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Decentralisation Playbook

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1. Introduction

This Playbook explores how devolving greater power and resources to sub-national units (decentralisation) can transform political and economic systems. By implementing different rules, regulations, and laws in special zones, cities, or regions, substantial transformation can be achieved, driving bottom-up market-creating innovations and growth. This Playbook uses case studies to identify when decentralisation is possible, what are the requirements for success, and what can be achieved. It discusses how low and middle-income countries can use the lessons of decentralisation to achieve prosperity.

Many countries claim to have a decentralisation policy, but relatively few have enacted a substantial transfer of power from national to sub-national units. Decentralisation implies ceding power, and politicians do not become politicians to give power away. Substantial decentralisation generally requires that national politicians are challenged and concede power under some type of duress.

Decentralisation is a highly contested policy because it relates to the distribution of power. In centralised nations, capital cities have a monopolistic grip on political power, using it to their advantage over the rest of the nation. Consequently, capital cities establish a form of “capital city primacy”, with great wealth disparity between capital cities like Santiago in Chile or Bangui in the Central African Republic and comparatively impoverished regions outside the capital.¹ However, through conflict and pressure, capital cities can be compelled to relinquish some of their power and privilege.

Decentralisation happens infrequently but, when it does, it is the ‘real deal’ because it redistributes political power; it is not about technical issues. Decentralisation is one of those unique policies that can be transformational, bring peace, create a nation, and support social stability, social cohesion, and a country’s development.

Countries as different as China, Bolivia, India, and Kenya have all shown the spectacular transformational impact of decentralisation.

Under pressure to consolidate his leadership after the Cultural Revolution, the Chinese leader, Deng Xiaoping, used decentralisation and local governments to experiment with reforms and identify those that were successful for scaling up to the national level. Local governments, although weak, were able to attract investment and Special Economic Zones were created. Forty years later, Shenzhen, initially a small fishing village, has grown into a global city with 13 million inhabitants. Economic decentralisation made Chinese capitalism possible, not only in Shenzhen but also in the whole of China.

In Bolivia, the Revolutionary National Movement (MNR, a centre-right party) enacted the 1994 decentralisation to counteract the influence of regional separatist groups and revitalise its rural appeal. President Sánchez de Lozada designed a well-crafted law transferring power directly to municipalities, bypassing regional interests. However, he miscalculated: the law brought down the entire traditional clientelist party system, including the MNR. It ushered in a new political system, with a predominance of local indigenous and mestizo parties that better reflected the country’s ethnic and cultural cleavages. Moreover, decentralisation was so popular in local communities that even left-wing populist President Evo Morales failed in his attempts to recentralise power in 2010.²

On becoming independent, India adopted a federal system backed by a strong Union government. This was seen as a way to keep a very diverse country together. The Union government’s socialist economic policies, with central planning and state intervention, gave the states little autonomy. However, the 1991 balance of payments crisis forced national politicians to liberalise the economy and lift many national controls. With the greater autonomy afforded by these policy changes, the states began to compete vigorously with each other to attract investment, create industrial clusters, develop infrastructure, and promote entrepreneurship and innovation. This competition has since become a major engine of growth in India.

The substantial decentralisation seen in Kenya, a large country with one of the world's most diverse populations, was possible because post-election violence in 2007 eroded the legitimacy of national politicians. They were forced to agree to a new Constitution, moving away from a winner-takes-all political system, in order to regain political legitimacy. The Constitution was well crafted and has given substantial power to 47 county governors whose interests lie not only in following national party lines but also in being responsive to their local electorate. Governors can act in concert with other governors and resist co-optation by the national government, putting limits on the powers of the executive.

Decentralisation works best when national politicians face strong armed or political opposition from the country's regions or an economic crisis. The success of decentralisation requires that national politicians are under some sort of duress, that a substantial devolution of power takes place, and that the decentralisation legislation is designed and implemented competently, offering simplicity, transparency, and accountability to citizens – not the national authorities – and a transfer of resources commensurate to responsibilities.

A successful decentralisation adds new players (closer to voters) to the political system. This weakens the dominance of vested political interests at the centre and can open the way to a more open and competitive political system and economy, with fewer political and economic privileges for the elites. The Bolivian and Kenyan decentralisations are starting to show results along these lines.

Decentralisation is not usually featured as a policy to address development problems since historical experience has generally been disappointing, often because these decentralisations did not involve a substantial transfer of power (in other words, they were not 'sincere' decentralisations, but only 'pretend' ones). They were not the result of hard-nosed political negotiations between strong groups and sub-national units. In the absence of strong accountability, administrative mismanagement and corruption at the local level can follow.

This Playbook proposes that a 'sincere', well-designed decentralisation can facilitate political negotiations to support a nation-building political settlement, greater political stability, and social cohesion, or pro-development economic policies. It has the potential to change fundamental political and economic structures in countries as diverse as Peru, Ethiopia, and the Central African Republic.³

Notes

- 1 On urban primacy or urban macrocephaly, see Kotlyakov, Vladimir; Komarova, Anna (2006), Elsevier's Dictionary of Geography: in English, Russian, French, Spanish and German (1st ed.), North Holland.
- 2 Faguet, J.P. and S. Pal (eds.). Forthcoming 2023. *Decentralized Governance: Crafting Effective Democracies Around the World*. London: LSE Press.
- 3 As explored in the Legatum Institute reports on Peru (2021), Ethiopia (2021), and the Central African Republic (2022).



Bangalore, India.
Credit: triloks, iStock.

2. How decentralisation works

In this paper, we follow Faguet¹ and characterise decentralisation as the process by which a national authority devolves powers over specific policies and resources to independent regional and local governments that are accountable to regional and local electorates.² In this definition, decentralisation is an institutional change that deeply modifies the structure of public authority, politicians' career incentives, political parties' internal structures, the number and types of parties, public officials' incentives, the decisions they take, public expenditure, etc.³ This is why decentralisation has been recognised as one of the most important reforms of the last 50 years.⁴

Benefits of decentralisation

The theoretical advantages of decentralisation are well documented⁵ and reflect the advantages of decentralised markets when compared to central planning: decentralisation brings decision-making closer to where the information and knowledge are located, producing better outcomes in public spending, the implementation of primary services, monitoring, etc.

Benefits of Decentralisation

- Decentralisation helps governments better match expenditures with citizens' needs because it facilitates their access to the often dispersed information they need or because citizens vote with their feet and move to the locality that provides their preferred bundle of public goods and taxes.
- Local governments that are more accessible to citizens produce public decision-making that is more accountable and responsive to citizens' needs. This is particularly important in a diverse polity.
- Decentralisation relieves political tensions and reduces the risk of political instability or demands for secession.

Source: "Incoherence of Institutional Reform: Decentralisation as a Structural Solution to Immediate Political Needs". *Studies in Comparative International Development*, 57, 2022. J.P. Faguet. <https://link.springer.com/article/10.1007/s12116-021-09347-4>.

Benefits of pretending to decentralise

The theoretical benefits of decentralisation are clear. However, they are not matched by the "hundreds of published studies in academic journals and many hundreds more reports and evaluations by reputable national and multilateral agencies" on the results of decentralisation in practice.⁶

Decentralisations often fail to increase the power of governors and mayors.⁷ This is because we generally observe 'pretend' or 'insincere' decentralisations that are decentralisation in name only. Governments do not have incentives to decentralise, but they do have incentives to claim they are decentralising.

National politicians do not have incentives to surrender power to sub-national authorities over whom they may not exercise control because politicians get into politics to gain power, not to give it away. However, they have incentives to claim they are decentralising because this helps appease demands from regional/local areas and, in the case of aid-dependent countries, because foreign donors are generally supportive of decentralisation.

Donors provide support to 'pretend' decentralisations that, for example, have the stated aim of improving the delivery of education and health at local levels and reducing corruption. However, while spending aid money is good for donors, consultants, and recipient governments, it is unlikely that the 'pretend' decentralisation they support will reduce corruption or improve service delivery because

there has not been a redistribution of political power. Political leaders will continue to use public expenditures to reward their essential supporters, not to deliver services to citizens efficiently.

Comprehensive global reviews of decentralisation – including Bardhan (2006) and Faguet (2023, forthcoming)⁸ – confirm that most decentralisations around the world are not ‘sincere’. As with reform conditionality, governments find it easier to pretend they are introducing policy changes than actually to do so.

When ‘sincere’ decentralisation happens

Prof. Bueno de Mesquita⁹ explains that the main goal of politicians is to gain and keep power, mainly by ensuring the backing of their essential supporters through rewards. Decentralisation cedes power to others whom they do not control and, through the surrender of resources, limits their capacity to reward supporters. Therefore, decentralisation is not a policy that politicians would choose to pursue of their own volition. They may pretend to want to implement decentralisation, but they will seek to ensure that a real transfer of power does not take place.

Decentralisation occurs under special circumstances: for example, to bring peace and stability to a large and ethnically, linguistically, and religiously diverse country. It often takes place when national elites have not yet consolidated their power, as at independence (India) or the restoration of democracy (Spain and Indonesia).¹⁰ In other cases, it occurs when the power of national elites is weakened by political factors (Chinese leaders’ need to consolidate political power in the late 1970s; the MNR’s need to weaken separatist regional groups in Bolivia in the 1990s; the Kenyan ruling party’s loss of political legitimacy post-2007 election violence) or by economic factors (India’s 1991 balance of payments crisis). Weakened national elites implement decentralisation when they consider it can work to their advantage in the short term by addressing a current problem. However, Faguet argues that, in some cases, this short-term focus leads politicians to miscalculate the negative long-term consequences that decentralisation can have for them, as in the case of the 1994 MNR decentralisation to municipalities, which resulted in that party’s obliteration.¹¹ Similarly, although the outcomes are still uncertain, the 2010 decentralisation in Kenya, which devolved power to 47 counties, seems to have limited the powers of the central government.

Finally, decentralisation can also take place, as a perfectly rational decision on the part of national politicians, in response to direct pressures from below – that is, when sub-national governments or citizens force national governments to transfer power and resources to them.¹² This was the case of the 1980s decentralisations in Argentina and Brazil, which were a response to the pressure of governors on national governments for political and economic autonomy. The largely economic Chinese decentralisation in the 1970s and 1980s also corresponds, though in a different context, to a “decentralisation from below”, according to Faguet based on the work of Liu, Shih, and Zhang.¹³

Transformational changes

A ‘sincere’ decentralisation happens only under a limited set of circumstances but, when it happens, it has a unique power to be transformational, affecting the country’s political development. It changes the relative power of different political and social groups, alters the country’s political settlement, and has the ability to sustain peace (for example, Northern Ireland), contribute to stability for nation-building (India), and provide greater legitimacy to the state and political system (Bolivia and Kenya).¹⁴

Politically, decentralisation creates a new layer of political actors at the local level and can, therefore, be key in weakening the dominance of national rent-seeking political leaders. It places some limits on the powers of the national executive and can minimise the winner-takes-all features of some political systems (Bolivia and Kenya). These factors can help to unlock the dominance of a clientelist closed political system, affecting who wields power in a society and whether the economy enjoys the benefits of local flexibility, or is centrally controlled.

Economically, decentralisation also has an awesome power to transform stagnant centrally-planned economies into world economic powerhouses, as evidenced by China's development and that of many Indian states. Even countries with a weak decentralisation process, such as Peru, have regions that have used their limited political and economic autonomy to attract investment and innovation and enhance their economic growth (e.g., Cajamarca in the last four years).

Factors in decentralisation success

Successful decentralisation is usually the result of tough political negotiations between national and regional leaders or other civil society forces. Such negotiations are possible in situations where national leaders can be challenged by the opposition, and where they can be forced to concede a decentralisation that is carefully designed to devolve substantial power.

The political process that produces this decentralisation legislation is key to ensuring that the process's design and implementation details are technically fit for purpose. There are many technical ways to get decentralisation process wrong. The success of the Bolivian and Kenyan processes is partly the result of the careful design of legislation, with a focus on simplicity and transparency to ensure that local authorities are accountable to citizens, rather than the national government. Similarly, decentralisation legislation needs to ensure that resources are commensurate with the transferred responsibilities. In China, the process of decentralisation has also been carefully and gradually designed and implemented since the late 1970s and has been complemented by the introduction of village and township elections, formalised through organic laws first enacted in 1987 and 1995, respectively.

In political terms, decentralisation is more likely to succeed when power is transferred from national clientelist political forces to local areas where there is a more competitive political system (often supported by a more diverse economy)¹⁵ and where there is more local social cohesion and social capital, both indicators of the community's potential for participation. This has been the case with the indigenous communities of Bolivia¹⁶ and in regions such as Kerala in India.

Notes

- 1 "Incoherence of Institutional Reform: Decentralisation as a Structural Solution to Immediate Political Needs". *Studies in Comparative International Development*, 57, 2022. J.P. Faguet.
- 2 Decentralisation has been defined and measured in many ways, and many researchers focus on its different fiscal, administrative, and political elements. For an up-to-date review, see OECD (2019), *Making Decentralisation Work: A Handbook for Policy-Makers*, OECD Multi-level Governance Studies, OECD Publishing, Paris, <https://doi.org/10.1787/g2g9faa7-en>.
- 3 "Incoherence of Institutional Reform: Decentralisation as a Structural Solution to Immediate Political Needs". *Studies in Comparative International Development*, 57, 2022. J.P. Faguet.
- 4 OECD (2019), *Making Decentralisation Work: A Handbook for Policy-Makers*, OECD Multi-level Governance Studies, OECD Publishing, Paris, <https://doi.org/10.1787/g2g9faa7-en>.
- 5 For the most up-to-date discussion on the benefits of decentralisation, see Faguet, J.P. and S. Pal (eds.). Forthcoming 2023. *Decentralized Governance: Crafting Effective Democracies Around the World*. London: LSE Press. The dangers of decentralisation have also been discussed extensively, in terms of inefficiencies, corruption, etc. See Rémy Prud'homme. Source: The World Bank Research Observer, Aug., 1995, an earlier and influential text.
- 6 "Incoherence of Institutional Reform: Decentralisation as a Structural Solution to Immediate Political Needs". *Studies in Comparative International Development*, 57, 2022. J.P. Faguet.
- 7 See A Sequential Theory of Decentralization: Latin American Cases in Comparative Perspective, Tulia G. Falleti, *American Political Science Review*, August 2005.
- 8 Decentralization and Local Governance in Developing Countries: A Comparative Perspective, edited by Pranab Bardhan and Dilip Mookherjee, MIT Press (2006). Faguet, J.P. and S. Pal (eds.). Forthcoming 2023. *Decentralized Governance: Crafting Effective Democracies Around the World*. London: LSE Press.
- 9 Bueno de Mesquita et al., "The Dictator's Handbook", 2012 and 2022.
- 10 In a similar way, the introduction of Free Trade Zones in the Dominican Republic in the 1970s was the result of pressures from the United States, which had invaded the Dominican Republic in 1965. "Political Economy of Special Economic Zones", Lotta Moberg, Routledge, 2017.
- 11 "Incoherence of Institutional Reform: Decentralisation as a Structural Solution to Immediate Political Needs". *Studies in Comparative International Development*, 57, 2022. J.P. Faguet. <https://link.springer.com/article/10.1007/s12116-021-09347-4>. Liu M, Shih V, Zhang D., The fall of the old guards: explaining decentralization in China. *Stud Comp Int Dev*. 2018;53(4):379–403.
- 12 See A Sequential Theory of Decentralization: Latin American Cases in Comparative Perspective, Tulia G. Falleti, *American Political Science Review*, August 2005 for the decentralisation processes in Argentina and Chile. The paper also argues that the sequencing of fiscal, administrative, and political decentralisations is a key determinant of the intergovernmental balance of power.
- 13 "Incoherence of Institutional Reform: Decentralisation as a Structural Solution to Immediate Political Needs". *Studies in Comparative International Development*, 57, 2022. J.P. Faguet.
- 14 State legitimacy and institutional trust are a continuum that varies from being subject to imperial powers to a political system dominated by an ethnic group to a political system where people find that all ethnic groups in society are represented.
- 15 The positive role of political competition at the local level can also be seen in Switzerland and Colombia.
- 16 See different experiences in the Bolivian towns of Viacha and Charagua, Faguet (2012) *Decentralization and Popular Democracy: Governance from Below in Bolivia*. University of Michigan.



Nairobi, Kenya.
Credit: wilpunt, iStock.

3. Country lessons

China: a new economy

China illustrates the case of a top-down authoritarian hierarchy that is, at the same time, highly decentralised administratively and economically.

In the late 1970s, just after the death of Mao and the end of the Cultural Revolution, Deng Xiaoping was under pressure to identify reforms to promote economic growth and consolidate his leadership. Considering the difficulty of moving swiftly from a planned economy to free markets and the diversity of China, Deng Xiaoping chose to experiment with incremental market reforms in existing institutions and in some coastal areas (through Special Economic Zones). Decentralisation and local state-led development were a natural way to facilitate this experimentation, with the added benefit of ensuring that local communist officials directly benefited from Deng's market reforms.

Decentralisation played a central role in China's successful escape from a poor communist economy to capitalism. The central authorities used decentralisation and local governments as a bottom-up adaptative search mechanism to identify local solutions to development.¹ After introducing markets in existing institutions, such as rural households, collective enterprises, etc., China harnessed weak local bureaucracies to work to attract investments to kick-start markets and generate growth in local areas. Only after growth had been consolidated were efforts made to improve local bureaucracies to enable them to seek high-quality investments and maintain and safeguard markets.

Deng was successful because regions were able to tap into their respective comparative advantages, following a local state-led development approach that combined political centralisation with economic decentralisation and a "franchise" model for providing incentives to the local bureaucracy. The central leadership did not dictate precise plans, allowing local governments to steer their economies, collect taxes, and finance and deliver public services. The centre provided reform packages and policy incentives that were wide in scope but incremental by, for example, giving the green light for local areas to attract investment. Because of the national leadership's sensitivity to the need to tailor reforms to local conditions, some policies in the reform packages were communicated with clear instructions or – when flexibility was needed – with vague instructions.

China was able to implement effective policies to attract investment in local areas, despite their extremely weak bureaucracies, because it implemented an innovative "franchise" model that provided the bureaucracy with strong financial incentives. This allowed local bureaucracies to establish aggressive sales teams that benefited personally from attracting investments through their own connections.²

Deng's bet on decentralisation was successful and not only helped to consolidate his leadership but also made the transition to capitalism irreversible, even after the Tiananmen Square protests. Economic growth has also continued to provide legitimacy to the Chinese Communist Party. Moreover, Chinese leaders at the national level have been able to combine their centralised political model with elections at the village and township levels. However, since the mid-2000s, as central government capacity has increased, the autonomy of elected village officials has been eroded.³

China's great leap forward to capitalism without freedom has proven that strong economic growth can be achieved even in the absence of strong institutions. In China, this was made possible by an adaptative decentralised bottom-up model that provides national guidance for local areas but leaves flexibility for local authorities to find local solutions that work. This is a model that many other countries with weak institutions could follow.

For more details about the Chinese decentralisation, see Annex.

Bolivia: a new political landscape

In Bolivia, a decentralisation process, initially instigated to weaken the influence of regional separatist interests (Santa Cruz, Tarija) and reverse the electoral decline of the MNR, a traditional centre-right party, brought down the oligarchic party system and ushered in the dominance of parties that reflected the country's key ethnic/rural cleavages and indigenous and mestizo groups. It resulted in the "massive entry and ascendance of indigenous Bolivians into politics, first at the municipal level, and from there making the leap – previously near-impossible – into national politics".⁴ The new political landscape better reflects Bolivia's ethnic/rural-cosmopolitan/urban cleavage and has increased the state's legitimacy. The 1994 decentralisation became so popular that local groups mobilised to resist the recentralisation attempts of left-wing strongman President Evo Morales in 2010.

The 1994 decentralisation was successful because President Sánchez de Lozada designed simple and transparent legislation with strong monitoring mechanisms (Community Oversight Committees). For example, the decentralisation's transfer of resources was based only on population size, which meant that everyone could understand the amount of resources received by each area. It was also successful because President Sánchez de Lozada had decided that the decentralisation law should benefit Bolivian citizens, and not the governing political party.⁵

The Bolivian decentralisation bypassed regions and devolved power and resources directly to municipalities (initially more than 300), weakening regional separatist politicians. Municipalities had concerns that were mainly local and many of them were backed by the strong social capital of indigenous communities and mestizo groups.⁶ These grassroots groups participated actively in ensuring that decentralisation could work. In other towns with non-competitive political systems and weaker social capital, decentralisation was captured by clientelist political interests.

Decentralisation has resulted in greater expenditure by poorer municipalities, particularly on education and health, rather than infrastructure. This better reflects local priorities.⁷ As a consequence of these trends, polls in 2004 indicated that the legitimacy of municipalities reached 52% compared to only 7% for the national government.⁸ These polls help to understand the popular resistance that frustrated President Evo Morales's attempts to recentralise in 2010. Indeed, he had no option but to support further decentralisation through the Law of Autonomies. In the end, decentralisation was the only Sánchez de Lozada policy that was not reversed, because it had empowered local communities and they resisted President Morales's recentralisation attempts.⁹

In 1994, Sánchez de Lozada could not have envisioned that his decentralisation reforms would result in the destruction of the oligarchic political order and launch a new era of bottom-up politics, strongly influenced by mestizo and indigenous parties. He could not have imagined that even strongman President Evo Morales – Sánchez de Lozada's nemesis – would not be able to reverse his decentralisation.

For more details about Bolivia's decentralisation, see Annex.

India: competition between states

India adopted a federal Union at independence as a way to accommodate linguistic, cultural, and regional diversity. The Constitution established a Union government with strong powers and states with autonomy in some areas, but without the power to secede, unlike, for example, the Ethiopian Constitution. In 1956, states were reorganised along linguistic lines.

India's economy had been partly centrally planned and involved substantial state intervention, limiting states' economic autonomy. However, the 1991 balance of payments crisis forced the national authorities to introduce economic liberalisation measures. In 1994, these policies included giving local governments constitutional status and mandating their regular election. It also recommended further devolving power and resources from state to local governments.¹⁰

Implementation of the local government legislation has varied significantly from state to state. In general, the devolution of power and resources from the state to local governments has often been limited by unfunded mandates.¹¹ According to some measures,¹² decentralisation is greatest in Kerala, West Bengal, and Rajasthan, with Kerala and a few other states having devolved most functions to panchayats.¹³

The economic decentralisation and autonomy of the states were greatly increased by the economic liberalisation of 1991, which limited the economic role of the Union government and permitted state-level initiatives to promote industrial development and economic growth. In the last 30 years, this decentralisation has resulted in intense competition among Indian states to attract investment, in a way similar to the 1980s efforts of local bureaucracies in China to attract investment to their local areas.

Competition between states has contributed to India's high economic growth, particularly in the 1990s, during the high growth of 2005–2010, and as a result of the 2014 "Made in India" campaign. In 2022, Gujarat and Rajasthan were the states that attracted the most domestic and foreign investment.¹⁴ States have also been ranked according to their "state investment potential" and Invest India (one-stop shop for investing in India) promotes the special advantages of each state.¹⁵ All these factors have created incentives for competition and improvement.¹⁶ Other states have competed by improving their human resources as, for example, in Kerala, the state that has shown the largest improvement in its human resource indicators.¹⁷

Many states have benefited from state competition and decentralisation, in part because of their initial resource endowments and governance. However, as in China, the challenge is to ensure inclusive development across all states.

For more details about India's decentralisation, see Annex.

Kenya: the beginning of new politics

In Kenya, a large country with one of the world's most ethnically diverse populations, decentralisation had been on the agenda since before independence. However, substantial decentralisation did not occur until 2010, after the legitimacy of national politicians had been weakened by the widespread violence that followed the 2007 election. The winner of that election, President Kibaki, was forced to agree to a coalition government with the opposition. It was only in these special circumstances that a devolution of power to 47 counties was included in the 2010 Constitution.

So far, Kenya's decentralisation has not resulted in the obliteration of the established political order, as occurred in Bolivia. However, it appears to have moderated the winner-takes-all nature of the Kenyan political system. It gives county governors – defined constitutionally as "equal partners" of the national government, not subordinated to it¹⁸ – real power and enables them to take concerted action to protect their powers, even if this requires opposing the interests of the national government.¹⁹

Decentralisation appears to have worked well in adding checks and balances on the executive because intense political competition at the county level creates strong incentives for local politicians to align themselves not only with their national party but also with the interests of the local electorate.²⁰ Governors have gained the ability to resist co-optation by the national government. This limits the executive's power to fully control the political agenda and its centralising powers. In some cases, this has resulted in successful negotiations to increase the resources available to counties and resist recentralisation.

The success of Kenyan decentralisation in transferring real power to counties and introducing new checks and balances on the executive has been possible because decentralisation was negotiated by strong political actors with a strong commitment and knowledge of how to achieve "majimboism" (federalism, already included but not implemented in Kenya's first Constitution). As a result, the 2010 Constitution considers elected county governors as equal partners to the national government,²¹ 15% of revenues are directly allocated to counties, and a second national chamber was created to represent counties, etc. Importantly, decentralisation powers are constitutionally protected, making them more difficult to curtail.

While recentralisation has remained under check, the national government has used provincial and district commissioners to interfere with the power and autonomy of governors. This has resulted in a number of conflicts that contribute to ethnic tensions, for example, in relation to county security. Other decentralisation challenges include insufficient resources in relation to mandates, wage bills consuming large parts of allocated budgets, a lack of qualified personnel, corruption and nepotism, and limitations on citizen participation due to high illiteracy rates (unlike the case of Bolivia which has high participation rates). Moreover, decentralisation has impacted different areas differently and poverty rates remain very high in the north and northeast (levels of just under 70%).²²

Despite these challenges, there is some evidence that, as in Bolivia, decentralisation is improving the alignment of spending with citizens' priorities: "The past three local election cycles reflect a gradual shift towards greater demand for performance and away from traditional voter patronage."²³ In the medium term, decentralisation is also likely to result in healthy competition to attract investment, innovation (as in Indian states), and collaboration between counties.²⁴

Finally, as in Bolivia, decentralisation in Kenya has allowed "long-marginalised communities to elect their own leaders and has also boosted the legitimacy of the wider political system" and has made it possible to "restrain some of the centrifugal forces at play in Kenyan politics".²⁵ The poor in local areas expect that decentralisation will bring more resources to their areas, as has already happened in Bolivia.

Conclusions

This Playbook argues that 'sincere' decentralisation processes are worthy of attention because they can produce spectacular economic and political transformations. Decentralisation helped to transform China from a poor communist country to a capitalist high-growth middle-income country and India from a crisis-prone stagnant economy to a high-growth dynamic economy while, in the case of Bolivia, previously marginalised indigenous and mestizo groups have gained political participation at all levels.

This Playbook also discusses the contexts in which 'sincere' decentralisation can take place:

- a. at the creation of new independent states when national elites are still fluid, as in the cases of India or the United States, or at times of regime change, as in the case of China, but also in the democratic transitions of Germany, Spain, and, more recently, Indonesia;
- b. when national political competition is intense (the pressures on the MNR in Bolivia in 1994) or a country faces the challenges of a severe economic crisis (India in 1991) or a political crisis (Kenya's post-2007 election violence);
- c. as a result of demands and pressures for autonomy from local governments, as in Argentina, Brazil, and (arguably) China in the 1980s.

The outcomes of 'sincere' decentralisation processes can be so radical that they may even surprise the politicians who introduced these policies. For example, in Bolivia, the decentralisation carried out by the centre-right MNR party resulted in the party's electoral obliteration. The parties that implemented decentralisation in China and India – the Chinese Communist Party and the Congress Party – were the parties that had introduced central plans and state intervention in their countries. As a result of the decentralisation they implemented, these countries are today strongly in the capitalist camp.

The optimal design of decentralisation often requires intense political competition between groups to ensure proper monitoring of the quality of decentralisation legislation. While decentralisation is fundamentally a political process, its success depends on it being designed and implemented with technical proficiency. An optimal decentralisation design should ensure:

- Simplicity and transparency so that politicians of different camps can support it and citizens are able to understand its key principles and monitor compliance. The simplicity of the inter-regional transfer system in Bolivia (population per municipality) has contributed to its success.

- Participation and accountability. Devolution works best when power is transferred to areas that are politically competitive and have strong social capital, and when local bureaucracies and politicians are accountable to citizens, not local governments. These factors worked particularly well in Bolivia's decentralisation, thanks to the role of the Oversight Committees, which encouraged the participation of indigenous communities with high social capital. In China, "franchise models" gave local bureaucracies effective incentives to attract investment to local areas. Similarly, Kenya's decentralisation success is based on the governor's accountability to citizens as a result of high political competition at the local level.
- New responsibilities for local governments are roughly matched by the resources they have available.

This Playbook notes that the central role played by decentralisation in the great economic success of China and India is not widely acknowledged. Decentralisation has allowed these countries to experiment with different policies and practices and scale up the successes – what the US Supreme Court's Louis Brandeis called 'laboratories of democracy'²⁶ (see also Annex). The Chinese leadership's skilful use of adaptative trial-and-error models of decentralisation, which allowed them to harness weak local bureaucracies to investment attraction and the creation of new markets, is a model that many low and middle-income countries could imitate. China has demonstrated that countries can escape the poverty trap, even if their institutions are weak. Similarly, India's economic decentralisation, which enabled states to compete fiercely with each other for investment, is a model that can be replicated by low and middle-income countries locked into poverty by national clientelist politics and a rentist economic system.²⁷

More encouragingly, economic success can be kick-started, even in the absence of a strong decentralising commitment, if local leaders identify political opportunities to grant *de facto* autonomy to some pro-market business practices.²⁸ Moberg and Yuen Yuen Ang²⁹ have argued that this process took place initially in China, with entrepreneurs and local politicians finding the political space to introduce and test policies and market-creating innovations, leading to changes in practices that supported an ecosystem of dynamic businesses. Decentralisation is powerful because a simple change in practices, rather than national-level legislation, can lead to economic transformation.³⁰

Decentralisation to a special jurisdiction, Special Economic Zones, or Charter Cities, creates new rules in a limited geographic area that can promote social and economic transformation. (For the extraordinary role that these decentralisations by jurisdiction can play, see Annex).

Politically, this Playbook has explained how decentralisation in Bolivia and Kenya has transformed the political system, providing it with greater popular legitimacy, particularly in the eyes of marginalised groups, and limiting excessive central government powers. The transformation has been more radical in Bolivia where indigenous groups today participate actively in all levels of the political system. However, even in Kenya, decentralisation appears not only to have revitalised the political system, but also moderated the winner-takes-all nature of its centralised political system.

This Playbook concludes that, given that many countries are in a poverty trap of dysfunctional politics, conflict, and instability, decentralisation has the potential to address some of the root causes of this underdevelopment and serve as a 'laboratory' of innovative policies. Provided that political and technical requirements are met, decentralisation may be one of the few policies available to promote development in countries such as Peru (dysfunctional politics) or Ethiopia and the Central African Republic (ethnic conflicts and political instability). In the medium term, a 'sincere' decentralisation has the potential to reduce the wide disparities in wealth between capital cities and the rest of the country, promoting growth that benefits all areas of the country.

Notes

- 1 The main arguments in this section are based on Yuen Yuen Ang, "How China Escaped the Poverty Trap". 2016. Cornell University Press.
- 2 Yuen Yuen Ang, How China Escaped the Poverty Trap. 2016. Cornell University Press.
- 3 The Rise and Fall of Local Elections in China, By Monica Martinez-Bravo, et al. American Economic Review, 2022. 112(9).
- 4 "Can Sub-National Autonomy Strengthen Democracy in Bolivia?", Publius, The Journal of Federalism, JP Faguet, Advance Access, May 2013. On the conflicts in Bolivia before decentralisation, see J.A. Robinson, https://scholar.harvard.edu/files/jrobinson/files/jr_wb_decentralization_bolivia.pdf. "Descentralización y democracia popular: gobernabilidad desde abajo en Bolivia", Jean Paul Faguet, 2016. Friedrich Ebert Stiftung.
- 5 Sánchez de Lozada, G and J.P. Faguet (2014), "Why I Decentralised Bolivia" London School of Economics and Political Science.
- 6 "Social capital" increases in Bolivia as one descends the social pyramid towards the poorest and least educated (Albó et al., 1990; Faguet and Ali, 2009; Healey, 1987). See also the comparison of social capital in the municipalities of Baures and Guayamerin, in Faguet, J.P. (2006), 'Decentralizing Bolivia: Local Government in the Jungle', in P. Bardhan and D. Mookherjee (eds.), 'Decentralization and Local Governance in Developing Countries: A Comparative Perspective', MIT Press, Cambridge, MA,.
- 7 Sub-National Autonomy in Bolivia: Analysing the Reforms and Predicting their Consequences, Faguet, December 2011. https://eprints.lse.ac.uk/49817/1/Faguet_Can_sub-national_autonomy_2013.pdf.
- 8 Descentralización y Democratización en Bolivia: La historia del Estado debil, la Sociedad rebelde y el anhelo de democracia. Moira Zuazo, Jean-Paul Faguet and Gustavo Bonifaz (editors). Friedrich Ebert Stiftung, 2012.
- 9 "Incoherence of Institutional Reform: Decentralisation as a Structural Solution to Immediate Political Needs". Studies in Comparative International Development., 57, 2022. J.P. Faguet.
- 10 For a good review of decentralisation in India, see <https://www.cambridge.org/core/books/social-sector-in-a-decentralized-economy/decentralization-in-india-history-laws-and-politics/C6DBC0C1267746CAACF37CCB290C1084>.
- 11 Chakraborty, P., Chakraborty, L., & Mukherjee, A. (2016). Frontmatter. In *Social Sector in a Decentralized Economy: India in the Era of Globalization* (pp. I-IV). Cambridge: Cambridge University Press. https://www.cambridge.org/core/services/aop-cambridge-core/content/view/812FEDF927DB3419C6ABAB48D4B6F697/9781107108561AR.pdf/Social_Sector_in_a_Decentralized_Economy.pdf?event-type=FTLA.
- 12 Decentralization and Local Governance in Developing Countries: A Comparative Perspective. Edited by Pranab Bardhan and Dilip Mookherjee, MIT Press (2006).
- 13 Ministry of Panchayati Raj <https://pib.gov.in/PressReleaseIframePage.aspx?PRID=1814116>.
- 14 Business Standard, November 22, 2022, https://www.business-standard.com/article/current-affairs/corporate-india-makes-a-beeline-for-gujarat-and-rajasthan-shows-data-122110701557_1.html.
- 15 Invest India, Investment Promotion and Facilitation Agency, <https://www.investindia.gov.in/states>.
- 16 https://smartnet.niua.org/sites/default/files/resources/1533372106the_ncaer_state_investment_potential_index_2018_report.pdf.
- 17 Global Data Lab. <https://globaldatalab.org/areadata/profiles/INDr110/>.
- 18 David Ndii, Decentralisation in Kenya, Background Note, September 2010.
- 19 See also the activities and motto of the Council of Governors, "48 Governments, 1 Nation": <https://www.cog.go.ke/>.
- 20 Cheeseman, N. et al., Decentralisation in Kenya, Governance for Governors. 2016 Journal of Modern African Studies.
- 21 Decentralisation in Kenya, Background Note, September 2010.
- 22 Country Partnership Framework for the Republic of Kenya for the Period FY23-FY28, August 22, 2022, World Bank Group.
- 23 Country Partnership Framework for the Republic of Kenya for the Period FY23-FY28, August 22, 2022, World Bank Group.
- 24 For example, an initiative to share devolution innovations in different counties. <https://maarifa.cog.go.ke/>.
- 25 Cheeseman, N. et al., Decentralisation in Kenya, Governance for Governors. 2016 Journal of Modern African Studies.
- 26 Louis Brandeis in *New State Ice Co. v Liebman* (1932), "a single courageous State may, if its citizens choose, serve as a laboratory; and try novel social and economic experiments without risk to the rest of the country."
- 27 Sir Michael Barber indicated that his experiences in many countries had taught him of the difficulty of engaging directly with national governments, for example in Peru given its unstable politics. However, regional spaces offer the opportunity to engage in furthering economic reforms and improving service delivery. Conversation with Francis Fukuyama, pX.
- 28 Podcast Charter Cities Institute <https://chartercitiesinstitute.org/podcast/charter-cities-podcast-episode-48-exploring-solutions-to-the-development-problem-with-efosa-ojomo/>.

- 29 "Political Economy of Special Economic Zones", Lotta Moberg, Routledge, 2017. Yuen Yuen Ang, *How China Escaped the Poverty Trap*. 2016. Cornell University Press.
- 30 Lant Pritchett has told the story of being asked to support the diversification of the economy of South Sudan. His answer was simply to bring in a world-class multinational company. He reasoned that this company's interactions with the government and other local companies would have the effect of improving local practices and the business ecosystem. This could later be incorporated into a legal framework for South Sudan. Unfortunately, the plan was not implemented as international organisations demanded that a good legal framework be in place first. A legal framework was introduced, but in the context of clientelist and corrupt local governance, and no world-class company came to South Sudan to improve practices. This decentralised development approach is being tested in places like Cajamarca (Peru) and Ethiopia. www.innovation-prosperity.org.



Potosí, Bolivia.

Credit: DavorLovincic, iStock.

4. Annex

These appendices provide greater detail about the key decentralisation themes discussed in the first part of this Playbook, including that of decentralisation as a laboratory for policy experimentation. They also include case studies and a thorough discussion of Special Economic Zones and Charter Cities as decentralisation by special jurisdictions. These last two issues are not generally discussed in the context of decentralisation. Annex 6 and 7 point to the ancient roots of the concept of Charter Cities and the immense innovation and developmental potential they offer today.

Decentralisation as a laboratory for scalable reform policies

The combination of decentralisation and competition among jurisdictions opens the way to experimentation in how public services are provided. Other jurisdictions can learn from the resulting success (or failure) and identify reforms suitable for scaling up to the national level.¹

Europe has historically been divided into decentralised administrative units (into 2,000 principalities after the fourteenth century). As a result, there was always competition and when one state tried something that worked, it was adopted by others. In this context, there were many opportunities for inventors. In the 1450s, Johannes Gutenberg hoped to monopolise his development of moveable type (as the Chinese state had successfully done) but, within a few years, it had spread across Europe and, by 1524, there were nearly 1,000 printing presses in Germany alone.²

In the early 1980s at the start of its market reforms, China, a single state, replicated this feature of Europe through decentralisation to special jurisdictions that allowed some coastal areas to experiment with reform. A Special Economic Zone (SEZ) in Shenzhen, created in 1979, became the country's most influential laboratory for reform. While China was still a centralised and socialist economy, Shenzhen pioneered reforms related to land acquisition, the price system, labour and financial markets, and enterprise reform. It was the first city to open up the land market and commercialise residential land, a process now key to financing local government across China (see Box below). Shenzhen abolished food quota-rationing in 1984, ten years before the rest of China. In 1982, it was the first city in China to permit the entry of foreign banks; in 1986, it was the first city to privatise a state-owned enterprise; and, in 1990, it opened China's first stock exchange. The reforms Shenzhen pioneered in the labour market, ending the tradition of government allocation of people to jobs and creating a job market as well as permitting migration from other areas, were crucial for the functioning of decentralised entities competing with each other.³ All of these reforms were first tested in Shenzhen and then scaled up to the national level, after demonstrating their success locally.

In India, the Employment Guarantee Scheme (EGS) was launched in the state of Maharashtra in January 1979, guaranteeing a right to employment for adults in rural areas. Upon request, adults were entitled to work within an 8-km radius of their home in usually intensive occupations, such as head-load carrying or breaking rocks. The scheme functioned through self-targeting. The better-off had an incentive to access schemes involving cash transfers or subsidies, but little to engage in this kind of labour. In 1986–1987, the scheme created 186.7 million man-days of employment.⁴ Inspired by this example, the central government launched the scheme nationally in 2008. The National Rural Employment Guarantee Act (NREGA) provides rural households with a legally mandated minimum of 100 days' work at minimum wages. In 2012–2013, NREGA generated 2.3 billion man-days of employment for 80 million people.

Decentralisation to special jurisdictions enables countries to experiment with new policies and then scale up the reform. In China, the one-stop service was first implemented and tested in SEZs before being generally adopted.⁵ SEZs were used to experiment with foreign ownership in Kuwait and liberalisation of the state telecommunications monopoly in Jamaica.⁶ A policy implemented in a SEZ can be a test case for new reforms or a showcase to convince reluctant interest groups.⁷

Yardstick competition between different geographical jurisdictions can enhance the ability of the local population to hold the local government to account by increasing their ability to monitor local officials through comparison between jurisdictions. Since 1991, state governments in India have competed as foreign investment destinations. India's Business Today magazine has conducted regular perception-based surveys of states in terms of quality of governance and reforming efforts. Credit rating agencies started ranking states according to their fiscal health and the Quarterly Business Manager to rank them on investment potential (based on measures of state finances and infrastructure provision).⁸ Chief Ministers, industry ministers, and even bureaucrats consciously seek out the media to advertise their industrial policies and achievements and explicitly compare themselves with competitor states. There is a much greater emphasis on conferences, meetings, exhibitions, road shows, and press conferences. During an election, local citizens can ask the basic questions: Is my local government delivering the public goods and services that local government officials promised at the last election? Do I think an opposition party can deliver better public goods and services? To this, decentralisation can add another question: Is my local government delivering public goods and services as well as other similar areas? In the 2014 national elections, the Chief Minister of the state of Gujarat achieved national office as Prime Minister with the promise to would roll out nationally the reforms which, he stated, had delivered economic growth and prosperity in Gujarat.

China

In 1976, on the death of Mao, China had a totalitarian and highly centralised political and economic system. The economic system was based on central planning. The government owned all large factories, transport and communications, and agricultural land whose management was collectivised. The state planning apparatus issued instructions to firms and state-owned farms (the collectives), specifying production targets, the inputs to be used, and details on where to deliver the final output. Prices lost their significance as a signal for the allocation of resources. The Chinese Communist Party (CCP) further reinforced control of the economy through a hierarchical personnel system under which it controlled managerial career paths. In politics, it penetrated the state (the legislature, bureaucracy, judiciary, and armed forces) at every level. It also imposed a monolithic cultural order on society.⁹

This centralised system allowed the government to achieve some of its key economic goals. It set the terms of trade (relative prices) between agriculture and industry. In practice, this meant low prices for agricultural goods and high prices for industrial goods, generating large surpluses for state-owned enterprises. The government was able to raise 25% of GDP in revenues and had no need of a modern tax system (taxes on sales, income, profits, etc.). This ready access to revenues enabled the government to push investment rates to very high levels for a poor, developing country (44% of GDP in 1958). This, in turn, allowed it to impose rapid structural transformation since 80% of this investment went into heavy industry. The share of industry in GDP increased from 18% in 1952 to 44% in 1978. However, the centralisation of decision-making, the capacity to issue orders that affected the entire economy, and the lack of independent discussion also produced catastrophes. The most notable example was the Great Leap Forward in 1958 in which 30 million people died due to famine.¹⁰

China did not follow contemporary conventional wisdom and establish good institutions (property rights) and good governance (democracy, transparent government, low corruption). Instead, it built a set of underlying conditions that fostered a bottom-up search within the state for localised solutions. This has been referred to as 'directed improvisation' since central reformers direct and local state agents improvise.¹¹ The centre set clear criteria for judging and rewarding success to help ensure that incentives were such that local agents utilised local autonomy to pursue local goals in line with the central vision for the economy, such as industrialisation.¹²

Chinese decentralisation after 1980 can be characterised as 'de-concentration' and 'delegation' with no 'devolution' and limited and delayed 'privatisation'. In the terms of this Playbook, the reform process (and particularly SEZs) revolved around the practice of decentralisation to special jurisdictions. By the 2010s, China had a system that was formally centralised but, in practice, highly decentral-

ised. In contrast to the US federal system, there is no constitutional division of powers between the central government and provincial governments. The CCP in Beijing appoints the senior leadership of all provinces and many cities. Many laws, such as the One Child Policy, have been enforced with a high degree of consistency across the country. The reality on the ground, however, is that local governments enjoy a high level of discretion and autonomy. The share of spending that occurs at the sub-national level averages 25% for democracies and 18% for non-democracies (1972 to 2000). In China, the average for 1958–2001 was 54% and, by 2014, had risen to 85%. This is an extraordinary degree of fiscal decentralisation for an authoritarian country.¹³

The reform era was marked by efforts to retain a strong central state. The state sought to transform moribund state enterprises into dynamic, internationally competitive, global multinational corporations and to utilise them as an arm of foreign policy, rather than privatising them. The CCP retained a monopoly of political power. The state made efforts to modernise the bureaucracy, making professional competence, technical qualifications, and economic achievement the key to success, rather than class background. From the 1980s through to the 2000s, the CCP was increasingly removed from economic management, but has made a comeback more recently under Xi Jinping.¹⁴

China's reforms have produced immense economic success. China has experienced the most rapid and sustained economic growth, perhaps in human history. Over the past 40 years, GDP growth has averaged 9–10%. During their own 'miracle' growth years, Japan, South Korea, Taiwan, and a few others achieved comparable growth rates, but not over so many decades. In China, absolute poverty was reduced from one-third (more than 250 million people) to less than 4% (50 million people) in the 20 years from 1980.¹⁵ China has challenged much of the conventional wisdom about economic growth, achieving its transformation without widespread economic liberalisation, privatisation, or democracy.

The initial breakthrough in economic growth came from agriculture. From the 1950s through to 1978, agriculture was organised in large, state-owned collectives, many employing tens of thousands of people. The collectives were successful in mobilising resources to transfer to the central government. However, problems in their management and a lack of incentives for workers were reflected in negligible productivity gains. In the late 1970s, agriculture accounted for nearly 40% of GDP and 75% of employment. Between 1978 and 1983, the basis of the agricultural economy changed due to the household responsibility system under which management was contracted down to individual households. This restored incentives by linking effort and reward. Between 1978 and 1984, grain output grew by more than 30%, production of oil seeds and cotton showed sustained annual growth of 15% and, in the case of meat production, 10%. Rural per capita income more than doubled between 1979 and 1984. The use of chemical fertilisers, which had risen gradually in the 1970s, tripled between 1978 and 1990 while pumps, small tractors, and food processing equipment showed similar increases.¹⁶ This rapid growth was due to a one-off institutional change and could not sustain long-term economic growth.

Chinese reform was underpinned by a series of institutional changes, creating what have been labelled 'transitional institutions'¹⁷ or 'using weak institutions to create markets'.¹⁸ These institutions worked because they simultaneously achieved two objectives: they improved economic efficiency and made the reform compatible for those in power. Decentralisation to special jurisdictions was key for each of the three most important transitional institutions in China.

The first example is market liberalisation through the dual-track approach. During the years of central planning, the state fixed prices and instructed farms and factories to deliver a quota of output to the central government at those prices. The dual-track system retained this structure for a fixed volume of production but allowed farms and factories to sell any surplus on the market at free-market prices. This reform preserved benefits for state-owned enterprises in terms of access to agricultural and industrial products, but created new incentives and benefits for farms and factories. Decision-making about production and sales was decentralised to the farm and factory level.¹⁹ The dual track is an example of what Ang²⁰ refers to as using weak institutions to create markets. However, the dual track

created two problems. It was costly to administer because, in principle, the state had to sign contracts with all economic agents (farming households and firms) to specify physical deliveries, prices, and any other taxes. In practice, decentralisation to special jurisdictions meant every household and firm delivering goods to the state at below-market prices also created a significant incentive for state corruption, with bureaucrats diverting goods to the free market to benefit from higher prices.²¹ The dual track was only a transitional institution. The share of compulsory procurement was gradually reduced and, by the end of 1993, planning had been abolished completely. Through the gradual decline of planning, the old-guard communists became accustomed to reform and the disappearance of planning occurred virtually unnoticed and without protest.²²

The World Bank and the IMF have long recommended the rapid privatisation of small-scale enterprises. In China, where private ownership was taboo during the 1970s and 1980s, this was not possible and China followed a different path. The second example is an innovative form of firm ownership, the Township and Village Enterprise (TVE). TVEs were owned by the local village or township government, which granted substantial autonomy to profit-oriented managers (a form of localised decentralisation to special jurisdictions). In the 1980s, China had no law to protect private property rights and a strong anti-private property ideology had been inherited from the Maoist era. The central state attacked private property rights during several crackdowns, such as the 'anti-spiritual pollution campaign' of 1983. TVEs were more secure than private ownership because they were owned and hence supported by the local government. The central government was happy to let them thrive because they created employment and their profits provided it with revenues. Local governments could provide local public goods – roads, water, irrigation – and so lightened the central government's responsibilities in these fields.²³ Local officials had powerful incentives to promote TVEs to provide jobs and income for the local economy and revenues for the local government. Revenues from local businesses could be 100% retained by the local government and not remitted to the provincial or national government. The local government was able to act as a guarantor of bank loans. About half of TVEs' after-tax profits were reinvested in local public goods and, by the late 1980s, local governments accounted for 60% of total government spending in China.²⁴ This was in stark contrast to the widespread problem of inadequate funding for local governments globally.

TVEs could pay lower wages (less than 60% of the total) than state-owned enterprises. They began producing goods, such as basic consumer goods (clocks, watches, radios, bicycles, and clothing), that were in short supply in the centrally-planned economy structured around heavy industry. In 1978, TVEs' return on capital averaged 32%.²⁵ They were the engine of China's economic growth from the mid-1980s through to the mid-1990s. In the 1980s and 1990s, their annual growth reached 9%, the number of jobs increased from 28 million in 1978 to 135 million at its peak in 1996, and the TVEs' share of GDP (in terms of value added) increased from 6% in 1978 to 26% in 1996.²⁶ In 1993, TVEs contributed 42% of China's national industrial output.²⁷

However, by the mid-1990s, TVEs were facing a more challenging and competitive external environment. The empty niches in consumer goods had mostly been filled and their growth rate slowed. Taboos against private ownership had dissipated and TVEs were privatised during the 1990s, with a peak in 1998 when the private sector was declared an important component of the economy under an amendment to the Chinese Constitution.²⁸ Large state-owned enterprises were retained under state ownership. In the terms of Ang,²⁹ weak institutions had helped build markets.

The third example of China's institutional transition is fiscal policy. On January 1, 1994, China introduced major tax and fiscal reforms that moved it closer to international best practices. Between 1980 and 1994, all fiscal revenues except customs duties were collected by local governments. After 1994, central government revenues were defined as including customs duties, direct taxes, profits from central state-owned enterprises, and a few other taxes. All other sources were considered local revenues. In 1994, fiscal federalism was established, introducing a clear distinction between national and local taxes and creating local and national tax bureaus, each responsible for collecting its own taxes. Local revenues were divided between the central government and provincial governments

according to pre-determined sharing schemes. Taxes were uniform and applied to all economic actors.³⁰ By granting local governments the right to retain taxes on land, the reform encouraged the urbanisation and industrialisation boom that began in the 1990s. This was an example of more general (fiscal) decentralisation, but gave local governments (and local elites) the incentives to promote economic growth by making decentralisation to special jurisdictions work.

There are examples of where decentralisation failed, particularly when it was not compatible with the principles of subsidiarity. While banks were the responsibility of the central state, their personnel were typically appointed by provincial or local governments, implying that lower levels of government could pressure the banks to lend, without having to bear the costs of bad debt. In the 1980s, provincial and local governments pressured banks to lend to inefficient state-owned enterprises, which were losing income and profits due to competition from TVEs, and to fund local infrastructure construction. By the late 1990s, bad loans accounted for some 40% of total loans, about eight times higher than in a healthy financial system. The central government was forced to allocate large sums to recapitalising the banks and introduced reforms to tighten central control.³¹

When Local Taxes Stimulate Urbanisation: Land Ownership and Revenue-Raising in China

In 1979, China allowed foreign investors rights to use (but not own) land by forming a joint venture with a Chinese business or government entity (Qun et al., 2015:433). The responsibility for allocating land was decentralised to city governments. They had an incentive to acquire land from agriculture and utilise it for urban construction because the revenues from land sales far exceeded the cost of land expropriation. The first major deal was arranged by the China Development Bank (CDB) in Tianjin in 2003 when the mayor of Tianjin announced a \$21 billion, five-year infrastructure development project. The cost was more than five times the city's annual revenues. The city planned to raise revenues from land sales to repay the 15-year loan and did so in seven years (Kroeber, 2016:118). This experience was replicated across hundreds of cities around China. City land would be transferred to special-purpose companies, which became known as local government financing vehicles, and the company would then use the land as collateral for a bank loan. Repayment of the loan was financed out of sales or leases of the land. According to a survey in more than 30 cities, revenues from land sales represented 18 times the cost of land expropriation. In three provinces (Jiangsu, Zhejiang, and Guangdong), land tax revenues and other tax revenues from urban expansion accounted for 40% of government revenues between 2003 and 2006 (Qun et al., 2015:432). After 2008, land-based finance models spiralled out of control. Land values rose to unrealistic levels and, by mid-2013, local governments had liabilities equivalent to one-third of GDP (Kroeber, 2016).

Kroeber, A.R (2016), *'China's Economy: What Everyone Needs to Know'*, New York, Oxford University Press.

Qun, W. L. Yongle and Y. Siqi (2015), 'The incentives of China's urban land finance', *Land Use Policy*, 42, 432–442.

Bolivia

As from the 1952–1953 revolution, Bolivia experienced top-down, centralised government with authority emanating from the office of the President down to appointed regional governments.³² Below the apex of the state, the government promoted the amalgamation of public servants, labour, miners, peasants, and professionals into 'peak associations' that were, in turn, structured according to a top-down hierarchy. These associations negotiated directly with the government and private business to coordinate a top-down, centralised development strategy to promote modernisation and industrialisation.³³

A Law on Popular Participation was introduced in 1994.³⁴ The motives for decentralisation were various. In a retrospective interview, then President Sánchez de Lozada proclaimed himself an ideological believer in the benefits of decentralisation and stated that he wanted to decentralise political power to below the level of the regional elites that were challenging the central government's polit-

ical authority and the viability of governance in Bolivia. In addition, after 15 years of economic stagnation, despite extensive economic reform, there was a view that more decentralised government would better unleash reform's growth potential. Another motive was more parochial and political. A rise of ethnic-based, populist politics in the 1980s undercut the ruling Revolutionary National Movement (MNR), which had controlled a rural power base since carrying out land reforms in the 1950s. In this context, the decentralisation of government was in part an effort to secure the rural vote for another generation.³⁵

The 1994 decentralisation comprised four parts. First, revenue sharing (resource allocation) with municipalities doubled to 20% of national tax revenues, switching from an ad hoc to a strict per capita basis. Second, responsibility for providing public services in education, health, irrigation, roads, sports and culture, and water and sanitation was transferred to municipalities. Staffing and salary issues continued to be managed by the central government. Third, Oversight Committees were established for municipal activities. Comprising representatives of grassroots groups, they provided a parallel channel of representation in local policymaking and, given their ability to have central transfers suspended, had real political teeth. Fourth, 198 dormant municipalities, out of a total of 311, were reactivated and the borders of existing municipalities were expanded to include suburbs and rural regions.³⁶

The results of decentralisation were striking. Previously, the three main cities in Bolivia received 86% of all devolved funds and 308 smaller municipalities only 14%. A few years after decentralisation, these figures were 73% and 27%, respectively.³⁷ Before decentralisation, the government invested very little in 40% of Bolivian municipalities. The per capita rule of funding allocation resulted in a massive shift of resources in favour of smaller, poorer, and more populous districts.³⁸ In the three years leading up to reform (1991–1993), central government investment was concentrated in transport, hydrocarbons, and energy, which together accounted for 73% of public investment. After decentralisation (1994–1996), local governments invested most heavily in education, urban development, and water and sanitation, which together accounted for 79% of all municipal investment.³⁹

There is good evidence that these new allocations were a response to objective local needs, rather than a bid to appease newly emerging groups of politically influential elites. After 1994, investment in education, water and sanitation, water management, and agriculture was a positive function of illiteracy rates, water and sewage non-connection rates, and malnutrition rates, respectively. Although investment in these sectors increased throughout Bolivia after decentralisation, the increase was disproportionate in those districts where the objective need for such services was greater.⁴⁰ These changes were driven by the actions of Bolivia's 250 smallest, poorest, mostly rural municipalities, which invested the newly devolved public funds in their highest-priority projects. Under central government, only 10% of municipalities received any investment in health during the seven years before reform. After the reform, 100% of municipalities were investing in health care.⁴¹ These changing patterns of government spending reflected real changes in local accountability. Before decentralisation, central officials stationed beyond national and regional capitals had little reason to understand local demands because career success was contingent on implementing instructions from above. Decentralisation changed this because local government officials needed to court local votes in order to attain and then retain public office.⁴²

The impact of decentralisation varied across Bolivian municipalities. The local government in Baures was rated highly by local civic leaders, grassroots respondents, business, unions, and religious authorities. The quality of its investment projects and the public services it provided found wide favour. Investment projects were discussed in detail at village-level assemblies, based on which the local government then planned its investment schedule. These meetings were reported to be extremely open and participatory and won broad approval among the local population. The mayor and municipal council were deemed to be of high quality and keen to engage with local voters.⁴³ In Guayaramerin, on the other hand, public investment and public services were viewed negatively and planning procedures were dominated by municipal staff and closed to popular debate.⁴⁴

These two municipalities operated within the same nationwide institutional framework. The reasons for the striking differences lie in the interactions between the local economy, political dynamics, and the social structure of each municipality.⁴⁵ Guayaramerin is a highly urbanised municipality with an extensive rural hinterland dominated by large commercial agricultural enterprises, including producers of almonds, Brazil nuts, and palm hearts as well as cattle ranchers, loggers, and timber merchants. A small group of powerful businesspeople together control much of the local economy and, on large rural properties and in villages, people work (and vote) from a position of economic subservience. Business uses its influence over local government to steer government spending and contracts to its own advantage. With little prospect of influencing decisions, voters in Guayaramerin have an unsurprisingly low turnout.

By contrast, the economy of Baures is based on subsistence or near-subsistence farming on family plots. There are a few cattle ranches but the dominance of large landowners has largely disappeared. The town provides some agricultural services and commerce but there is no industry. The more fragmented nature of economic power in Baures is reflected in a competitive party system, divided between a governing party and a viable opposition, with a high rate of turnout in elections.⁴⁶

Another poorly performing municipality was Viacha where a corrupt local government failed to respond to local needs in terms of public services. The mayor and the ruling political party were funded by a single local brewery. The mayor sought to undermine and divide civil society to reduce its capacity to call for local government accountability.⁴⁷ The well-run municipality of Charagua, on the other hand, was underpinned by a revival of local civil society, formed by members of the Guarani, a local indigenous population that had previously existed on the margins of society as slaves to large landowners or isolated subsistence farmers. The Guarani mobilised under an umbrella organisation (the Guarani People's Association (APG)), which assumed control of the local government and the oversight committees. Consensus-based decision-making in the APG and a sense of solidarity among a recently marginalised group helped to facilitate wider social cooperation.⁴⁸ Registered voters increased by 72% between the 1993 and 1995 elections.⁴⁹ The mayor, working in concert with the Oversight Committee implemented an investment planning system that was transparent and participative and responded to real local needs.⁵⁰

The 1994 reforms had a clear effect in distributing resources far more equally across the country. The rise in oil prices in the 2000s generated huge new revenues for a few, often sparsely populated municipalities.⁵¹ A new regional-based opposition to the central government emerged around demand for the redistribution of oil revenues. This redistribution rendered local governments more dependent on the central government. Local efforts to raise tax revenues appear to have declined because oil dwarfed other revenue sources and local governments turned their attention to national politics.⁵² Large resource rents, including oil, often complicate local democracy. One way of mitigating this issue would be to make central transfers dependent on local tax-raising efforts.⁵³ However, even in this case, there is the risk that such transfers may become unstable and subject to politics and negotiation at the national level. An important component of Bolivia's success with the 1994 decentralisation can be ascribed to the transparency of the transfer rule it set: a simple per capita amount.⁵⁴

Carefully Planned and Swept Away: Decentralisation in Bolivia and Indonesia

Bolivia's Law on Popular Participation was unveiled in January 1994, approved by Congress in April, and started its implementation in July. The scale of the changes it introduced in resource flows and political power were enormous (Faguet, 2003:4). The President, who initiated the decentralisation (Gonzalo Sánchez de Lozada) was adamant that the change was ideological. In an interview (much later), he declared, "I became a real believer in something that was intrinsic to the experience of the town hall meeting – of people discussing their problems and coming up with solutions. When people talk about decentralization, they usually think of handing off responsibility but not authority. We wanted to hand down authority" (Sánchez de Lozada and Faguet, 2014:13). Decentralisation in Bolivia was aimed at a level just below that of the regional elites who were staunch opponents of the Sánchez de Lozada regime. In the same interview, he likened this to pulling "the rug out from under these dominant elites and their attempts to control public funds" (Sánchez de Lozada and Faguet, 2014:17).

In Indonesia, decentralisation was not the deliberate choice of any political leader or governing party, but the consequence of mass mobilisation. The 1997 Asian crisis, the loss of international confidence, and discontent with corruption led to a mass popular movement against President Suharto. Mobilisation also flared up in regions long associated with separatist demands, including Aceh and East Timor where there had been long standing armed conflicts against the central government. In other resource-rich regions, simmering resentment against the national government for 'stealing resources' burst into the open. After Suharto, there was a succession of short-lived presidencies until Susilo Bambang Yudhoyono was elected in a popular vote in 2005. A new constitution was introduced in a formal recognition of the mass mobilisation that had swept away the centralised political system and embedded decentralisation and regional autonomy into the new politics of Indonesia. Decentralisation was able to build upon a relatively well-developed deconcentrated governance system under which all core ministries had well-established bureaucratic outposts in each district. These agencies were folded into local government structures (Hofman and Kaiser, 2006).

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Bolivia after 1994: A Virtuous Circle of Decentralisation and Empowerment

In Bolivia, from the 1950s through to the 1990s, more than 90% of members of Congress were privately educated, prosperous urban residents, with European surnames. Between 1952 and c. 2000, despite periodic coups, guerrilla insurgency, and hyperinflation, the same political parties, and even the same individuals, kept returning to political office (Faguet, 2019:206).

Decentralisation began in 1994 and, thereafter, new groups did not merely emerge, they obliterated the pre-1994 political system. Out of the three decades-long established governing parties, two did not field any candidates in the 1995 election and the third received only 6% of the national vote. From the 1950s through to the 1990s, Bolivian politics revolved around European-style ideology, with parties on the left appealing to workers and those on the right to professionals and business. The problem was that Bolivia had little industry, low levels of urbanisation, and few (unionised) workers. Politics of the left and right revolved around small fractions of the national population. Decentralisation was intended to re-build a rural power base for one of the traditional ruling parties but, in practice, had the unintended effect of revealing the real social cleavages of Bolivian society between the urban, Spanish-speaking elite and the rural, indigenous majority. Turnout increased by 127% in the first election after the 1994 decentralisation. In the local elections of December 1995, 93% of the candidates were farmers (Alderman, 2017:13). Candidates for hundreds of local offices throughout the country came not from the usual political elite, but were bricklayers, truck drivers, and peasants with surnames such as Callisaya, Mamani, and Choquehuanca (Faguet, 2019:226). The new ruling party, the MAS, grew rapidly by agglomerating hundreds of independent local organisations under its political umbrella and empowering a new generation of grassroots leaders. The internal characteristics of the MAS were organised around self-representation and the attainment of power (local and national) by the Bolivian majority (Faguet, 2019:229).

The rise to power of these new groups went beyond 'a sense of control'. They actively changed the political trajectory of Bolivia. Under popular pressure, the government of President Morales was forced to deepen decentralisation through the 2009 Constitution and the 2010 Law on Autonomies and Decentralisation. These new laws defined Bolivia as a "plurinational state with autonomies" and stated that "indigenous nations and peoples" had the right to autonomous self-government (Alderman, 2017:1). Within such areas, traditional institutions and practices superseded the legal forms of the state, such as elected mayors and municipal councils (Sánchez de Lozada and Faguet, 2014:48). The 1994 decentralisation in Bolivia initiated a reinforcing momentum of political empowerment and autonomy for lower levels of government.

The other aspect of this virtuous circle was that, as discussed above, decentralisation brought benefits in terms of public services and public goods for local communities.

Alderman, J (2017): Indigenous autonomy and the legacy of neoliberal decentralization in plurinational Bolivia, *Latin American and Caribbean Ethnic Studies*.

Faguet, J-P (2019), 'Revolution from Below: Cleavage Displacement and the Collapse of Elite Politics in Bolivia', *Politics & Society*, 47:2,.

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India

Decentralisation in India from the 1990s onwards was driven by two factors also present in Bolivia: liberalising economic reforms, introduced and expanded after 1991, and longer-term political changes around the decline in the dominance of a political party. In addition, it took the form of a deliberate policy intervention, accompanied by constitutional change, to decentralise governance to village and city governments.

Before 1991, central government approval had to be obtained for all large private and foreign investment projects and permissions were required on what to produce, the volume of output, the location of production, and the use of any foreign technology or imported inputs. An elaborate regulatory structure concentrated power in the hands of central agencies. The abolition of the licensing system in 1991 meant that private businesses could make decisions based on market incentives, rather than the dictates of central regulation. During the early decades after independence, more than 50% of national investment was conducted by the state. State governments were compelled to compete amongst themselves for central preferment in the allocation of investment projects, such as airports or steel mills. However, as from the 1990s, an increasing share of investment was carried out by the private sector, implying that states could compete amongst themselves to attract private investment, often in the form of foreign direct investment (FDI), without reference to the centre. As states copied each other, this process of inter-state competition unleashed processes of dissemination and learning. The communist government of West Bengal announced a new industrial policy in 1994, welcoming foreign investment and technology. Chandrababu Naidu, who took office as Chief Minister of Andhra Pradesh in 1995, sought to make his state particularly welcoming to foreign and domestic investment, especially in IT-related services.⁵⁵

Political decentralisation in India was accompanied by a widespread perception that centralised government had failed to provide good governance and good public services.⁵⁶ In 1993, the government of India passed two constitutional reforms. The 73rd Amendment to the Constitution formally recognised a third tier of government at the sub-state level. This created a legal framework for local governance, known as *Panchayati Raj*. The amendment listed 29 areas in which the panchayats could have jurisdiction. They included agriculture, irrigation, animal husbandry, fisheries, forestry, small-scale industries, land reform, housing, and electrification as well as public services such as health, sanitation, and primary, secondary, and vocational education.⁵⁷ All seats in the panchayats were to be subject to direct election and elections were to be held every five years. The amendment also included provisions to create state-level Finance Commissions (to make recommendations to the state government about the distribution of funds to local government) and State Election Commissions (to supervise, organise, and oversee local elections). In India, unlike most other countries, states were given the role of determining the exact form that decentralisation should take. As a consequence, the process of decentralisation has varied widely, ranging from ambitious attempts at decentralisation in Kerala to re-centralisation in Karnataka.⁵⁸ The second constitutional reform was the 74th Amendment, which mandated the establishment of urban local bodies and the devolution of power to them.

Compared to other countries, India ranks high when judged by 'political' decentralisation. In the first decade of the process, most states held at least one round of local elections with turnout that, according to many surveys, reached over 90%. Before 1994, an average of 200,000 voters were represented by an MP in the national parliament but, after 1993, elected local government officials in most states represented just a few hundred residents. Decentralisation brought about a dramatic broadening of the representative democratic base of India.⁵⁹ The constitutional amendments reserved one-third of seats for women and low caste (traditionally disadvantaged) groups. In most states, the mandatory quota for women was met.⁶⁰

The nature of the party political system impacts how decentralisation functions. When local government officials are elected as members of a national political party, they may be more concerned about showing loyalty to senior members of the party than representing local voters.⁶¹ In India, local

public services (such as reducing child malnutrition) are delivered more effectively in those states where the voice of the poor has more influence on local politics. Where state politics remain dominated by traditional elites (Orissa and Madhya Pradesh), less progress has been made on reducing child malnutrition. In states where national political parties lost out early to regional state-based parties representing the poor (Kerala, Tamil Nadu, and West Bengal), more progress has been made on reducing child malnutrition.⁶²

The functioning of decentralisation is also influenced by the nature of competition between political parties. To obtain office, politicians must form winning coalitions. The number of competitors a party faces in a first-past-the-post system influences the size of the constituency a politician needs to appeal to in order to obtain a majority. If there are only two effective parties or alliances, each needs a majority to win the seat and hence the party needs to build broad alliances across social groups. In other words, politicians will seek a more encompassing interest. As the number of parties increases, a party will require an ever smaller coalition to take the seat. In elections to the national parliament between 1957 and 1991, a winning party needed 55% of the vote in districts where there were two competitive parties and 38% in districts with 3+ effective parties. The empirical evidence shows that, in India, multi-party systems spend less on public goods relative to targeted goods and salaries.⁶³ The successful implementation of the Employment Guarantee Scheme in the states of Andhra Pradesh⁶⁴ and Rajasthan⁶⁵ is linked to close, two-party competition for power at the state level.

On the other hand, India ranks low when judged by 'administrative' or 'fiscal' decentralisation. The constitutional change did not include the right to levy new taxes or an obligation to transfer additional resources down to local governments. While the amendments did lead to the creation of State Finance Committees to improve fiscal management at the local level, most of these committees chose to recommend no changes to the existing tax powers of local bodies.⁶⁶ Among the states where they did make recommendations, only some, such as Kerala, accepted and implemented the recommendations.⁶⁷ Local revenue collection has been correspondingly poor. Locally raised taxes and fees accounted for less than 4% of panchayat revenues.⁶⁸

In the state of West Bengal, decentralisation preceded the constitutional amendments by well over a decade. The Left Front won electoral office in 1977, campaigning on an agenda of decentralisation to village-level government. The reforms created the gram panchayat (GP), with a jurisdiction covering eight to ten villages. They had approximately ten to 18 elected members, each representing 500 voters in non-hill areas and 125 voters in hill areas. The state made significant efforts to decentralise real responsibility for key developmental functions such as land reform, the construction and management of local roads, and irrigation. Primary education remained a state-level responsibility owing to the political influence of the teaching unions which had no wish to subject themselves to local Village Education Committees were, established, membership was by appointment, not election, and they were packed with supporters of the state government (in other words, subject to political control, rather than democratic accountability). Not surprisingly, attendance at meetings and the Village Education Committees' independence were severely compromised.⁶⁹ The West Bengal panchayats were successful in terms of providing an opportunity for the poor to be heard and represented in the formal system of government. Landless agricultural workers, women, and marginalised groups were better able to stand up in public meetings and openly ask village leaders critical questions about public services. In West Bengal, reserved panchayat places for women caused a shift in the allocation of public spending of gram panchayats. A comparison of the local infrastructure available in villages with and without reserved places for women found, two years after the introduction of the reserved places, that the former invested more of their budget in drinking water and roads.⁷⁰ These outcomes are consistent with the relative priorities expressed by women in their complaints or suggestions to the gram panchayat. Their highest priorities were drinking water and road improvement (both with 31%).⁷¹ The Left Front initially had a left-wing, Marxist orientation but gradually became a social democratic party. Its promotion of decentralisation helped to strengthen its rural powerbase and provide a counterweight to urban-business opposition groups. This effort was initially successful and the Left Front was returned to office in seven state elections between 1977 and 2011.⁷²

In 1996, the Left Democratic Front (LDF) coalition was returned to power in Kerala and the government fulfilled one of its most important campaign promises by launching the People's Campaign for Decentralised Planning. All 1,214 local governments in Kerala were given new functions and decision-making powers and were granted discretionary budgetary authority over 40% of the state's developmental expenditure.⁷³ This was a dramatic increase in the financial capacity of local government and was based on financial transfers, rather than an increase in local tax-raising powers. Local governments were charged with designing and implementing their own development plans, including projects across the full range of development sectors, but were mandated to do so through participatory exercises.⁷⁴ The People's Campaign sought not only to transfer administrative power from the state governments to the panchayats, but also to elicit people's participation in development. This represented the largest non-formal education programme ever undertaken in India. In the first year in seven rounds of training at the state, district, and local levels, some 15,000 elected representatives, 25,000 officials, and 75,000 volunteers received training.⁷⁵ It was estimated that more than 2 million people participated in the local meetings, illustrating a success in generating public debate on development. The shift to local planning brought participation, but suffered from a lack of expertise.⁷⁶ The early years of the decentralisation saw an overall shift in local spending from major irrigation and major industry and in power to small-scale sectors, animal husbandry, and health and housing services. This marked a shift from productive investment to social services and the housing sector.⁷⁷

There remain significant constraints on the functioning of decentralisation in India. States are responsible for a higher proportion of government spending than in most low and middle-income countries (only China has a higher ratio). However, revenue-raising does not match expenditure responsibilities and tax autonomy is relatively low.⁷⁸ The most buoyant sources of tax revenues (international trade, personal income, corporation taxes) lie with the central government. Although states are responsible for important development functions such as education, health, and rural development, there remains a significant vertical imbalance. This gives the central government much potential leeway over how central resource transfers are allocated and how they are spent. Some of the most significant government welfare interventions of the 2000s, such as the NREGA, began as central government initiatives and were then taken over by the central government and rolled out nationally under central-level directives. The years since 2014 have seen the return of a pattern of single-party political dominance in India. The Bharatiya Janata Party (BJP), led by Narendra Modi, has become increasingly dominant at the centre and in state-level governments, shifting the balance of power back towards the central government.

While there are mixed signs of progress in decentralisation to rural-level local governments, India has made limited progress in decentralisation to city governments. Across India, urban governance was marked by the minimal decentralisation of authority and resources, a lack of capacity in urban government, and a lack of transparency and accountability in urban service provision.⁷⁹ The Jawaharlal Nehru National Urban Renewal Mission (JNNURM) was launched in 2005 with a seven-year budget of \$20 billion to build and better maintain existing infrastructure and improve public service provision to the poor across 67 cities. The programme was striking in the degree of central intrusiveness and control and undermined the faltering progress made in urban decentralisation under the 74th Constitutional Amendment. The JNNURM imposed a single set of centrally-determined binding, pre-conditions for cities to receive funding. The conditionalities encompassed governance, taxation, public transparency, and land and property law.⁸⁰

Decentralisation by Special Jurisdiction and Special Economic Zone

The standard literature on decentralisation and the literature on decentralisation to special jurisdictions (Special Economic Zones and Charter Cities) deal with two issues that are closely related, but rarely discussed together. This Playbook seeks to integrate their discussion. Decentralisation by special jurisdiction is generally limited geographically and is, therefore, less likely to threaten the political power of incumbent politicians and bureaucrats in central government, compared to a broader

decentralisation. Chinese decentralisation is frequently discussed but not in terms of decentralisation by special jurisdiction. This form of decentralisation is crucial to explain the success of its policy reform. The big-bang, nationwide 1994 decentralisation in Bolivia, by contrast, did not include decentralisation to special jurisdictions.

Decentralisation by special jurisdiction offers a more gradual approach to decentralisation. Geographical decentralisation can be targeted at regions to benefit local elites through the creation of local tax revenues that can be useful to the central government. The model of charter cities offers an additional option to the traditional model of Special Economic Zones.

Special Economic Zones (SEZs) are defined as “demarcated geographic areas contained within a country’s national boundaries where the rules of business are different from those that prevail in the national territory”.⁸¹ There are many subtle variations on SEZs, such as export processing zones, free ports, and single unit zones. For our purposes, we refer to them here collectively as SEZs. The first modern SEZ was established in Shannon, Ireland, in 1959. SEZs were introduced first in developed countries to promote the development of backward regions. After the 1970s, SEZs were also adopted by developing countries, first in East Asia and Latin America, to attract foreign direct investment (FDI) in manufacturing, to boost exports and employment, and, in some cases, to test economic reforms in small-scale ‘laboratories’. The first SEZs in Africa were set up in the 1970s (Liberia 1970, Mauritius 1971, and Senegal 1974). There was then a brief pause after which Africa joined the global flood of SEZ creation in the 1990s and 2000s.⁸² The number of SEZs increased from an estimated 900 in 1998 to 5,400 in 2018.⁸³ SEZs typically offer a mix of duty-free imports of capital goods and industrial inputs, income and profits tax reductions, and easier access to land and public utilities such as water and electricity. As with decentralisation more generally, the governance of SEZs exhibits significant variations.

Special Economic Zone: Shenzhen, China

Between 1949 and 1976, China was largely closed to the outside world in terms of trade and investment. In 1978, the Chinese government launched the ‘Open Door’ policy, one part of which was Special Economic Zones (SEZs). This was decentralisation to special jurisdictions as the local governments that hosted the SEZs and the SEZ management authorities themselves were given a significant degree of management autonomy, even to the extent of making deals directly with foreign investors. In August 1980, Shenzhen, Zhuhai, and Shantou in Guangdong province and, in October 1980, Xiamen in Fujian province were designated as SEZs. Each comprised a large area within which the policy aimed to promote broad-based economic development.⁸⁴ All four SEZs were granted various incentives, including tax breaks, reduced duties on imported equipment and production materials, depreciation allowances, and negotiated but limited access to the domestic Chinese market for goods produced within the SEZ, residence and work permits, and income tax exemptions for foreigners working within the SEZ. These incentives covered both domestic and foreign investment.⁸⁵ The four SEZs were deliberately located far from Beijing to minimise the risk of establishing an island of capitalism in a sea of communism and also to shield them from domestic political interference. Compared to the country’s average annual GDP growth of roughly 10% in 1980–1984, Shenzhen grew 58%, Zhuhai 32%, Xiamen 13%, and Shantou 9%.⁸⁶ In 1981, the four zones accounted for almost 60% of total Chinese foreign direct investment, with Shenzhen alone accounting for 50.6%.⁸⁷

The initial opening to trade and investment proved successful. Between 1980 and 1984, 14 new SEZs were established in different coastal cities and, in the following years, in cities in the Pearl River Delta, the Yangtze River Delta, and the Min Delta in Fujian. In 1988, the entire province of Hainan was designated a SEZ, and, in 1989, the Shanghai Pudong New Area was given SEZ status and was followed in 2006 by the Tianjin Binhai New Area. In 1992, the State Council created another 35 SEZs.⁸⁸ By 2010, China was home to about 2,500 SEZs and they accounted for 30 million jobs, 22% of national GDP, 46% of foreign direct investment, and 60% of exports.⁸⁹

The Shenzhen SEZ occupied an area of almost 330 km², though the main expansion was from the city centre westwards along an industrial corridor where most of the electronics industry was eventually

located.⁹⁰ In its first year of operation, Shenzhen received \$15 million of foreign direct investment in and, in 1994, \$1.4 billion. By 1985, Shenzhen's output of televisions and cassette players was one-sixth and one-third of the national total, respectively. By the following decade, this competitive advantage had extended internationally and, by 1998, hi-tech industries accounted for almost 40% of the SEZ's industrial output. Shenzhen accounted for 14% of world output of floppy disks, 6.2% of PC motherboards, almost 8% of hard disk drives, and 10% of magnetic heads. Within China, Shenzhen ranked first among all cities in 2008, registering 2,480 new patents.⁹¹ In 2007, its high-tech industries were producing \$111 billion in output, of which \$80 billion was exported.⁹² Between 1980 and 2008, Shenzhen's GDP increased from \$4 million to \$114.47 billion while the population increased from 300,000 in 1979 to 12.6 million in 2021 and per capita income from \$122.43 in 1979 to around \$30,000 in 2021.⁹³

Shenzhen permitted the central government to experiment with economic reform in a geographically delimited area, far from Beijing, at a time when markets in labour (capitalism and exploitation) were considered too risky elsewhere in China. Shenzhen was autonomous, but at the centre of national political struggles. Senior Chinese Communist Party members saw the SEZ as a new form of colonialism and protested about capitalism, corruption, smuggling, money laundering, and collusion with foreign powers. In 1985, the mayor of Shenzhen was replaced by an appointee from Beijing in order to strengthen central government control over the state government of Guangdong.⁹⁴ However, the tax revenues, foreign exchange, and access to international technology generated by Shenzhen's rapid growth proved enough to overcome this ideological opposition. The new mayor, Li Hao, continued with economic reform.⁹⁵

The various master plans bore little relation to the actual growth of the city and were a deliberate fabrication. By 1984, temporary migrant residents accounted for 50% of the population of the SEZ. The city authorities knew the true figure but could not reveal it in planning documents as the central government was still nervous about large-scale internal migration and retained strict national-level controls.⁹⁶ In 1984, Deng travelled to Shenzhen and declared, "The development and experiences of Shenzhen have proved the correctness of our policy on the establishment of special economic zones."⁹⁷ In 1992, Deng returned to Shenzhen. The defining moment of his trip was a visit to the World Trade Centre. When Deng first saw its construction in 1984, it was 160 metres tall, double the next tallest building in China. Now Deng could see a city full of high-rise buildings. Shenzhen was part of Deng's famous Southern Tour, which gave renewed impetus to reform. Soon after the trip, in August 1992, the Chinese central government announced that five inland cities along the Yangtze River, nine cities located on the national border, and all 30 provincial and prefectural capital cities would be designated as SEZs.⁹⁸

The rise of Shenzhen owed much to the geographical presence of Hong Kong, only one hour away by road from Shenzhen.⁹⁹ In the 1980s, wages were rising in Hong Kong and the city was looking to relocate its labour-intensive manufacturing. Shenzhen offered vast supplies of cheap labour. The province of Guangdong in which Shenzhen is located has a long history of foreign trade and connections and, in 1948, accounted for 20% of China's foreign trade. The province was also home to over 80% of overseas Chinese. However, the closeness was more than geographical since Shenzhen and Hong Kong share the Cantonese language and culture.¹⁰⁰ Geographical proximity does not suffice. While the relation between Shenzhen and Hong Kong flourished, that between Zhuhai and neighbouring Macao failed to ignite. Shantou and Xiamen are adjacent to Taiwan but were undermined by corruption scandals and the ongoing political stalemate with Taiwan.¹⁰¹ Between 1986 and 1993, Hong Kong accounted for 66% of total foreign direct investment in Shenzhen, but Japan (15%) and the US (11%) also made an important contribution.¹⁰² By 2008, foreign direct investment in Shenzhen was coming from as many as 82 countries, involving 148 Fortune 500 Companies.¹⁰³

The traditional image of pre-SEZ Shenzhen is of a small fishing village, with a population of 3,000, dilapidated buildings, and no traffic lights.¹⁰⁴ This story of an instant, top-down planned city is a myth used to legitimise China's wider reform policies. In reality, the Shenzhen SEZ contained over

300 urban villages with a population of around 100,000.¹⁰⁵ Shenzhen was more of a bottom-up story than is often imagined. Development was channelled through the existing structure of villages, which held significant economic power through their rights (not ownership) over the land on which the SEZ was to be built. In November 1984, the Caiwuwei Grand Hotel was built on village collective land. This was China's first farmer-built star-rated hotel. Over the next few years, more than 30 factories were built in the village, producing electronics, furniture, toys, and other consumer goods. The village farmers all became factory workers.¹⁰⁶ Elsewhere, 24 production teams collectively formed Huanggang Industry Ltd. and set up the Shapuwei Industrial Zone, which attracted enterprises that included the Weihuang Knitting Factory and the Lilai Electronics Factory. A second zone, Jilong Industrial Zone, attracted tens of thousands of workers from all over China. Huanggang villagers became rent-collecting landlords, instead of working in the factories.¹⁰⁷

The SEZ policy also had costs. Between 1981 and 1985, SEZ spending on imports reached \$2.4 billion, 2.5 times revenues from exports. The SEZs were initially heavily reliant on domestic investment rather than foreign direct investment.¹⁰⁸ Shenzhen was exempted from submitting tax revenues to the central and provincial governments during its first ten years. This deprived the government of tax revenues (a stake in the success of Shenzhen).¹⁰⁹ Maintaining the autonomy and reform impetus of Shenzhen required strong central leadership from Deng, exemplified in both his 1985 and 1992 visits to the city. Eventually, Shenzhen's success generated overwhelming benefits for the national economy, but sustaining reform was a closer call than many imagine today.

In economies that are largely agrarian or based on mineral exports, SEZs can foster new manufacturing investment and boost employment which can, in turn, be preliminary steps towards structural transformation. SEZs in Africa, other than Mauritius, have largely failed to achieve even this preliminary step. SEZs in Asia went further, promoted manufacturing, and then led the climb up the value chain in East Asia. In South Korea and Taiwan, labour-intensive industries comprised 50% of SEZs in the 1970s and technology-intensive industries 80% of output by the 1990s.¹¹⁰ The first four SEZs in China (Shenzhen, Zhuhai, Shantou, and Xiamen) accounted for around 60% of national foreign direct investment flows in the 1980s.¹¹¹ By 2018, it was estimated that there were more than 3,300 SEZs globally.¹¹² By 2008, 92% of Chinese municipalities were hosting a SEZ.¹¹³ China had turned into a single super-SEZ. Promoting successful SEZs in the future will require a change in mindset, away from the traditional reliance on fiscal incentives and wage restraint and focusing instead on facilitating a more effective business environment to foster firm-level competitiveness, local economic integration, innovation, and social and environmental sustainability.¹¹⁴

Special Economic Zones: The Charter City

Original Charter Cities through History

City states have existed for as long as humans have lived in cities. The phenomenon of decentralisation to special jurisdictions is taking the global population back to historical norms of governance.

The Classical Age of ancient Greece was characterised by over 1,000 Polis or independent city-states (Kito, 1991:11). Between the collapse of the (Western) Roman Empire in the fifth century and the ninth century, urbanisation declined in Europe. The ninth century saw a revival of commerce, long-distance trade, and the growth of a class of merchants that brought increased urbanisation in its wake, particularly in the Netherlands, Germany, England, and Italy (Pirenne, 1956).

The share of the European population living in cities or towns with over 1,000 inhabitants increased from 3% in 800 CE to more than 13% in 1600 CE while, in China, the rate stagnated (Henrich, 2020). The revival of urbanisation saw a flourishing of different models of sovereignty, including centralised states, city-leagues (for example, the Hanseatic League) and independent city-states (Spruyt, 1994). Many of the new and revived cities grew on the basis of charters that gave a ruling merchant class independence from feudal overlords. There are many examples. The charter of the City of London was granted in 1075 by William I (the Conqueror), giving residents various rights and powers. Even today, the charter survives in giving business more influence over local governance (Kohn, 2020). In 965 CE, Emperor Otto I granted formal privileges to traders in Magdeburg. Over the next few centuries, more than 80 cities would copy Magdeburg's charter, laws, and governance. By 1500, most cities in Western Europe were at least partly self-governed (Henrich, 2020:310).

At its peak, the Hanseatic League (c. 1150–1669) comprised more than 300 cities in northern Europe. These cities were not formally independent because they were members of other sovereign entities, principally the Holy Roman Empire. In these cities, town councils were dominated by merchants, who represented their cities in the Hansetag Convention. The Convention discussed commercial treaties, negotiated with foreign rulers, regulated the commercial economy, and made war and peace (Gebel, 2018:134). The city of Venice became *de facto* independent from the Byzantine Empire in 697, with the appointment of the first Doge. By the sixteenth century, the city was a major European trade and naval power and survived as an independent entity until conquered by Napoleon in 1797 (Crowley, 2011).

On March 4, 1681, William Penn was granted a charter by King Charles II of England to experiment with a then-radical concept of religious freedom in Pennsylvania and its main 'charter city' Philadelphia (Castle-Miller, 2015; Cao, 2019). The end of the Thirty Years War in 1648 and the associated Treaty of Westphalia prioritised the role of centralised state authorities as legitimate signatories at the expense of other forms of sovereignty (Spruyt, 1994). The French Revolution accelerated a Europe-wide process to end local governance autonomy and set in train a move towards more centralised states and national-level citizenship (Kohn, 2020).

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The charter city is a mechanism that, like the SEZ, decentralises to a special jurisdiction, but changes the focus from tax incentives and low wages to institutions and governance. A charter city has been defined in terms of its “special jurisdiction”. A host country delegates authority to the administration of an existing or prospective city to write new laws of governance.¹¹⁵ Some view charter cities in a minimalist manner, as an extension of the long-established SEZ project. According to this view, charter cities build on the SEZ model, “increasing its size to the scale of a city and expanding the scope of its reforms”.¹¹⁶ SEZs reform laws at the margin, while charter cities re-write an entire legal framework to encompass labour, taxes, business registration, and dispute resolution. While the geography of a SEZ is often relatively small, charter cities focus on a much larger geographic area, enough to accommodate an entire city.¹¹⁷ While *Special Economic Zones* may not be very ‘special’, a charter city is defined by the distinctive features of its special jurisdiction.

Paul Romer became the leading global advocate of charter cities with his now-famous TED Talk in 2009 and offered a deeper vision for charter cities as a ‘meta-rule’. Charter cities were a mechanism for helping a country change its rules towards those that support rapid and inclusive economic growth.¹¹⁸ Innovation in rules is best served by the presence of laboratories for experimentation to permit the observation and evaluation of diverse rules operating in different contexts before scaling up those rules that work and quickly discarding those that do not.¹¹⁹

The literature often represents governance as being ‘either’ (centralised) ‘or’ (decentralised). The reality is much more complex. The central government is always likely to retain important functions. The literature often comments on the greater ability of local government to recognise and respond to the diverse preferences of the local population. In schools, parents may be better placed than central ministry officials to monitor the attendance of teachers and the quality of teaching. By contrast, the central government may have advantages in using expertise to design a national teaching curriculum and a national system of examinations. Decentralisation is not about separation, but rather about cooperation: in education, cooperating to mobilise revenues, hire personnel, define curricula, build infrastructure, and supply non-teaching materials.¹²⁰ A strong central state is needed to build strong decentralisation. This is particularly the case when a SEZ or charter city is being used as a laboratory for reform. The central state is then tasked with monitoring and evaluating the relative performance of the competing laboratories and deciding which policy experiments to discard and which to scale up to other jurisdictions or the national level.

The UN has estimated that, in the 40 years as from 2010, an additional 2.6 billion people will move to cities. Since the early 2000s, construction has started on hundreds of new cities across Africa and Asia. Indonesia alone is building 27 new cities.¹²¹ Over a dozen countries in Africa are building more than 70 new cities. The charter city is also a practical response to this rising tide of urbanisation and the phenomenon of new city construction.

Work from Romer¹²² onwards has coalesced around five principles that define charter cities and distinguish them from related concepts such as Free Cities or SEZs: ‘new cities, new rules’; ‘autonomy’; ‘greenfield construction’; the ‘developer-manager model’; and the ‘sovereign guarantor’. This section reviews these five principles in turn.

A charter city is a ‘new city, with new rules’ that is defined in terms of its ‘special jurisdiction’. This allows the charter city to develop a governance model from scratch. Advocates of charter cities argue that writing new rules enables the city to become a welcoming destination for domestic and foreign investment and for residents to more easily start a business or find employment. The legal framework they advocate is typically structured around simple, low-cost business registration, tax administration, labour law, and dispute resolution.¹²³ A charter city has autonomy enshrined in and legally protected by a charter. The host country delegates all authority to the city government, except for criminal law, international treaties, and the constitution.¹²⁴ Charter city practitioners argue that autonomy allows a new city to “establish a streamlined and high-capacity administration” autonomous from the pre-existing governance system of the host country.¹²⁵

Advocates of charter cities generally agree that the first-best policy is the creation of good institutions at the national scale to promote inclusive economic growth. However, this can be difficult because 'good' institutions may threaten the benefits existing elites are reaping from 'bad' institutions, such as corrupt income from smuggling or the non-transparent allocation of licenses. A more politically feasible strategy is to create a new city with new rules in a delimited geographic area, rather than aiming to change an entire country's institutional framework.¹²⁶ Greenfield cities, argue proponents, will not threaten the gains made by elites from existing patterns of governance and corruption. Public sector construction projects may give state officials an incentive to inflate costs in order to obtain corrupt private income.¹²⁷ Turnkey projects may give private developers an incentive to boost profits by cutting costs through compromising on quality. The 'developer-manager' model holds that the construction firm that builds a city should also be responsible for managing the city after construction. The construction company is granted ownership or a long-term lease over the land on which the city is built. Because the city developer leases-owns the land, it has an incentive to create an effective administration, good institutions, and cost-effective and well-built infrastructure, and to provide public goods in order to increase economic activity and raise the value of the land.¹²⁸

One example of a charter-type city is Gu'an, 50 km south of Beijing in Hebei province. Despite the advantage of its proximity to Beijing, Gu'an was still poor and undeveloped in the late 1990s, with 85% of its population working in agriculture and a GDP per capita of less than \$1,000. Gu'an is in a county belonging to the city of Langfang. The county and its local government did not have enough resources to commence urban development and, in 2002, the local government signed a concession (not quite a *charter*) with the China Fortune Land Development Co. (CFLD), a newly founded local private enterprise, to build Gu'an New City (it was a new city). Without fiscal resources or the capacity to borrow, the local government agreed to performance-based payments from incremental tax revenue. The government outsourced the responsibilities of planning, land preparation, infrastructure construction, real estate development, city operations, and industry services to CFLD.¹²⁹ CFLD was given ownership of the city for 50 years and the freedom to exercise control over all aspects of city planning in return for sharing tax revenues with the local government (the developer-manager model).¹³⁰ The deal solved a market failure whereby private providers of infrastructure incur costs while surrounding proprietors enjoy extra benefits. The deal with CFLD internalised these positive (or negative) externalities as CFLD would benefit from any increase in land values (from sales or leasing) created by building good infrastructure.¹³¹

By the end of 2017, CFLD had built 204 km of roads, 627 km of underground pipelines, four thermal power plants, six water supply factories, a wastewater treatment plant, three sewage pumping stations, and 30 heat exchange stations.¹³² By the late-2010s, the city was host to advanced display manufacturing, aerospace and aviation companies, and biomedical R+D, each with a production capacity worth more than \$16 billion per year. The city also hosts an incubator for commercialising scientific research from Tsinghua University and a business park for airport-based logistics.¹³³ GDP per capita increased to \$7,000 in 2018 while tax revenues rose from \$16 million in 2002 to \$1.5 billion in 2017.¹³⁴ The local government did not incur any debt and now receives around 60% of tax revenues and CFLD 40%.¹³⁵

CFLD was founded in 1998 and grew to become a China Fortune 500 company. It now manages around 125 new cities or towns with a total area of over 4,000 km² in China, Brunei, Egypt, India, Indonesia, the Philippines, and Vietnam. CFLD originally outsourced industrial research to McKinsey and Roland Berger, but now employs 5,000 people in its Beijing Industrial Research Institute to do this work.¹³⁶ In Gu'an and elsewhere, CFLD recruited firms through its corporate network. Out of the 5,000 employees at its head offices, 3,750 work in 'corporate solicitation'. CFLD can offer individual negotiation of land prices, access to office space, tax breaks, and subsidised housing for employees. It can also help with tax registration, patent applications, legal and financial business services, and negotiation with the local government.¹³⁷

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