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Decentralisation and Poverty Reduction: A Conceptual Framework for the Economic Impact

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Abstract

This paper contributes to providing insights into the impact of decentralisation on poverty. It starts out with an overview of which role decentralisation plays in strategies and policies for poverty eradication and derives economic and political impact channels. It concentrates on the economic channel, the reasoning of which is rooted in fiscal federalism theory. It shows that decentralisation cannot only influence poverty by assigning expenditure responsibility to lower levels of government but also by assigning tax-raising power, which has so far been neglected by the literature. The paper concludes by pointing out a number of possible risks for realising the poverty-reducing potential of decentralisation.

Key Words: Local public goods, local revenue, poverty
JEL Classification: I38 ; H72 ; H71

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Zusammenfassung

Dezentralisierung und Armutsreduzierung:
ein konzeptioneller Rahmen für die wirtschaftlichen Auswirkungen

Dieses Arbeitspapier untersucht den Zusammenhang zwischen Dezentralisierung und Armut. Es legt zunächst dar, welche Rolle Dezentralisierung im Rahmen von Strategien und Politiken zur Armutsbekämpfung spielt. Es zeigt einen ökonomischen sowie einen politischen Wirkungskanal auf, konzentriert sich dann aber auf den ökonomischen, dessen theoretische Begründung dem Fiskalföderalismus entstammt. Es erläutert, dass Dezentralisierung nicht nur durch die Übertragung von Ausgabenverantwortlichkeiten auf die lokale Regierungsebene einen Einfluss auf Armut haben kann, sondern auch durch die Übertragung von Steuerkompetenzen. Dieser Punkt wurde bisher in der Literatur vernachlässigt. Das Papier deutet am Ende auf mögliche Risiken hin, die das armutsmindernde Potential von Dezentralisierung gefährden können.

Article Outline

1. Introduction and Definition of the Problem

In the course of the past two decades, two major trends have significantly influenced the political reality of numerous developing countries. First, poverty reduction has come to be the overarching goal of development policy, which had been heavily influenced by stabilisation and structural adjustment until the early 1990s. Stabilisation and structural adjustment measures, commonly known as the "Washington Consensus", had increasingly been criticised because they turned out to be aggravating poverty and inequality in some countries (Cornia et al. 1987, Khor 2003). It is for this reason that academics and policymakers worldwide entered into a comprehensive debate about the design and implementation of poverty reducing policies. In contrast to the view held before, it is today widely accepted that macroeconomic reforms and economic growth are necessary but hardly sufficient conditions for the reduction of poverty. Growth policy needs to be complemented with specific interventions in favour of the poor, while macroeconomic and political stability and good governance are regarded as prerequisites for the alleviation of poverty (World Bank 2001, Klasen 2004).

Second, the developing world has experienced a downright decentralisation wave as a large number of countries have transferred power and responsibilities from the centre to the local government level since the beginning of the 1980s. The reasons for doing so are manifold and differ from country to country. While decentralisation was implemented by design in some cases, it occurred by default in others.[1] In most countries, decentralisation was part of broader political and economic reform processes, such as democratisation and structural adjustment programmes. In the first regard, the potential of decentralisation for higher popular participation through local elections and opportunities for people to get involved in public decision-making played a crucial role (Litvack/Seddon 1999, Manor 1999). In the second regard, it was often attempted to solve fiscal crises and circumvent the limitations of central bureaucracies by transferring fiscal responsibilities to the local level. This aimed at increasing the efficiency of public service provision as well as the effectiveness of public administration. But sometimes it merely took the form of shifting the fiscal deficit downwards thereby maintaining the legitimacy of the national government (Litvack/Seddon 1999, Manor 1999, Shah/Thompson 2004). An additional motive for decentralisation was to foster national unity and bring divided groups into a formal rule-bound bargaining process in cases where regional or ethnic groups demanded more control or participation in the political process (Litvack/Seddon 1999, Crock/Sverrisson 2001).

Clearly, these two trends have not been directly interrelated. Poverty alleviation has not been a principal motivation for decentralisation. And decentralisation has until recently not played a major role in the debate about poverty reduction. Nevertheless, it has come to be commonly accepted that decentralisation can be an effective tool for implementing poverty reduction policies because people at the local level have the information and incentives to design and implement policies that respond to local needs and preferences (Litvack et al. 1998, World Bank 2001, BMZ 2002). Furthermore, decentralisation as a means to achieve good governance in terms of greater public participation, accountability of the public sector and reduced corruption can be expected to lead to poverty reduction (World Bank 2001, Crook/Sverrisson 2001, Asante 2003, Jütting et al. 2004). These arguments are very popular among policymakers, but academic evidence is rather scanty.

Some empirical studies confirm that local governments have an informational advantage compared to the centre and indicate higher accountability and better targeting to the poor under decentralisation (Alderman 1998, Galasso/Ravallion 2000, Azfar et al. 2001, Faguet 2001). However, they also show that this does not hold in general. There is no automatism in decentralisation bringing about the expected outcomes. In contrast, evidence points to seri-

[1] Decentralisation by design is when governments choose to transfer responsibilities to lower government levels because they are convinced of the potential benefits of this. Decentralisation by default implies that governments are forced to decentralise due to political reality (Jütting et al. 2004).

ous constraints in the implementation of decentralisation, which inhibit any significant increase in participation, accountability and efficiency and hence an impact on poverty. The success of decentralisation appears to depend on a number of factors such as political commitment of the centre, human and financial capacities, clearly defined procedures, the institutional setting, competitive local elections, the level of information of all relevant actors, and policy coherency (Bossuyt/Gould 2000, Crook/Sverrisson 2001, Johnson 2003, Jütting et al. 2004). Only if these are in place or are developed in the process of implementation, it can be expected that the transfer of power and responsibilities for poverty alleviation policies will yield fruits.

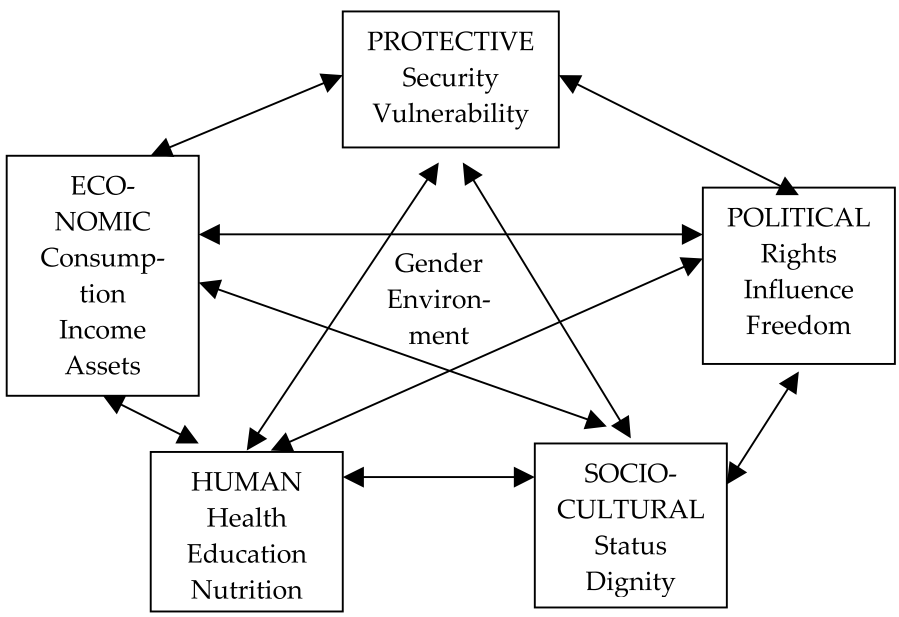
This paper intends to provide insights into the impact of decentralisation on poverty. It is structured as follows. Chapter 2 defines both poverty and decentralisation. Poverty is understood in its multidimensional sense, and decentralisation refers to devolution including political, administrative and fiscal elements. Chapter 3 starts out with an overview of which role decentralisation plays in strategies and policies for poverty eradication and derives economic and political channels for the impact of decentralisation on poverty. The following considerations concentrate on the economic impact channel, the reasoning of which is rooted in fiscal federalism theory. Relevant parts of this literature, which were not originally related to poverty, are integrated with poverty eradication issues. Thereby, it is examined whether the commonly used argument of decentralisation leading to increased efficiency and thus poverty reduction has a theoretical underpinning. It turns out that decentralisation cannot only influence poverty by assigning expenditure responsibility to lower levels of government but also by assigning tax-raising power, which has so far been neglected by the literature. Chapter 4 concludes by pointing out a number of possible risks for realising the poverty-reducing potential of decentralisation. It shows that if there is lack of political commitment to decentralisation, high corruption, and insufficient human and financial capacities, decentralisation is rather unlikely to bring about poverty eradication.

2. Defining Poverty and Decentralisation

In order to identify the potential linkages between decentralisation and poverty, it appears of essential importance to clearly define both these concepts. This is even more important as the academic literature does not offer a unique, commonly accepted definition neither for poverty nor for decentralisation. Poverty means different things to different people at different points of time. Most attempts for a definition are thus kept relatively open for subjective interpretation. For example, the World Bank (2001: 15) describes poverty as “pronounced deprivation in well-being” and emphasises that poverty has different aspects. Low income,

limited access to education and health care, voicelessness, powerlessness, vulnerability and exposure to risk are considered equally important aspects of poverty. Similarly, the Development Assistance Committee (DAC) of the OECD defines poverty as "the inability of people to meet economic, social and other standards of well-being" (OECD 2001: 37).
This paper follows these definitions and understands poverty as a status of unsatisfied basic needs and deprived well-being. Very much in line with Sen's capabilities approach (Sen 1983), this implies that poor people suffer from a lack of capabilities, opportunities and freedoms. Importantly, this lack refers to different dimensions of well-being, which makes poverty a multidimensional concept. The DAC differentiation of poverty dimensions (OECD 2001) shall form the basis of the below analysis. It distinguishes between five dimensions and two cross-cutting aspects, gender and environment (figure 1). The economic dimension identifies poverty as insufficient income to meet certain basic needs. The human dimension focuses directly on the question of an individual's access to basic needs, such as education, health, and nutrition, without making specific reference to income. The political dimension refers to the deprivation of basic political and human rights as well as limited influence on public policy-making. The socio-cultural dimension indicates social exclusion and a lack of dignity within or between communities, while the protective dimension implies vulnerability to social, economic or security-related shocks.

Figure 1: Dimensions of poverty



Source: OECD 2001: 39.

As indicated above, there is no commonly accepted, unambiguous definition for decentralisation either, mainly because decentralisation can vary substantially in scale and scope. The literature provides several categorisations of decentralisation, two of which are most widely used. Rondinelli (1981) differentiates between delegation, deconcentration, devolution, and privatisation or deregulation. Delegation refers to the transfer of responsibility for the provision of public goods and services to parastatal or semi-autonomous institutions, which act on behalf of and are directly liable to the central government. Deconcentration implies the outsourcing of central government functions to local or regional offices of the same. Subnational officials are appointed by the centre and are subject to directives from above. Devolution is the creation of autonomous subnational administrations, which dispose of full discretion over most local affairs. They are not or only to a minor extent accountable to the central government. Privatisation or deregulation relates to the transfer of previously public functions, or at least the right to implementation of those, to private organisations and companies.

Besides, there is the distinction between administrative, political (or democratic), fiscal, and economic (or market) decentralisation (Litvack/Seddon 1999). Administrative decentralisation is the hierarchical and functional transfer of executive powers between different levels of government. By way of political decentralisation, citizens or their elected representatives are given increased influence in political decision-making at the local level. Fiscal decentralisation implies that local authorities become responsible for local revenue and expenditure assignments, while economic decentralisation refers to the transfer of certain functions from the public to the private sector. Some authors put this categorisation on a par with the previous one. In the case of privatisation and economic decentralisation, this is straightforward. In the other cases, however, there is no convincing equivalence. Manor (1999), for example, suggests that deconcentration corresponds to administrative decentralisation, and devolution to political decentralisation. Yet, he himself relativises the usefulness of this typology when he notes that devolution is likely to fail if it does not entail a mixture of political, fiscal and administrative elements. As figure 2 shows, this paper starts out from the same understanding and considers devolution the most far-reaching form of decentralisation comprising of the transfer of administrative, political and fiscal powers whereas delegation and deconcentration only include the transfer of administrative power. As becomes clear below, devolution is therefore the form of decentralisation that is of interest for the question to be analysed. This is in line with John and Chathukulam (2003) who note that only devolution fulfils the normative characteristics commonly associated with decentralisation while delegation and deconcentration are merely empirically rooted.

Figure 2: Forms of decentralisation

	Privatisation	Delegation	Deconcentration	Devolution
Economic				
Administrative				
Political				
Fiscal				

Source: Author's illustration.

3. Decentralisation-Poverty Links

3.1. Poverty Reduction Policies and Decentralisation

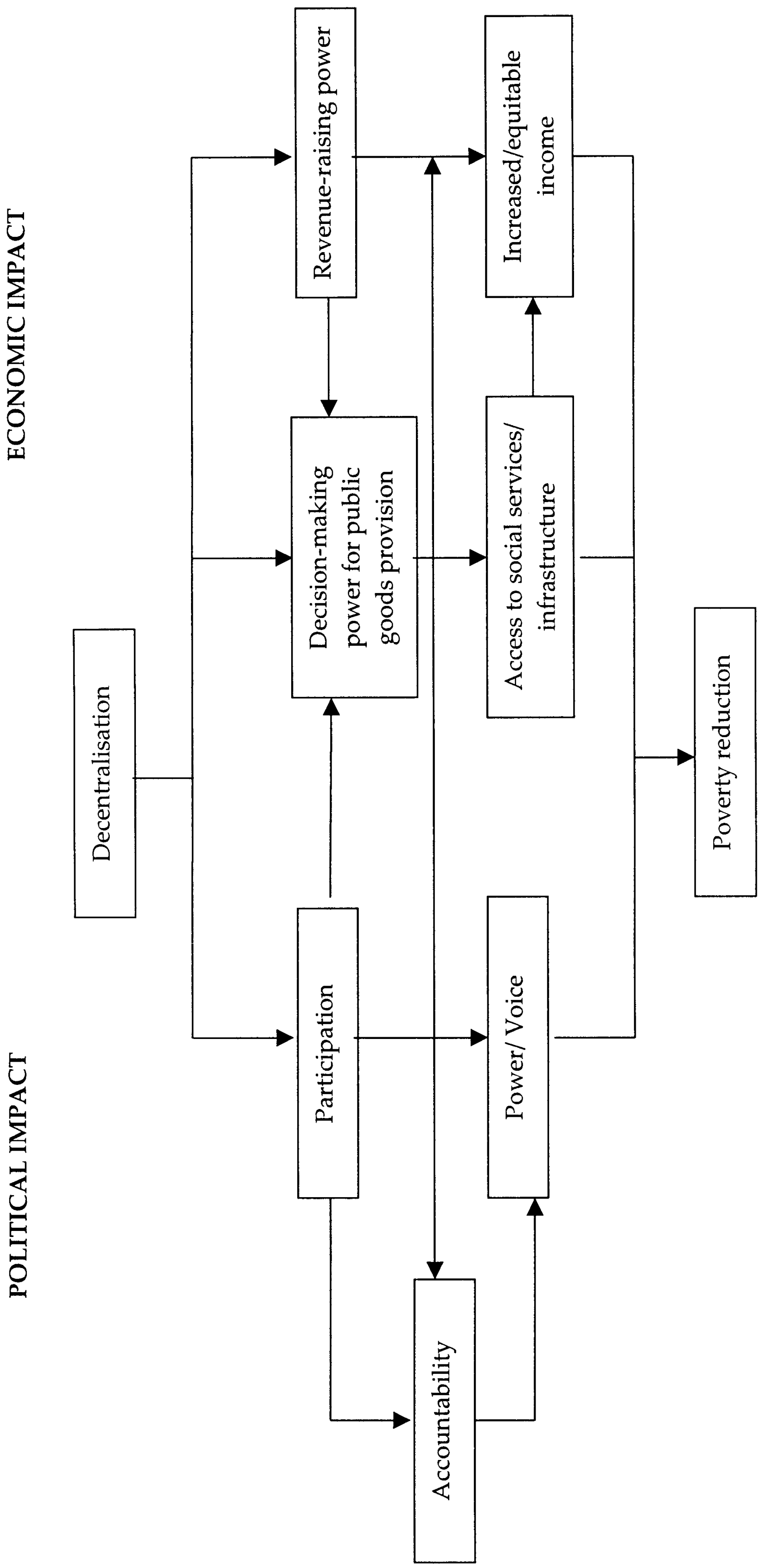
After having defined both poverty and decentralisation, the question arises where to find the link between the two. Given the understanding of poverty as a complex, multidimensional concept, it must be clear that poverty eradication cannot be achieved by any single remedy like decentralisation but that it requires a combination of policies designed for country specific (or even local) conditions. The World Development Report 2000/01 (World Bank 2001), which is dedicated to the topic of "Attacking Poverty", proposes a strategy of three complementary elements: promoting opportunities, facilitating empowerment, and enhancing security. First, promoting opportunities refers to giving poor people the chance to improve their material situation of life, and this includes providing access to employment, markets, financial services, infrastructure (roads, electricity, telecommunication), social services (education, health care), and land. Second, facilitating empowerment implies the inclusion of all people in a society in decision-making processes in order to achieve responsive and accountable public actions and policies. Non-discrimination, good governance and the rule of law are key in this regard. And third, enhancing security means reducing poor people's vulnerability to different threats, like economic shocks, natural disasters, ill health, disability and personal violence. This requires macroeconomic policies to manage the risk of economy-wide shocks, diversification of household activities, a public welfare system and a range of insurance mechanisms.

How is decentralisation related to these poverty reduction policies? Considering the definition of devolution, i.e. elected sub-national units of government have full discretion over (most) local affairs, decentralisation comes into play for the first and second group of policies. With regard to the second group, i.e. measures to facilitate empowerment, the link to decentralisation is relatively obvious. Decentralisation brings about increased opportunities for people to participate in public decision-making, from which they are generally excluded in a highly centralised government system (World Bank 2001, Crook/Sverrisson 2001, Asante

2003). This in itself represents a form of poverty alleviation as poor people are given voice and thus power (figure 3), given citizens' voices are heard (Goetz et al. 2001). Of course, poverty reduction here refers to the political dimension of poverty. At the same time, participation can increase the supervisory power of local (poor) people and this in turn can lead to higher accountability of public officials: Due to the greater proximity, citizens can easier monitor and thus influence government actions at the local level (von Braun/Grote 2002, Asante 2003), and this can again affect the political, and possibly this in turn the socio-cultural, dimension of poverty. Among several possible accountability mechanisms, officials are assumed to be held accountable through local elections, which serve as a means to evaluate officials' past performance. Only if local citizens have the opportunity to observe officials' performance and reward or punish them at upcoming elections, these can be assumed to have an incentive to act in their electorate's interest (Seabright 1996). In this sense, decentralisation can be thought of as a means to bring about good governance, the relevance of which for poverty reduction has been shown by Kaufmann et al. (1999).

With regard to the first group of poverty reduction policies, the link between decentralisation and poverty is more complex. The role of the public sector for these policies can range from creating an adequate framework for private sector activity to providing services itself. For example, government may either limit itself to determining national objectives and standards for the education sector and leave the "production" of education to private institutions, or it may run own public schools. In many regards, there is in fact no consensus on how extended the role of the public sector should be. It is for example not straight-forward whether water and electricity are public or private utilities and should thus be provided by the public or private sector, and whether education and health care are (impure) public or private goods. The distinction between public and private goods lies in the fact that public goods are characterised by non-rivalry and non-excludability. Non-rivalry implies that an individual's utility from consuming the good is not compromised by another individual consuming the same good. Non-excludability refers to the impossibility or at least non-feasibility of excluding any individual from consuming the good (Boadway/Wildasin 1984).

Figure 3: The links between decentralisation and poverty



Source: Author's illustration adapted and developed further from Jütting et al. (2004).

Despite or because of this – possibly unsolvable – imprecision, it is not intended to answer the question in this paper, which goods are public and which are private.[2] For the purpose of this work, it is ultimately irrelevant. It is also unimportant which unit – the centre, the local government, or the private sector – produces a particular good or implements a particular policy. It is the power for decision-making rather than for the final provision, which matters. Hence, decentralisation is related to poverty eradication if the decision-making power for poverty reduction policies is transferred to the local government level, which often is the case for social services and sometimes for infrastructure. Due to the informational advantage of local authorities over the central government with regard to local conditions and preferences, this can lead to an improved correspondence of demand and supply and thus substantial efficiency gains in the provision of public goods and services (World Bank 2001, von Braun/Grote 2002, Asante 2003, Jütting et al. 2004). Note that local governments have full discretion only when decision-making power includes authority over fiscal matters, which confirms that devolution is the only form of decentralisation that is of interest in this regard.

If it cannot be taken for granted that local governments possess perfect information over local preferences, participation of the people plays a crucial role for achieving efficiency as it paves the way for integrating local needs and preferences in decision-making and thus enhances pro-poor choices of investment (von Braun/Grote 2002). At this point, the interrelation between the economic and the political impact channels as referred to in figure 3 becomes particularly evident.[3] Without participation, an increase in efficiency might not be possible. Responsive public good provision gives poor people better access to social services and infrastructure, which potentially reduces the human dimension of poverty. At the same time, better access can have an impact on people's opportunities to engage in productive

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2 Some might argue that such goods as education and health care are neither public nor private but merit goods. The concept of merit goods was introduced by Musgrave (1959) and is based on interference with consumer preferences. It is assumed that consumers, if left on their own, consume less of merit goods (or more in the case of demerit goods) than is socially desirable. The government therefore "interferes into the market allocation of a good by inducing a consumption pattern different from the one voluntary exchange would have brought about" (Müller/Tietzel 2002: 380). The public finance literature has seen a highly controversial debate on this concept. The main criticism refers to its incompatibility with the basic principle of consumer sovereignty underlying welfare economics. Main contributions to this debate are McLure (1968), Head (1988), and Müller and Tietzel (2002).

3 For some, this interrelation is so important that they do not distinguish between the two channels. Romeo (2002), for example, suggests that the impact of decentralisation on poverty is the following: Decentralisation affects local governance, this in turn local development, and this poverty. Yet, compared to the above-mentioned publications, his analysis runs short of many related aspects.

activities, and this in turn can improve their income situation though possibly only in the medium to long run.

Besides, decentralisation typically involves changes in the tax structure and a greater reliance on local taxes in order to internalise costs and benefits. Since taxes provide the resources for public expenditure programmes, they represent a precondition for the responsive and efficient provision of public goods. In this sense, they indirectly affect the human dimension of poverty. It could be that decentralisation leads to improved resource mobilisation through local governments' better ability to identify taxable households and enterprises (Bahl/Linn 1994) or through a higher motivation of the population to commit to the common good (Bossuyt/Gould 2000). This presupposes of course that local governments are accountable and respond to people's demands, or that people at least trust their governments to do so (Smoke 2003, Fjeldstad 2004). But the opposite way may also be true. Relying more on local revenue could help to increase accountability because local voters are more likely to hold elected officials accountable if local public services are mainly financed from locally imposed taxes, which would in turn affect the political poverty dimension. And finally, if equity concerns are considered in assigning tax-raising power to the local level, taxes may to a certain extent correct for an unequal distribution of market incomes and hence influence the economic dimension of poverty. To date, these latter considerations have been largely unattended by the existing literature on decentralisation and poverty.

It should be pointed out that the efficiency argument for assuming a poverty impact of decentralisation as just introduced derives from fiscal federalism theory. Even though it has often been brought up in the literature and by policymakers, it has never been questioned and re-examined for its relevance and appropriateness. It has simply been taken for granted. Since this cannot be considered satisfying from an academic point of view, the relevant literature on fiscal federalism is reviewed and integrated with poverty reduction concerns in the following section. It is thereby examined whether the mostly used argument in the decentralisation-poverty debate can count with a theoretical underpinning. This exercise automatically leads to the revenue side of decentralisation and its role for poverty alleviation.

3.2. Assigning Expenditure Responsibilities to Different Levels of Government

One of the main concerns of the theory on fiscal federalism is the problem of assigning functions or decision-making power to different levels of government (Musgrave 1959, Oates 1972). In principle, it argues that the central government should assume primary responsibility for the stabilisation and redistribution functions of government as well as for the allocation of national public goods. In line with the principle of subsidiarity, local governments should be in charge of providing local public goods. First, stabilisation is assumed to be severely hampered under decentralisation as each jurisdiction would have strong incentives to rapid monetary expansion in order to evade burdening its own constituents with taxation. Besides, since local economies are generally highly open economies, the effect of any fiscal policy would tend to be small in the own jurisdiction.[4] Second, it is argued that redistribution cannot work in a decentralised system because jurisdictions with aggressive redistributive strategies would attract poor people from and repel rich people to other jurisdictions. The mobility of the people thus undermines local redistribution.[5]

And third, with regard to the allocation function of government, the difference has to be made between national and local public goods. This difference lies in the fact that the benefits of national public goods accrue to the same amount to all individuals nationwide while the benefits of local public goods accrue only to the individuals of a particular subnational jurisdiction. An often-cited example for a national public good is defence, and for a local public good street lighting. The theoretical rationale for assigning the responsibility for local goods supply to the local level is given by Wallace Oates' Decentralisation Theorem: "For a public good – the consumption of which is defined over geographical subsets of the total population, and for which the costs of providing each level of output of the good in each jurisdiction are the same for the central or the respective local government – it will always be more efficient (or at least as efficient) for local governments to provide the Pareto-efficient levels of output for their respective jurisdictions than for the central government to provide any specified and uniform level of output across all jurisdictions" (Oates 1972: 35). In other words, the theorem lays out that as long as there are no economies of scale in the provision of public goods whose benefits accrue to geographically separable populations with differing preferences the level of welfare of local provision will always be at least as high as the level of welfare that can be achieved from central provision. The reason lies in the fact that local provision is more sensitive to local needs and preferences and supplies public goods in accordance with those while central provision leads to uniform supply over all jurisdictions.

To the extent that individuals in a particular jurisdiction are not satisfied with the set of local public goods provided, Tiebout (1956) suggests they can "vote with their feet", i.e. relocate

[4] Some authors argue that if subnational jurisdictions are sufficiently large, these can assume stabilisation functions to a certain extent (Sewell 1996).

[5] This traditional view has been opposed by some authors who claim that there is room for decentralised redistributive policies because the concern for the poor is typically higher in one's own jurisdiction than elsewhere (Pauly 1973, Tresch 1981). Sewell (1996) points out that the federal systems of Switzerland and the Scandinavian countries represent good examples that distributional authority can be assigned to subnational levels of government.

to another jurisdiction, which better matches their preferences.[6] This mechanism resembles a market solution to the problem of resource allocation and guarantees efficient supply levels of local public goods. The Tiebout hypothesis has been extensively investigated in empirical studies and in general these have provided evidence in support of it (Cebula 2002). However, all of the existent studies have used data for either the United States or Canada. Since there is no systematic evidence with regard to fiscally induced migration in developing countries, it is not clear whether the hypothesis holds here as well (Lucas 1998). It may well be that (expected or actual) wage differentials between different jurisdictions as well as social networks are more important determinants of internal migration than differentials in fiscal outcomes. Yet, no final conclusion can be drawn unless this issue is addressed by further research and empirical analysis.

A highly critical assumption of the Decentralisation Theorem is that the central government has an informational disadvantage in the sense that it is insensitive to geographically varying preferences. Central provision of local public goods thus corresponds with a uniform supply level across jurisdictions, from which the inefficiency results. As has been proposed by some, this assumption does not necessarily hold: It is neither theoretically nor empirically evident that the centre can only allocate a uniform level of local public goods to different jurisdictions (Lockwood 2002, Besley/Coate 2003).[7] In that case, it is not straightforward that decentralised provision is welfare enhancing. If the government were able to provide differing levels of local public goods, it could choose the welfare maximising level for each local jurisdiction. The centralised system would then always produce at least as much welfare as a decentralised system and strictly more in the presence of spillovers. Nevertheless, it is questionable whether the central government would indeed supply welfare maximising levels for each and every jurisdiction. Political economy considerations suggest that legislative behaviour strongly influences decisions of public goods provision.

Besley and Coate (2003) model public spending decisions under centralisation as being determined by a legislature of elected representatives, where each local jurisdiction elects one representative. When decisions are taken by a minimum winning coalition, i.e. a coalition of 51 percent of the representatives sharing the benefits of public spending among their jurisdictions, there is a substantial misallocation problem as public spending is skewed towards

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6 This so-called Tiebout hypothesis is expanded by Tullock (1971) to include differing preferences for local taxes: Individuals then make a choice between alternative bundles of local public goods and tax liabilities.

7 This obviously is in contrast to Oates (1998) who states that a locally differing provision of goods would not be possible for political reasons as the centre could not justify different treatment of jurisdictions.

those inside the coalition.[8] This problem is particularly severe in the case of low spillovers because coalition members have little incentive to allocate spending to jurisdictions outside the coalition. With increasing spillovers, public goods are more and more allocated to districts outside the coalition but chosen levels still reflect the preferences of coalition members. Centralisation produces a welfare maximising level of local public goods only when jurisdictions are fully homogenous and spillovers are complete. The same holds when decisions are taken in a more cooperative way with legislators choosing the allocation of public goods that maximises their joint welfare. For both identical and heterogeneous jurisdictions, decentralisation dominates centralisation for low levels of spillovers, while centralisation dominates for high levels of spillovers. The reason lies in shared financing of public goods under centralisation, which leads voters to delegate strategically to representatives who provide excessive public goods levels. Even when spillovers are high and jurisdictions share an interest in each other's public goods levels, this strategic delegation problem can result in centralised decision-making that is far from welfare maximising outcomes. Though the specifications of this model are relatively strict, it seems plausible that real world decision-making leaves sufficient room for favouring some jurisdictions over others, and it is not unlikely that this problem weighs particularly heavily in developing countries that are characterised by systems of patronage. Hence, there is no reason to believe that non-uniform central provision of local public goods could increase social welfare compared to decentralised provision.

Does the Decentralisation Theorem apply to poverty reduction policies? In particular, can these policies be classified as local public goods for which there are geographically varying preferences and no economies of scale in production? This is important to know as decentralisation may only lead to efficiency gains if this holds. Hence, policies that are of a national concern do not lend themselves for the decentralisation debate. Macroeconomic policies, good governance measures or the provision of a welfare system fall in principle in this category. Of local concern in turn is the delivery of basic social or economic services and basic infrastructure, e.g. primary education, primary health care, drinking water, sanitation, feeder roads, electricity, or business support services.

These latter services tend to benefit exactly the population within the respective jurisdiction where they are provided. In other words, they do no exhibit any substantial inter-jurisdictional spillovers. In addition, it is reasonable to assume that there are heterogeneous preferences for these services. The prevalence and causes of poverty vary substantially among different jurisdictions within a given country and each jurisdiction thus requires spe-

8 The distributive politics literature (Weingast 1979, Shepsle/Weingast 1979, Ferejohn et al. 1987) has come to similar conclusions but it suffers from the drawback that it does not take spillovers into account.

cific policies for eradicating poverty. For example, while one jurisdiction might prioritise the construction of a primary school over investment in drinking water supply, the opposite might be true in another.[9] And lastly, the decision-making process with regard to the mentioned services is not generally associated with economies of scale. Therefore, it can be concluded that for these poverty reduction policies, local responsibility is preferable. Note that this does not rule out the possibility for sharing functions between different levels of government. With regard to the education sector for example, it may well be advisable that the centre formulates national guidelines and supervises local implementation while executive decisions are taken at the local level. In sum, the notion of the Decentralisation Theorem does indeed hold for poverty reduction policies of the kind of local public goods, at least in principle. There are a number of concerns that may qualify it, which will be considered below.

Up to this point, poverty reduction has been treated as an allocative function of the state as the argumentation has been built around efficiency concerns. However, recalling the three main functions of the public sector the question may be raised whether poverty reduction is not rather (or also) a redistributive function. It appears worth to dedicate a thought to this question because if poverty reduction was a redistributive rather than an allocative function, fiscal federalism theory suggests that it should be a central responsibility as already noted above. The standard argumentation for decentralising the delivery of poverty reduction policies would then be null and void. In the Musgravian sense, redistribution is the use of tax-transfer mechanisms in such a way that incomes are taxed progressively and the resulting tax revenue is used for welfare payments to low-income people or to finance public goods and services principally used by them. Alternatively, such goods and services that are mainly consumed by high-income people can be taxed and others consumed by low-income people subsidised (Musgrave 1959).

Since this definition of redistribution corresponds largely to some of the poverty reduction policies referred to here, it should be clear that allocational considerations could not be singled out from distributional concerns.[10] In fact, it is questionable whether a fully separate analysis of the allocation and the distribution functions of the public sector is possible at all. On the one hand, redistributive policies, in particular those of a welfare payment kind,

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9 Azfar et al. (2001) addressed this question and found that there are indeed large differences in household preferences across Philippine provinces and Ugandan districts over the use of additional funds for public services.

10 Musgrave (1959) emphasised that in the context of merit goods a clear separation between the allocative and distributive functions is not possible; or in other words, the provision of merit goods fulfils both an allocative and a distributive purpose. Hence, if one accepts the merit goods argument, one might get to the same conclusion drawn here.

change the individual level of disposable income and hence the aggregate income distribution and demand for public goods. On the other hand, providing public goods requires taxing residents, and most taxes distort the distribution of income. In order to assess the net beneficial effect of public goods, the effect of taxes used for their financing must thus be taken into account. As Oates (1972: 124) already noted, "we must consider explicitly the effect of both public expenditures and revenue programs on the distribution of income." It is therefore surprising that most of the literature on decentralisation and poverty ignores this crucial aspect by concentrating on efficiency considerations. Equity appears to play a role only implicitly in the sense that the concerning public goods have a poverty reduction potential. In contrast to previous analyses, the allocative and redistributive character of poverty reduction policies shall here be made explicit by treating the tax dimension of decentralisation processes as an independent component of the link between decentralisation and poverty.

3.3. Revenue Assignment to Different Levels of Government

The questions of assigning expenditure and assigning revenue to different levels of government must be analysed together as they are fully interrelated. A carefully designed system of expenditure assignment will not work satisfactorily unless it is supported by a matching financing system. Whatever local governments are made responsible for, they must possess the financial resources to fulfil their responsibilities. Otherwise services will be severely underprovided, if provided at all. Central funding of local expenditures does generally not represent a good solution because local authorities are then often unlikely to exert final control over the funds and this would come to delegation or deconcentration rather than full-fledged decentralisation (or, devolution).

The main source of local revenue is local taxation. Local taxes shall be understood as taxes that are assessed by local governments, at rates decided by them, collected by them, and whose proceeds accrue to them. In reality, many taxes do not possess all of these characteristics and it is now commonly accepted that the freedom to set the tax rate is the most important requirement for local tax autonomy (Bird 1999a). In the following, it is crucial to keep two general features of taxation in mind. First, all taxes – whether central or local, direct or indirect – have an impact on three different dimensions: They affect the redistribution of income, they change the allocation of resources, and they raise revenues (Musgrave/Musgrave 1989, Burgess/Stern 1993). No single tax affects only one of these dimensions. Hence, a separation between taxes used to finance public goods, taxes that correct for undesired consumption behaviour, and taxes used to redistribute income, is impossible. And second, with regard to the relationship between taxation and expenditure it would be wrong to see the tax problem as simply one of financing a given aggregate expenditure (Burgess/Stern 1993). In contrast, it is very well possible that the level and the composition of taxes exert a feedback on the final expenditure decisions of a government (Gordon/Wilson 1999). However, with regard to decentralisation this does not imply that revenue assignment should come first and expenditure assignment second. In contrast, for efficiency reasons the rule is "finance should follow function" (World Bank 2000: 117).[11]

Starting out from the very general, the literature provides for five desirable attributes of any tax system: It should be economically efficient (or neutral), administratively simple, politically responsible, equitable, and flexible (Stiglitz 2000). With regard to local taxation, the main rule is that members of each benefit jurisdiction should pay for the public goods, which that jurisdiction provides (Musgrave 1983, Musgrave/Musgrave 1989, Bird 1999b). This implies that wherever possible user charges are to be applied. Since many local public goods are impure public goods (for which exclusion is possible), this seems feasible. The more a good takes the characteristic of a pure public good, the more the recovery of costs should be done through lump-sum taxes. This principle of benefit taxation is widely supported because it fulfils most of the desired characteristics for good local taxes. Most importantly, it allows for efficiency: in the ideal case, an individual pays a tax price that just equals his/her marginal benefit for consuming a particular public good. Since this is in analogy to a perfect market mechanism, benefit taxation leads to optimal allocation outcomes (Bird 1976). This is of essential importance as people are willing to sustain public programs only if they benefit from them. Taxpayers are in general more willing to pay taxes if they believe the taxes are spent on expenditures that are useful to them and this can work as a compliance incentive (Bahl et al. 1984, Musgrave/Musgrave 1989).[12] Besides, it promotes transparency in the use of resources, and possibly local accountability. On the one hand, benefit taxation can be considered fair because people pay for what they get and they get what they pay for. On the other hand, however, it may be regarded highly unfair and not desirable on equity

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11 In practice, this rule is not always followed. Some countries proceed the other way round because the assignment of expenditure responsibilities appears to be more of a political issue than revenue assignment. The decentralisation of functions obviously shifts the balance of power away from the centre and this cannot easily be reversed, while the decentralisation of revenue is a less permanent issue (Bahl 1999).

12 Of course, compliance also depends on people's ability to pay and the effectiveness of the tax administration. But Fjeldstad (2004) finds that beside these factors non-payment of service charges in many South African municipalities can also be explained by whether people perceive the local government to act in their interest. He identifies three dimensions of trust that are at work here: 1) trust in the LG to use revenues to provide expected services, 2) trust in the authorities to establish fair procedures for revenue enforcement and distribution of services, 3) trust in other citizens to pay their share of service charges.

grounds because it does not allow for an equal treatment of equals and distinguished treatment of unequals (Bird 1976, Musgrave/Musgrave 1993).

Due to this trade-off between efficiency and equity, it is not an easy task to design and implement an optimal tax system in general and for multi-level governments in particular. In his seminal paper, Gordon (1983) addresses the question of an efficient and equitable performance of taxation in a two-tier government system and develops a normative model providing broad guidelines for tax assignment. Nevertheless, it is found that in practice the level and composition of local government taxation vary significantly across countries (Norregaard 1997). This is not particularly surprising as the final tax system has to be thought of as an outcome of the political bargaining process of any particular country rather than a mere implementation of theoretical models. But still, there appears to be one overwhelming similarity. In most, if not all, countries local governments end up with less own revenues than needed to meet expenditures, which is commonly referred to as vertical fiscal imbalance (Bird 1993).

This vertical fiscal imbalance is then almost invariably resolved by intergovernmental transfers. While some view this principally as a fault of the standard tax assignment model and call for rethinking it (Bird 1999a), others do not see a problem and even find a theoretical justification for this practice. Boadway et al. (2000) explain that while theory provides clear arguments for increasing efficiency from assigning expenditures to the lower government level, equivalent efficiency advantages of transferring revenue-raising power are not straight-forward. To the opposite, decentralisation of taxation can lead to significant inefficiencies and inequities in an economy because each jurisdiction's optimal strategy ignores the consequences of its own tax rate on neighbouring jurisdictions and on residents without political weight (Inman/Rubinfeld 1996). Hence, it may be preferable to collect taxes at the centre and send them to local governments in the form of intergovernmental transfers. For completion, it shall be noted that beside closing the vertical fiscal gap there are three other purposes of intergovernmental transfers: achieving equalisation between jurisdictions, pricing externalities, and promoting political (national) objectives (Bird/Smart 2001).

In analogy to the previous section, the question shall be addressed whether and how poverty reduction plays a role in considerations of revenue assignment. A fundamental question in this regard is whether poverty reduction is an objective of only public expenditures or also of public revenue. Can taxes affect poverty at all, and if so, how? As already indicated above, this question has not received much attention among academicians and there is very little research on the general effects of taxes on the poor.[13] But poor people do pay taxes, and the characteristics and operation of the tax system may influence the extent, nature and possibly even duration of poverty (Bird/Miller 1989). There is both an indirect and a direct interaction between taxation and poverty. In an indirect way, taxation can affect the human dimension of poverty by providing the finance for poverty-oriented expenditure. In a more direct way, (benefit-related) taxes can have an impact on the political dimension of poverty by increasing accountability and on the economic dimension by changing the market distribution of income.

From a poverty reduction perspective, the trade-off between efficiency and equity in taxation becomes particularly relevant. For example, it may be difficult to justify the application of user charges for primary education or primary health care if education and health are regarded to be priority areas for poverty reduction. If distributional considerations are key, equitable ability-to-pay taxes should therefore be preferred even if this is at the expense of efficiency. But this represents a dilemma because most ability-to-pay taxes are imposed on mobile bases, and according to the traditional view (Musgrave 1983, Norregaard 1997) they are therefore better assigned to the central government. Abstracting from this for a moment, there is empirical evidence that the potential of taxes to address equity concerns is rather limited. For the case of income taxation, it has been shown that progressive taxes are not very effective in altering the distribution of income (Tanzi 1974, Harberger 1998). As Bird (1976: 11) notes, "the indirect approach to fiscal redistribution through pro-poor expenditure may be more effective than the direct approach through anti-rich taxation because the latter gives rise to greater political resistance." But even if taxes may not have the potential to significantly lessen income inequality, progressive taxation may still play a supportive role for revenue-raising for equity-driven expenditure programs (Zee 1999).

What has been said so far relates to the problem of poverty or inequality within a particular jurisdiction, be it national or local. In decentralised government systems, there is additionally the problem of inequality between jurisdictions. If some jurisdictions are poor and others rich, ability-to-pay taxation can bring about serious constraints in terms of substantial differences in net fiscal benefits. Compared to poor jurisdictions, rich ones can provide a particular set of public goods with lower tax rates, or supply more public goods with equal tax rates. In the extreme case, this means that public good provision in poor jurisdictions is severely curtailed (Bahl et al. 1984). And this in turn hurts the goal of horizontal fiscal eq-

[13] There are of course numerous studies on the incidence of taxes but these concentrate on who – typically the rich or the poor – actually bears the burden of taxes. They do not address the question of the ways in which taxes impact on the poor. One of the few exceptions is Maag and Rogers (2000) who concentrate on the effect of US state taxes on the working poor.

uity, i.e. equity between jurisdictions of the same level, which makes the case for central interference (Sewell 1996). Instead of insisting on the application of ability-to-pay taxes, equity concerns can then better be addressed by making use of equalisation transfers from the centre to local governments. It would of course be over-enthusiastic to assume that this could lead to truly horizontal equity, but it may at least level out part of the difference in net fiscal benefit. In sum, this analysis revealed that the major contribution of the tax system for poverty reduction is first to provide the revenue needed for essential expenditure and second to avoid the generation of horizontal inequities between individuals and between jurisdictions. This should not be ignored in investigations of the impact of decentralisation on poverty.

4. Conclusions and Outlook: Risks to the Poverty-Reducing Potential of Decentralisation

The previous chapter makes clear that there is a compelling case for promoting decentralisation for poverty reduction reasons. As has been shown, there are several ways of how decentralisation can have an impact on poverty in its different dimensions. On the one hand, it is thus very plausible that decentralisation has found wide support among policymakers. But on the other hand, their enthusiasm seems to have run well ahead of the evidence and due considerations. It is relatively straightforward to imagine that there may be a number of strong reasons not to decentralise. First, if the costs related with the decentralisation process outweigh the potential benefits, this can represent a sufficient counterargument. Oates (1972) points out that costs of collective decision-making can be much higher under decentralisation than under a centralised government system because of the related increase in the number of government levels. At all these levels, government units have to be established or extended and maintained, which leads to higher administrative costs for salaries, buildings and the like, and entails higher costs to the electorate in the form of increased time and effort involved in the election of public officials. Besides, economies of scope and economies of scale in the provision of public goods can represent a substantial cost advantage of the central government weighing higher than benefits from decentralisation (Prud'homme 1995).
A second strong argument against decentralisation is any reason, which causes an interruption of any of the links in figure 3. In other words, if certain preconditions are not fulfilled, it is hard to assume that the poverty-reducing effect of decentralisation can be realised. Three such preconditions come to mind: commitment of all relevant stakeholders to the decentralisation process, the absence of corrupt practices and elite capture, and the capacity to design and implement the process. With regard to political commitment, it is not uncommon that different actors in the central government oppose decentralisation because it includes the transfer of substantial power from the centre to the local level. Possibly the largest oppo-

nents are authorities in the line ministries who have to sacrifice much of their rights and discretion to the benefit of local governments. If they refuse to do so, local autonomy suffers a great deal, and as a result, neither an increase in participation and accountability nor an efficient provision of public goods seem likely. Lacking commitment at the local level is an equally important issue. It is not sufficient that people get the opportunity to participate in decision-making and voice their demands; local authorities must also have an incentive to respond to these demands (Crook 2003). Closely related with the question of political commitment is that of popular support. If the population does not back the decentralisation process, which can happen due to mistrust in local politicians for example, the outcome is not quite clear.

In many societies, the poor lack both economic and political power and thus public policies tend to become the battleground for various interest groups and rent seekers, and benefits end up with the more vocal and not with the more needy (Conyers 1990, Harberger 1998). The influence of the more vocal can be of different kinds. It can either be the policy-makers and bureaucrats, the providers of public goods, or the final recipients who intend to influence decisions and direct policies and financial flows for their personal benefit. First, if those deciding or administering policies gain substantially from rents conferred by these policies, they will take decisions, which allow them to benefit from the exercise of their discretion. Here, policy has an endogenous element in the sense that it is determined – at least in part – by agents acting in their self-interest (Burgess/Stern 1993). Second, providers of public goods, like heads of schools or health care facilities, have an incentive to veil the true costs of provision because in many cases they receive their recurrent expenditures from the central or local government (Tanzi 1998). And third, due to the proximity between citizens and public officials at the local level, there is room for local elites to influence the behaviour and decision-making of local officials for their private benefit (Bardhan/Mookherjee 2000a and 2000b). If there is room for such practices, decisions are obviously not taken on efficiency and accountability grounds, which compromises the case for assuming a poverty impact of decentralisation. Of course, the problem of corruption afflicts the centre just as much as local governments and it is impossible to determine a priori whether it is worse at the central or local level. As Bardhan and Mookherjee (2000a) note, it essentially depends on a country's history, culture, and geography. But the problem remains the same: High levels of corruption are likely to bias public spending in undesirable directions and reduce the quality with which public goods and services are provided (Deininger/Mpuga 2005).

In a similar way, lacking capacity can be as much a constraint for efficient and accountable policy-making under centralisation as under decentralisation. Yet, if insufficient capacity is an issue it is likely to become more pronounced under decentralisation due to the higher need for public officials. While it may be relatively easy to attract educated and trained personnel at the central government level where career chances are better (Prud'homme 1995), it can be extremely difficult to recruit adequate staff at every single local government unit. Inadequately trained staff in turn will find it hard to implement decentralisation so that it leads to poverty reduction. For example, it is unclear whether they can use the informational advantage at the local level to ensure a responsive provision of local public goods or whether they can organise the local decision-making process so that citizens have equal opportunities to participate. Besides, capacity constraints are closely related to corruption. This is not to say that high capacity safeguards from corrupt practices but it makes the existence of and compliance with procedures to deal with them more likely. It is important to emphasise that the question of capacity is not only limited to human capital but also refers to a lack of financial and technical capacity (Prud'homme 1995, Crook/Manor 1998, Romeo 2002). If local governments are equipped with adequately educated personnel able to make responsive policies but they do not possess the financial or technical means to implement these, it is rather unlikely that decentralisation brings about an increase in public participation, accountability and efficiency of public good provision.

In sum, even though there is extensive scope for decentralisation having a poverty-reducing impact, low political commitment, corruption, and a lack of capacity represent serious risks to the potential benefits from decentralisation. How serious these risks are, is of course a question of empirical assessment. In fact, this paper is part of a larger research project evaluating the impact of decentralisation on poverty in the case of Uganda. This country case was chosen because the Ugandan decentralisation reform embarked upon in 1992 has coincided with a remarkable success in terms of poverty reduction. Besides, data availability is relatively good in this country. Using household survey data, the empirical analysis will intend to evaluate this impact. It will be based on the observation that although the legislative framework on decentralisation is identical for all Ugandan districts, the functionality of local governments varies. While some have succeeded in putting the decentralisation reform into practice quite well, others struggle with capacity and/or corruption problems. The key hypothesis is that decentralisation can have an impact on poverty if and only if local governments are fully functional. The variation in functionality is to be captured by defining a functionality index, which represents one of the right-hand side variables in the empirical analysis. Others are the initial poverty level, a set of individual (or household) characteristics and a set of community characteristics, whereas the left-hand side variable is current poverty measured by different poverty indicators such as per capita consumption, number of schooling years, literacy status, access to health care, and access to drinking water.

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