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Decentralization and Municipal Spending Ability in Developing Countries

For fiscal decentralization to succeed, budget allocations need to match not only local needs but also local capacity

Over the past 30 years there has been a wave of fiscal decentralization reforms across low- and middle-income countries. The hope has been that local governments would be better placed than the central government to respond effectively to local needs—thanks to both a better understanding of those needs and greater accountability. But the results have been mixed. In many countries soft budget constraints have led to irresponsible spending and pressure on the national accounts. Local elite capture has often kept decentralization from fulfilling its promise of offering greater accountability. A lack of local administrative capacity has also undermined the success of reforms. Reviews of early programs of decentralization found that in many places it was a case of "too much too soon."

Recent studies have identified a set of prerequisites for successful decentralization in developing countries. These include an educated and politically aware electorate, a prevalence of law and order, effective political competition, a capable local administration, and effective oversight mechanisms. But because of data limitations such studies have been either qualitative or focused on only one factor. There is a lack of knowledge about the relative importance of the different factors determining the success or failure of decentralization reforms.

A new study by Loayza, Rigolini, and Calvo-González represents an important step forward. The authors have assembled a panel database that includes disaggregated spending records for 1,688 Peruvian municipalities over three years. An important concern in Peru is that municipalities lack the capacity to spend the money allocated by the central government. In 2009, for example, municipalities spent between 63 and 97 percent of their allocated budget. Drawing on their extensive database, the authors estimate the effects of key factors that constrain the ability of municipalities to spend the funds allocated to them. Following the previous literature, the authors group the constraints into four broad categories: size of the allocated budget, local capacity, local needs, and political economy.

The results confirm some of the qualitative findings of the previous literature. The size of the allocated budget has a significant negative effect on municipalities' spending ability. Those with a larger budget generally spend a smaller share, and this is particularly true for capital expenditures. Local capacity has a significant positive effect on spending ability: more populous and more educated municipalities execute a larger share of their budget. This is consistent with the concern that municipal managers often lack the necessary personnel and technical ability. Indeed, the authors' results show that municipalities with a larger share of white-collar workers are able to spend more of their budget.

Given such findings, the effect of local needs on spending may be somewhat surprising: all else equal, municipalities with higher poverty rates spend a larger share of their budget. A plausible explanation for this finding is that areas with greater poverty have greater investment requirements: problems are more apparent, and solutions easier to identify.

The final group of constraints relates to political economy. Results show that popular support for elected officials matters: municipalities where the mayor is elected with a larger share of the vote spend a larger share of their budget. Mayors who are reelected are also better able to execute the budget, but only at the beginning of their term in office.

A key purpose of this research is to produce quantitative estimates of the relative importance of these different factors. The study focuses on the results related to capital expenditures because this is the budget category with the lowest execution rates. By far the most important factor determining spending ability is the size of the allocated budget: a bigger budget means a greater share left unspent. Clearly, local governments have found it difficult to absorb the large resources flowing from the center. This is confirmed by looking at the size of capital expenditure projects: municipalities facing more ambitious projects spend less of their budget. Of the other factors, population size appears to be the most important. A larger population means a larger and more diverse set of projects and a larger pool of individuals to implement them—and therefore a larger share of the budget spent.

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The authors' findings suggest that effective fiscal decentralization can be achieved if budget allocations are matched not only with local needs but also with local capacity. But in the medium term local capacity itself can be the target of purposeful economic policy. Improving the incentives for local leaders to hire better managers and administrators, facilitating coordination between small municipalities for large common projects, and clarifying the different mandates of the different levels of government are just a few of the elements of much-needed second-generation decentralization reforms.

Norman Loayza, Jamele Rigolini, and Oscar Calvo-González. 2011. "More Than You Can Handle: Decentralization and Spending Ability of Peruvian Municipalities." Policy Research Working Paper 5763, World Bank, Washington, DC.