below, the design and the institutional arrangements governing the implementation of decentralization can make a large difference in its effectiveness concerning service delivery to the poor (World Bank, 2001).

4.1 BASIC EDUCATION

The rationale for education decentralization involves improving the efficiency, effectiveness and equity with which education is provided. Additionally, decentralization allows the accountability relationship between the users of public services (including the poor) and politicians, politicians and providers, and providers and clients to be strengthened.

These benefits of decentralized education contribute both directly and indirectly to sustainable economic development and poverty reduction. Education provides knowledge, skills, values and attitudes that increase productivity and employability, and an educated population enhances civic order as well as political and economic stability. Education not only helps to improve the income-earning potential but it also has the ability to empower individuals; education enables someone to participate in local and national government, it provides skills and knowledge to improve quality of life, and to become more productive.

Provision of basic education is particularly suitable for decentralization as having less technical constraints but bringing the highest return. For instance, numerous studies have found that the return to investment in education is higher for primary education, followed by secondary and higher education. In particular, for Sub-Sahara African countries the return on investment in primary, secondary and higher education has been estimated at 24, 18 and 11 percent, respectively (World Bank, 2005). In addition the distribution of benefits from primary education seems to be more pro-poor than at higher levels of education. In Colombia, while the distribution of the subsidies to public primary education was found to be highly progressive, the incidence of higher education spending was found to be highly regressive (Selowsky, 1979).16 In Malaysia, the distribution of benefits was found to be increasingly regressive with the level of education (primary, secondary and post-

[16] The benefit approach to measuring the incidence of government expenditures was pioneered by twin World Bank studies by Selowsky (1979) for Colombia, and Meerman (1979) for Malaysia. The main goal of benefit incidence analysis is to identify who benefits from public spending and by how much. Formally, benefit incidence measures by how much the income of a household would have to be raised if the household had to pay for the subsidized public services at full cost.

secondary) (Meerman, 1979). However, as argued above, education should not be seen as only redistributive consumption, but rather as an economic investment in pro-poor economic growth.

In practice, governments are faced with the challenge of to which government level to devolve responsibility and decision-making authority for primary and secondary education. Several alternatives exist which have consequently led to different forms of educational decentralization around the world, ranging from centralized provision, to provision by regional and local governments, to community-level or school-level control and privatization of service delivery. Given that primary and secondary education are often considered a national priority both on efficiency and equity grounds, central government involvement in the financing and regulation of education (including determining curricula and setting educational standards) is essentially universal. Nonetheless, in accordance with the subsidiarity principle, the actual provision or delivery of basic education is often characterized by decentralized provision, where local governments are responsible for assuring the actual provision of education.[17]

While the global experience with education decentralization has been mixed with respect to improving access and quality of education, studies have generally shown that education decentralization contributed to improvements in access to education (El Salvador and Nicaragua); student learning (El Salvador and Nicaragua); student attendance (India); teacher attendance (El Salvador, India, and Nicaragua); and education quality including poor and rural poor areas in these countries (Jimenez and Sawada, 2000; Ozler, 2001; Barrera-Osorio, 2003). In particular the case of Educo schools in El Salvador has become a world model on successful improvement in access to education, quality, and accountability, particularly to the poor, through devolution of responsibilities to lower levels of government including schools and the community Another important success experience has been a community-government partnership in Madhya Pradesh, named Education Guarantee Scheme (EGS) which has successfully established 31,000 new schools and enrolled 2 million additional children, many from the poorest groups in society, while at the same time reportedly reducing the unit cost and improving the quality of the education provided in only few years (McCarten and Vyasulu, 2004).

4.2 HEALTH CARE SERVICES

Decentralization has long been advocated as a desirable process to improve health systems, service quality and coverage. Although decentralization should not be regarded as panacea for improving health care services, decentralization can contribute to achieving greater equity, efficiency, and quality in health spending, including improved efficient resource management and accountability (Bossert, 1998; Hearse, 2001). The most important potential advantage of decentralization for health service delivery is allowing a closer flow of information and interaction between health service providers and clients, leading to health services that are more differentiated and better targeted to varying local needs. When successful, decentralization of health care can lead to more systematic involvement of citizens in decisions regarding health policy goals, design, and financing, and in motoring service provision and holding health care providers accountable for the delivery of services.

On the other hand, anecdotal and country-study evidence confirms that poorly designed and hastily implemented decentralization has serious consequences for health service delivery (Gilson et al, 1994; Kolehmainen-Aitken et al, 1997). Therefore, in order to achieve the desired outcome, clients/citizens need to have access to information and bargaining power to elicit appropriate

[17] In many federal countries – Brazil, Canada, Germany, India – the states or provinces have constitutional responsibility for education, although the responsibility for primary and secondary education in many of these countries in turn is devolved to the local government level.

responses from health care providers at the decentralized level. Health providers, in turn, need to have the appropriate incentives, and have access to the skills, supervision, material support, and discretionary authority needed to offer high quality services.

Improvements in healthcare services should help fighting poverty due to bi-directional relationship between economic growth and health status. Indeed, better health enhances income by improving productivity, while higher economic growth allows better human capital formation and better health outcomes (Gupta and Mitra, 2004). Since poor health status and prolonged spells of illness reduce the earnings of households, the bi-directional nature of the relationship can also result in a vicious cycle that prevents the poor from accessing treatment.

In most countries, poor households have a greater demand for basic health services in response to a higher incidence of illness. Therefore, in countries with greater emphasis on universal access to health services in their organization of the health sector, public health services are likely to have a progressive incidence of benefits. By contrast, in countries where access to health care services is largely a function of formal employment—as health insurance and other health care provision is commonly linked to employment—poor households are less likely to have health insurance coverage and have less access to health care than non-poor households. For example, while the incidence of Colombia’s National Health System was found progressive, the health care benefits provided by the Social Security System tend to favor the middle-income groups, since access depends more on having a job in the formal sector (Selowsky, 1979).

Several features of health care (e.g., the controversial nature of some services such as family planning, the significance of formal training for personnel, and the integrated nature of services) make decentralization in this area more complex and potentially more difficult than in other sectors.

Empirical investigation on the impact of health decentralization on outcomes for the poor provides mixed results. In some cases, the decentralization of health services performs positively and pro-poor, while in other cases there has been no significant impact on responsiveness to the poor and development orientation (Sekher, 2005). Naturally, the incidence of decentralized health care services depends to a large extent on the design of the system of intergovernmental fiscal relations. When health care services are devolved in the absence of corresponding intergovernmental transfers, local authorities will be required to charge user fees and mobilize substantial own local resources to improve local services (Prudhomme, 1995; Lubben et al, 2002). As such, decentralization of health care services can place a substantial fiscal burden on poor areas and communities, unless the central government provides equalizing resources through the transfer mechanism.

Some country experiences, do show, however, successful experiences with decentralization as is the case of district health care in Burkina Faso (Devarajan, 1999 and Edmond et al, 2002), and municipal health care programs in Brazil in reaching the rural poor (World Bank, 2004). Other success stories relate to hospital autonomy and privatization which mostly relate to increased accountability, lower staff absenteeism, and better allocation of funds (Chawla et al, 1996).

4.3 AGRICULTURAL EXTENSION

Agriculture, in its broadest sense, constitutes a major opportunity for improving the well-being of the developing economies, where the majority of people still live in rural areas. To the extent that agriculture extension and livestock development focus on supporting agricultural production by poor subsistence farmers and small-holders, the link between agricultural programs and poverty reduction is often even more direct than in the cases of education and health care. The dissemination of technical know-how to small farmers, improved or subsidized access to seed and fertilizer, support for irrigation schemes, improved market access, or the provision of veterinary services for livestock owners provides a benefit that is directly proportional to the increases in production that result from these interventions. Thus, to the extent that agricultural extension and support programs are effective in increasing agricultural production, these programs directly increase the earning potential of poor rural households.

In the context of agricultural development, the basic aim of decentralization is to improve the level of efficiency by assuring that the extension services that are provided respond to local needs. Indeed, decentralization facilitates the use of local knowledge, local participation and ownership by utilizing local resources. Furthermore, decentralization has the potential to enhance transparency and accountability in the delivery of agricultural services, allowing local governments and community groups to more closely monitor service providers in order to reduce shirking by extension workers and to ensure that extension services are actually delivered.

4.4 CAPITAL INFRASTRUCTURE

Potential gains from decentralized investments in social infrastructure are similar to the benefits of decentralized service provision discussed earlier. As we argued before, efficiency gains come from allowing local players to make efficient decisions based on their superior knowledge of local conditions. The right mix of capital and non-capital inputs to the production of public services is one of the most important economic decisions. Therefore, planning development of local infrastructure from the center can lead to inefficient modes of service production.

A decentralized development strategy typically also assigns important responsibilities for the provision of economic infrastructure to the local government level, including the construction of local roads and transportation networks; water pumps, boreholes, piped-water and sewerage and sanitation schemes; irrigation projects; the construction of local markets, and so on. Both urban and rural areas exhibit significant demands for local capital infrastructure development, albeit often in different ways.

In rural areas, the demand for capital infrastructure emanates from a lack of access to public services due to lower population density. Thus, assuring equitable access in rural areas to basic education, health care services, as well as access to markets for local agriculture products would require a disproportionate investment in roads and transport infrastructure. Moreover, local responsibility over rural roads allows a comprehensive approach encompassing both the network of social facilities (rural schools, clinics, etc) and transport access to these facilities and materializing any trade-offs between the two. In addition to improving access to basic services, construction of rural roads also alleviates income poverty by increasing agricultural productivity and enabling the poor to find better paying work. At the same time, rapid urbanization in many developing countries has created tremendous demand for urban infrastructure and basic services in urban areas. For instance, it has been estimated that in 2002 only 61 percent of the urban population in low-income countries had access to public sanitation services (World Bank, 2005).

While in centralized systems, the full benefits of infrastructure investments are often not realized because of inadequate maintenance, a study by Humplick and Moini-Araghi (1996) determines that decentralized maintenance of roads results in efficiency gains and leads to an improvement in the general condition of roads, and a reduction in maintenance backlogs. As Sachs (2005: 278) notes, "investments are needed in hundreds of thousands of villages and in thousands of cities. The details [of public investments] will have to be decided at the ground level, in the villages and cities themselves, rather than in the capitals or in Washington. Decentralized management of public investment is therefore a sine qua non of scaling up."

4.5 IMPLICATIONS FOR POLICY REFORM

The assignment of expenditures is the first and fundamental step in the design of a decentralized system of government. Indeed, without a specific and clear assignment of expenditure responsibilities it will not be possible to assess the adequacy of the revenue assignment to different levels of government, or the need and effectiveness of a system of intergovernmental transfers. Donor agencies and international financial institutions can play a major role in supporting a sound assignment of expenditure responsibilities as part of a country's decentralization process in the context of a broader poverty reduction strategy. As there is no single best assignment of expenditure responsibilities and no absolute best way for deciding which level of government should be responsible for particular public services, national governments would benefit from technical assistance in identifying expenditure responsibilities with a potential for reducing poverty when devolved to the local level. This potential should be sought in improved efficiency in the use of public resources for delivering public services and better targeting these services to the poor. A careful analysis will help assign expenditure responsibilities to the respective levels of government with comparative advantage in performing each function.

Once consensus has been reached on the scope of functions that would be devolved to the local level, it is necessary to establish by law a clear assignment of expenditure responsibilities for each government level. A lack of clear assignment can become a source of conflict between the central and subnational governments and can lead to an inefficient provision of public services. Local official can avoid accountability for their poor performance by blaming it on the limited authority they have over the issue. In extreme cases unclear division of authority can lead to a failure to deliver services vital for the poor when one government expects the other to take charge and so nobody acts. Therefore donor agencies can play an important role in helping host countries to develop legal and regulatory framework for the decentralized provision of public services. National legislation drafted with donor support should explicitly specify the "attributes"–regulation, financing or delivery–for each function to be devolved to the local level. To ensure access of the poor to basic services, the regulatory framework can include centrally-defined norms and service delivery standards to be followed by local governments assuming the responsibility for these services.

5. POVERTY REDUCTION AND REVENUE ASSIGNMENT

After expenditure assignment is finalized, the next important step is to provide local governments with adequate sources of revenue. In this respect, it is important to recognize that fiscal decentralization affects poverty reduction not only through public expenditures but also by how these expenditures are financed. On the surface, it is not obvious that raising revenue by local governments is connected to poverty reduction. In fact, this issue has not received much attention in the literature other than studies that have attempted to determine the share of the local tax burdens borne by the poor in the context of tax incidence analyses.[18]

We argue that the tax incidence analysis, although important, it must not determine the choice of local taxes. Identifying a particular local revenue source as coming more than proportionally from the poor should not put it necessarily in a must not do list. The reason is that those particular sources of revenues may have significant effects on the efficiency of public service provision with important secondary effects on poverty reduction (as in the case for example of water local charges) or on the ability to undertake public expenditures with also positive significant effects on poverty reduction.

Furthermore, focusing on the incidence of local taxes alone may be misleading unless there is a clear reference to the burden distribution of the tax system as a whole, or even more preferably, to the distribution of net fiscal incidence where both benefits from public expenditures and tax burdens are evaluated together. For example, a program that charges cost recovery fees in the health sector may be regressive from the revenue side but it may have progressive fiscal incidence if the revenues are used to finance better health services or easier access to services by the poor. Moreover, to avoid distortion of location choices by population and businesses, resources that are raised and spent locally should be redistributionally neutral. That is payments from local residents have to be offset in terms of individual welfare by the benefits received from those services. Therefore, local programs with progressive net fiscal incidence would call for central government financing discussed in the next section.

It is important to recognize that despite their possible regressivity, local taxes may bring many benefits such as enhancing the accountability of subnational governments to their constituency, and by generally strengthening local taxpayer awareness of taxes and interest on the quality and level of local services delivered. Furthermore, despite their possible regressivity, local taxes are important especially when some local government services would not be available in a particular community without these revenues.

Sound revenue assignment can contribute to poverty reduction by making sure that local government revenue is raised in a way promoting good governance while not creating unnecessary obstacles to growth. A number of recent studies (e.g., Ter-Minassian, 1997; Ebel and Yilmaz, 2002) suggest that outcomes of decentralized spending depend on the form of financing used for these expenditures, with a crucial aspect being the extent of control that local governments can exercise over the revenue sources assigned to them.

Improved efficiency levels of service provision are achieved when there is a link between costs and benefits. When local governments have autonomy to levy fees and local taxes, there is not only a great potential for improved revenue mobilization and increased resources available for redistribution and allocation towards pro-poor programs, but this also reinforces local accountability. Accountability, expenditure efficiency and budgetary flexibility of local governments can be considerably enhanced through higher levels of local tax autonomy.

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[18] Perhaps another policy discussion which marginally concerns local taxation in the context of poverty is the effect of taxes on economic growth.

5.1 IMPLICATIONS FOR POLICY REFORM

International donors can play in important role in strengthening local revenue-raising powers particularly in the framework of technical assistance to the host country in reforming its tax system. The experience with tax reforms in countries ranging from Russia to Tanzania reveals that central governments tend to underestimate the importance of subnational governments' revenue autonomy for instilling good governance at the local level, which in turn has a direct impact on poverty reduction. Besides misleading assessments of local tax progressivity made out of the context of the whole tax system and benefit incidence, local taxes are commonly eliminated in the name of simplified tax structure, uniform environment for economic activities and uniform treatment of taxpayers. While these goals appear valid they are not necessary incompatible with larger revenue autonomy of local governments. A closed list approach to revenue assignment can achieve many benefits of local revenue autonomy while minimizing losses to economic efficiency and equity. In particular the authorized list could exclude the most distortionary taxes thus removing obstacle for internal commerce and economic growth.

International donors can provide national governments technical assistance in developing a list of authorized local taxes with desirable characteristics, possibly including their positive effects on poverty reduction. These characteristics would follow logically from the goal of decentralization and the role that local governments are expected to play in poverty reduction. To the extent that economic rationale for decentralization is to improve efficiency of government services, the benefit principle is pursued to link the costs of public services to the benefits delivered to local residents. Similarly, horizontal or political accountability of subnational officials requires the ability of subnational governments to affect at the margin the level of their revenues by choosing tax rates for some of the most important taxes assigned to them.[19] Inadequate revenue autonomy generally weakens local taxpayer awareness of taxes and interest on the quality and level of local services delivered. Finally, local revenue instruments should generate a stable revenue yield to ensure the continuity of provision of basic public services and safety nets for the poor.

Although local taxation is not an appropriate instrument for income redistribution, it can include provision of relief of hardship and other measures to protect those with the lowest incomes. International donors can be instrumental in providing technical advice on how to design such tax relief provisions in an efficient manner.

[19] Other forms of local tax autonomy, including the ability to change tax bases or the ability to introduce or eliminate some taxes, are generally less desirable since they can easily lead to increases in compliance and administration costs.

6. INTERGOVERNMENTAL FISCAL TRANSFERS AND BORROWING

If local governments are to play a credible role in supporting the implementation of a national poverty reduction strategy, then the system of intergovernmental transfers should assure that subnational governments are provided with adequate resources for the purpose at hand. While subnational own source revenues have important efficiency and accountability effects indirectly affecting poverty reduction, by themselves they only have limited potential for funding such services in a pro-poor manner. As such, the intergovernmental fiscal transfer system can play an important role in financing the delivery of services at the subnational level in a pro-poor manner.

6.1 RECURRENT INTERGOVERNMENTAL TRANSFERS

The first step in assuring that an intergovernmental transfer scheme is supportive of a pro-poor allocation of public resources is to assure that pro-poor public functions that are delivered by subnational governments are adequately funded. Besides ensuring that national budgets allocate adequate resources for the local government sector as a whole, it is important that the distribution of transfers among local government jurisdictions is actually pro-poor. It is not unusual to find that central governments allocate public resources unevenly across their national territory, with wealthier regions and urban local governments often receiving greater resources (Boex and Martinez-Vazquez, 2004).

A review of international practices shows that there is no single “right” way to provide intergovernmental transfers: in additional to assigning own source revenues to the regional and local government levels, different countries pursue the funding of different types of subnational expenditure programs in a variety of ways. Some countries choose to provide support for certain local expenditures through earmarked or conditional grant schemes with or without matching arrangements; this is especially the case for expenditures in key local sectors, such as primary education, basic health care, and so on. In other cases, higher-level governments may supplement the funding of local expenditure responsibilities through revenue sharing arrangements or unconditional equalization grant schemes. In fact, most countries rely on some combination of conditional and unconditional grants in supporting local government finances. Naturally, the particular design and combination of individual grant schemes in a country will determine the overall potential pro-poor impact of the intergovernmental transfer system.

Pro-poor and formula-based transfer system is virtually always a precondition for local governments to become an effective partner with the central government in implementing a country’s poverty reduction strategy. Although designing and implementing a sound intergovernmental transfer system can be as much an art as a science, the technical tools and international experience are available to assure that intergovernmental transfers are designed in a pro-poor manner.

6.2 CAPITAL GRANTS AND LOANS

Theoretically, revenue-raising powers and predictable intergovernmental transfers should enable local governments to achieve creditworthiness needed to obtain credit from private capital markets. Access to credit enhances local governments’ ability to undertake investments into public infrastructure in a way that efficiently balances spending choices over time. Besides making large-scale project at all possible, borrowing achieves inter-generational fairness and also smoothes out tax financing of large-scale projects. As such, access to credit is necessary for local governments to extend infrastructure to meet the demands for infrastructure, particularly in urban areas that can afford to repay such loans.

Moreover, debt financing in open credit markets has potential benefits with respect to local transparency and accountability. Credit markets can potentially correct irresponsible fiscal behavior by charging adequate risk premia or excluding fiscally irresponsible local jurisdictions from further borrowing altogether. Also private lenders can instill better financial management and fiscal transparency, which indirectly facilitates poverty reduction through better governance. In short, the introduction of market discipline into the funding of local capital development is a desirable situation in the long run, as local government borrowing has the potential to provide financial resources for the development of pro-poor local capital infrastructure.

However, at the current stage of development in most developing and transition economies, credit markets might not be able to provide each local government with adequate financial resources to engage in pro-poor local capital development. There might be lack of financial institutions able to provide long-term financing, such as insurance companies and pension funds, lack of financial market infrastructure to channel these resources to local governments, lack of effective regulation of subnational borrowing, and finally lack of technical capacity on the part of local government to manage their debt.

Perhaps more significant is the recognition that local government borrowing is not inherently pro-poor; typically, credit markets are most responsive to larger and wealthier local governments. At the same time, smaller and poorer local governments are typically excluded altogether from access to credit because of the small size of their financial needs, substandard financial management practices, lack of experience with capital markets concepts and practices, etc. As a result, alternative mechanisms for funding local capital infrastructure are needed in the short and medium term to assure that local governments are able to fund the pro-poor local government services that are assigned to them, including the capital infrastructure that is required to deliver these services most efficiently. In this case, access to local capital development grants as well as credits from international donors (through a combination of on-lending and on-granting arrangements) can be desirable.

In order to provide local governments with access to funding for capital infrastructure where credit markets fail to do so, capital financing mechanisms can be developed in which capital grants may complement loan financing. In order to achieve a more pro-poor incidence, the share of local capital infrastructure covered by the grant component could be made to depend on the national importance of the local project, benefit spillovers, and the (lack of) fiscal capacity of the local government.

Complementing borrowing with equalizing capital grants allows the grants component to be means tested, thus representing an upfront payment of future gaps between debt service costs and revenue collections at some reasonable rates. Such upfront grants can be superior to subsidized interest rates and operating subsidies as they bring transparency and eliminate the need for future surveillance and administration (Varley, 2001).

However, care should be taken to express a clear vision for the funding of local capital infrastructure, as both intergovernmental loans and local capital grants have the potential to undermine private credit markets by retarding their development (Smoke, 1999). Depending on the state of economic development in a country, the arrangements for local credit assistance should attract rather than suppress or just supplement private capital in a country. Whenever possible, government co-financing should leverage private sector funds by providing comfort to private participants or taking positions with greater risk or lower liquidity.

6.3 IMPLICATIONS FOR POLICY REFORM

The transfer system is often the most powerful technical entry-point into the discussion linking local government finance to poverty reduction, as the transfer system typically provides a majority of the resources used at the subnational government level.

First, of all, technical assistance efforts could aim at improving the central government budget formulation process in a way that would strengthen the budgetary position of intergovernmental transfers.

International donors can also assist host countries to systematically analyze whether the transfer system allocates public resources in a way that is consistent with their poverty reduction strategy. Performing such an analysis would reveal whether fiscal decentralization reforms are indeed being implemented in a manner that is contributing to the government's own poverty reduction objectives, or whether the system of intergovernmental transfers needs to be reformed in order to assure a pro-poor distribution of finances among subnational governments.

If the current system of allocating intergovernmental transfers is found to be unsatisfactory or not pro-poor, international donors could provide technical support in the development of a sound, formula-based system of intergovernmental fiscal transfers that is in line with the objectives contained in the country's poverty reduction strategy. This technical support can take various forms:

- developing the capacity of the Ministry of Finance, the Ministry of Local Government, and/or parliament to monitor and assess the role intergovernmental fiscal relations as part of the annual budget processes, including establishment of a fiscal analysis unit;
- strengthening the institutional framework for intergovernmental transfers (and the vertical allocation of fiscal resources in particular) by providing technical support to local government associations.
- sponsoring so-called Public Expenditure Tracking Studies (PETS) to identify the extent to which central government resources actually reach the local government level to fund the delivery of public services, such as primary education and basic health care services.

Besides providing capital for on-lending and on-granting as a short-term assistance strategy, donor agencies and international financial institutions can play a role in making market borrowing a viable option in the long run. Donors can sponsor technical assistance and training for local governments in local financial management, identifying and analyzing capital investment projects, operating and managing facilities, capital planning, cash flow projections, and project management. Likewise, evolving intergovernmental fiscal systems–especially in more advanced developing and transition economies- could benefit from donor assistance in the structural development of the financial sector and securities markets.

7. CONCLUSIONS

This study provides an overview of how to design building blocks of decentralization to make it an effective instrument for contributing to fight poverty. While for practical convenience we discuss these building blocks separately in respective sections, we need to emphasize that intergovernmental fiscal policy must be thought of as a system. Various elements of this system such as delineation of functions, assignment of revenue sources, intergovernmental transfers, and local borrowing powers, can be introduced with separate pieces of legislation. However the pieces of the system must fit together. A 'one-of' piecemeal reform, encompassing only one element of the system (e.g., delivery of services), is not likely to lead to success. The review of international experiences with decentralization shows that some positive impact on poverty occurs only under a comprehensive devolution of powers to lower tiers of government along the multiple dimensions of government authority as apposed to just deconcentration with tight control over local government decisions (Jutting et al, 2004).

Therefore international donors should advocate and provide financial and technical assistance to the host country in the design of its pro-poor devolution strategy, encompassing all aspects of fiscal decentralization. Thus, for decentralization to improve accountability, the strategy should result in clear assignment of responsibilities, visible local levies with stable revenue yield, adequate and predictable intergovernmental financing, and sound borrowing regulation preventing shifting of liabilities beyond the electoral term. In fact, the decentralization strategy should go beyond the realms of public finance to include political institutions, such as representation and participation.

Any properly designed decentralization reform should be coupled with the development of institutions that support strong local governance through promoting greater voice, participation, accountability, and local planning; these are preconditions for improved service delivery, especially for the poor. Therefore, international donors should support the development of accountability institutions at the local government level, combining upward controls (audit, inspection, account committees) with downward or "horizontal" accountability mechanisms. With respect to the latter, international donor efforts can include:

- supporting grassroots-based governance-building from below, establishing systems for bottom up planning.
- supporting the capacity of local government officials to develop local plans and budgets in a participatory manner.
- developing the capacity of local civil society organizations to engage local government officials, participate in the local budget process, and empower them to hold their local authorities accountable.
- combining support to local governments and civil society groups by designing programs that enhance partnership between local government and civil society groups.

Besides comprehensiveness of the national strategy, successfully fighting poverty through decentralization also requires coordination of international assistance. Thus, an important way which the international donor community can support pro-poor decentralization reforms is to ensure that all of their own programs –including sectoral programs- consistently support the vision of decentralization. In many instances, even when each donor mission supports decentralization reforms through one office, it is not unusual for other programs within the same mission not to be operating within the same policy framework in support of more decentralized service delivery. Therefore, in order to avoid creating parallel structures, duplication and confusion, it is important that donor agencies assure that all of their programs properly take into account the appropriate role of local governments and decentralized provision of public services.

It is not uncommon for bilateral donor agencies to create donor-funded projects and parallel funding modalities that essentially compete with -and thereby undermine- the system of intergovernmental fiscal transfers. Especially when local governments are extremely weak and participatory mechanisms are lacking, it may be tempting for development agencies to support the provision of basic pro-poor services (such as primary education) to local communities in a way that circumvents local governments. However, such parallel mechanisms (including funding of basic services through NGOs) are rarely sustainable in the long run and may contribute to duplication and reduced transparency and accountability. Donor-funded development programs that seek to work around (rather than with or through) local governments in delivering public services to local communities have the undesired consequence of undermining the decentralization process.

Finally, international donors could more broadly contribute to the policy debate on decentralization reform world-wide by systematically examining the conditions under which decentralization reforms and intergovernmental fiscal arrangements benefit the poorest sections of the population. We would like to consider that the current study may be part of this broader policy agenda. Priority for further research should be given to evaluating the lessons learned from cases where donors have successfully been able to shape the poverty-orientation of decentralization reforms.

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