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Institutional Change and New Incentive Structures for Development: Can Decentralization and Better Local Governance Help?

Since decades decentralization is regarded a hot topic in development. Particularly for policy makers. Many governments today are on a dual track toward greater market orientation and decentralization to local-level authorities (Bennett 1990b: 7-9). And subnational governments are on the move as well. Decentralizing the public sector is high on the agenda of many governments in Africa, Asia and Latin America. Worldwide some seventy countries began decentralizing during the 1990s in the hope of improving allocation, management, and mobilization of resources; providing higher quality services for citizens; achieving greater accountability; and, eventually, generating more balanced economic and social development (World Bank 1995a). Moreover, recent debate has stressed the importance of decentralization and 'localization' being complementary to 'globalization'¹.

Today, decentralization is bringing many benefits in China, India, much of Latin America, and many other parts of the world. It can improve the quality of government and the representation of local business and citizens' interests. And competition among provinces, cities, and localities can spur the development of more effective policies and programs. Decentralizing state power and resources seems a logical continuation of the many recent efforts to bring government closer to the people, or people closer to government. Like the broad range of participatory mechanisms discussed in the literature, decentralization offers the chance to match public services more closely to local demands and preferences and to build more responsive and

* This paper summarizes some results of recent work on decentralization and local government, in particular: Campbell, Tim and Harald Fuhr (eds.) (Forthcoming) *Does Decentralization Work? Case Studies on Innovative Local Government in Latin America*. Washington, D.C.: The World Bank; and World Bank (1997) *World Development Report 1997: The State in a Changing World*. Oxford: Oxford University Press. Special thanks to Vikram Nehru and Bill Dillinger for contributing to box 1.

¹ See Jun and Wright 1996; for a more critical review Mander and Goldsmith (1996: Part IV).

accountable government from below. But there are also *pitfalls* to decentralization, including the possibility of increased disparity across regions, loss of macroeconomic stability, and institutional capture by local factions, especially in highly unequal societies, with high incidence of rent generation, and appropriation.

This paper focuses on some of the factors explaining recent trends in decentralization, and some areas where it has had positive impact, including bringing citizens into public affairs and stimulating local economic development. It concludes by exploring the dangers, and the implications for governments of differing capabilities starting out on the decentralization path.

Three different schools of thought, and groups of practitioners, have tried to approach the subject of decentralization, and its role in development: Fiscal economists highlighted the chances of, and risks associated with, renewed intergovernmental fiscal relations; political scientists and sociologists favoring broader participation and democratization focused on the merits of local civil society involvement in local governance; and sector specialists pointed to the merits of improved service delivery, particularly in education, health, and infrastructure. While the first remains skeptical and reluctant, the second and third groups seem overly optimistic on the potential benefits of decentralization.

This paper tries to bridge these different schools of thought by stressing stronger the underlying *incentive structures* within states in reform. Employing the New Institutional Economy (NIE)- as well as political economy approaches, it suggests a thorough, and country-specific, discussion of both *vertical* and *horizontal* incentive structures, as well as clear-cut accountability within a public sector in change. As will be pointed out below, vertical incentive structures mean defined rules for intergovernmental relationships. Horizontal incentive structures in turn mean defined rules between local governments, their citizens and the local private sector. Both sets of incentives are product of underlying socio-political processes. Such rules, in order to be credible, accepted, and sustainable, need to be agreed upon by major stakeholders. Both sets of incentives may each stimulate better results from decentralization and better performance of local government. Yet sustainability of such reforms, and improvements in overall capability and effectiveness of the state, is likely to occur only if there is better synergy, at least over time. Opting for swift decentralization without due consideration of these intertwined incentive structures, or worse, omitting one of these two sets, could harm development. Particularly in the poorest developing countries. Above all, politics and processes are key to understanding, and, eventually, managing decentralization effectively.

The age of decentralization?

The rising demand for decentralization has come as part of the broader process of political and economic liberalization, privatization and other market reforms in many countries. These reforms are distinct, but the underlying rationale is similar to the

case for decentralization: that power over the production and delivery of goods and services should be allocated to the lowest unit capable of capturing the associated costs and benefits effectively (cf. Oates 1972: Ch. 2). In many countries this will involve scaling back the power of central government, but reformers must be careful in discriminating. Depending on the institutional environment, decentralization can improve state capability by freeing it to focus on its core functions; it can also undermine that capability.

The demand for formal, political decentralization has been driven by at least three major recent developments:

- *The minimum size of self-sufficient government has declined.* New technological options and new demands from citizens, producers, and consumers mean that some of the advantages (security, for example) that kept countries, regions, and provinces working together under a central government have become less important². In Europe and North America the pressure from global markets is creating a strong demand for local and regional governments that can better provide the infrastructure and skilled labor force needed by transnational businesses³.
- *Political changes have given way to local demands.* Centralized authority in Yugoslavia, Czechoslovakia, and Soviet Union collapsed once the unifying force of the Communist Party collapsed. Elsewhere, regions and subnational governments benefited from the political vacuum created before and during regime changes, as in Argentina, and Brazil in the late 1980s, and South Africa in the 1990s⁴.
- *Countries often turn to local and regional governments following prolonged failure of the centralized state to provide essential services.* In the second half of the 1980s Colombia initiated decentralization and political reform that reversed a long tradition of centralism. A new government changed direction, transferring social service delivery to the local level and opening up the rigid political appointment system to local electoral choice. Similarly, in Venezuela and other countries in South America, active local governments have changed the responsiveness of local administration and the quality of services provided, often dramatically⁵.

² Buchanan 1990; Reinicke (1998: 4); on the Canadian discussion see Fallis 1992; on the debate in Spain see Armet et al. 1988.

³ For a broader overview see e.g. Keohane and Milner (1996: Part 1); Sassen (1998: Ch. 10); and Ohmae (1995: Ch. 7) on the emergence of 'region states'.

⁴ On former socialist countries see the contributions in Bird, Ebel and Wallich 1995; on Latin America see e.g. Nohlen 1991; Fuhr 1992; Murphy 1995; CEPAL/GTZ 1996. On Brazil see Abruzzo 1998; and on South Africa cf. Ahmad 1995.

⁵ On Latin America see Peterson 1997; Campbell 1997; and Campbell and Fuhr (forthcoming). On Colombia cf. the excellent study directed by Wiesner 1992; and Cifuentes Noyes et al. 1994 for an overview of results achieved. On Venezuela cf. de la Cruz 1995; on Mexico cf. Cabrero Mendoza 1995.

Before assessing how governments can seek to meet such demands it is worth asking what decentralization actually is. In fact, the term encompasses a wide range of distinct processes. The main ones are: administrative deconcentration, or the transfer of functions from higher to lower levels of government; fiscal decentralization, or the ceding of influence over budgets and financial decisions from higher to lower levels; and devolution, or the transfer of resources and power to lower-level authorities, that are largely independent of higher levels of government. Rarely does decentralization embrace all three⁶. This wide diversity of experience makes it difficult to compare trends across countries or draw many hard and fast conclusions. Also history and path dependency matter, often crucially.

History matters

Historically, most of the world's populations have lived under 'decentralized' rule. The large empires of Egypt, Mesopotamia, China, Rome and Constantinople were the first to interrupt the fairly independent local organizations of peasants, hunters, craftsmen, and traders. Centralization was achieved mainly through control over agricultural land, technology, and religion and through force⁷. In order to ensure cohesion, however, even these empires needed to respect local traditions and, to a certain extent, „self-government“ by the peoples they dominated.

By contrast, after secularization Europe's development toward mercantilism and capitalism was accompanied by a deconcentration of power and property. In a largely fragmented Europe with a number of important city-states, independent merchants became increasingly powerful. Taking advantage of the niches left by the elites, of the new opportunities of emerging national and international markets, and (later) of technology, these groups escaped successfully from feudal control and, eventually, financed feudal politics, thus gaining access to the formal political arena in this process as well.

The people that left Europe for North America in the sixteenth and seventeenth centuries left behind feudal control in order to preserve previously established religious, political, and/or economic freedoms. Although government was established in the New World, there was an interest in keeping central government small and checking it with strong local powers. Several of the early presidents of the United States were rich farmers (Washington, Jefferson) uninterested in the daily business

⁶ See Nellis and Rondinelli 1986, Conyers 1985, and Leonard and Marshall 1982 for different approaches.

⁷ Cf. in general Wittfogel's hydraulic societies (Wittfogel 1957), and Moore's classical work on the obstacles to modernity in Asia due to agricultural structures and highly centralized states (Moore 1966: Ch. IV-VI). On pre-colonial Central and South America cf. Rowe (1957: 157-160); Rostworowski 1983; Collier, Rosaldo, and Wirth 1982.

of government. The authors of the *Federalist papers*⁸ (Federalist Papers 1987) rejected Hobbes' argument that only rule by a single powerful sovereign could prevent life from becoming „nasty, brutish and short,“ advocating that the best way of preserving liberty was to divide power. If power were concentrated in any one place, they maintained, it could be used to crush individual liberty.

During the nineteenth century the reforms that helped reestablish Prussia's power after its defeat by Napoleon in 1806 built upon – besides state reform at the top – reinforced local government and strong participation at the local level, particularly in the administration of taxes, police, and other public affairs. Local reform was the price the aristocracy was willing to pay for national reconstruction and reformers sought to balance strong top-down reform with effective modernization of local government⁹.

The specific circumstances of fragmented – and decentralized – economic and social development in Europe and North America meant that today's industrial countries needed to cede different degrees of autonomy to existing local governments and civic actors to achieve their goals and (re)gain power and influence against other nations. For the most part the center was unable to succeed without the localities and vice versa. Both were capable of agreeing upon mutually respected rules, meaning: they agreed on appropriate institutional arrangements. Much of the flexibility and adaptability of these nations and their potential to survive even turbulent crises probably stems from such well-established arrangements at the local level. A key ingredient that provided additional momentum was the dynamism of the local private sectors¹⁰.

Historically, then, local governments played a very important role in many modern industrial countries, sometimes even more significantly than central governments. At the beginning of the twentieth century, for example, subnational governments in the United States and in Germany accounted for more than sixty percent of total government spending; in Switzerland and Canada the figure was as high as eighty. In 1932 local governments revenue (from own sources) in Canada accounted for some eighty percent of total government revenue¹¹.

⁸ The US constitutional debate on federalism in the 18th century is documented and discussed broadly in Rakove (1996: Ch. VII); on the original papers see Federalist Papers 1987.

⁹ See Moore (1966: Ch. II) on France; Craig (1955: 38-42), and Stein 1807 on reforms in Prussia.

¹⁰ Cf. Townsend (1990: 35-37) in general; Johnson (1975: 258, 271-272) on Prussia; Krugman (1994: 224-226) on clusters in 19th century Britain. Humphrey and Schmitz 1995 on the role of industrial clusters in recent development efforts. Senghaas (1985) on the role of local ('domestic') networks of markets in European development.

¹¹ For an overview see Bird 1986 and Ter-Minassian 1997; Wright (1988: Ch. 2); Krelove, Stotsky, and Vehorn (1997: 203) Peterson (1995: 5-10) on Canada and the USA. Cf. Spahn 1997 on Switzerland.

Historical trends in most *developing countries* were rather different. Before independence autonomous clusters of local governance and entrepreneurship faced serious challenges. Some fell early under the control of the dominant pre-colonial ruling class or were forcibly integrated into larger entities by the colonial powers. After independence state-led development was the priority in many countries and governments expected development to be promoted both through strong, centralized bureaucracies and large-scale private or public enterprises. Supported by Soviet experiences, many newly independent countries believed centralized rule was essential to force unity among their diverse societies.

As central governments expanded local governments tended to be marginalized politically and economically. Local institutions and their capacity to plan and execute policies were undermined and the central state became increasingly remote from the rest of society. Public investment patterns discriminated against small and medium-sized private sector enterprises, contributing to the underdevelopment of local (horizontal) clusters of production and exchange that had provided such an important source of dynamism and flexibility in the industrial market economies. Yet as long as the center and state-led development was (or seemed to be) capable of allocating resources it created local constituencies that were committed to maintaining centralized governance. Local decision makers rationally preferred vertical relationships instead of seeking benefits from a horizontal mobilization of resources¹².

During the 1970s and 1980s the cumulative crises of debt and macroeconomic instability meant that old institutional arrangements and traditional ties to central governments began to weaken. Malfunctioning central governance and an incipient crisis of legitimacy coincided with demands from citizens and entrepreneurs for stronger local development (Fuhr 1992).

History suggests that initial conditions, in particular the presence of deconcentrated sources of power, broad-based control over property, and a dynamic local private sector, matter for the future success of decentralization. Consequently, decentralization may be quite a different process in many of today's developing countries.

Richer and larger countries tend to be more decentralized in terms of the share of subnational governments in overall public expenditures and revenues. In the aggregate, however, industrial countries have become slightly more centralized since 1974 (Table 1). This is especially true of Germany and the United Kingdom, while Australia, France, Spain, and the United States are continuing to decentralize central government functions to local levels. Developing countries, most of which went through the nation-building phase of development in the aftermath of colonialism in the 1950s and 1960s, have become more decentralized since the 1970s (Table 1). Striking examples include Argentina, Brazil, and Colombia. In both groups of countries decentralization has been significantly larger for expenditures than for corresponding revenues.

¹² See e.g. Haber (1992: 6, 12) for Mexico, and the literature reviews in Fuhr 1992, 1993, 1994.

Table 1: Changes in subnational finance in selected countries
(percent of expenditures or revenues for all levels of government)

| <i>Country</i> | <i>Subnational expenditures</i> | | | <i>Subnational revenues</i> | | |
|----------------|---------------------------------|------|-------|-----------------------------|------|-------|
| | 1974 | 1994 | Trend | 1974 | 1994 | Trend |
| Argentina | 25 | 45 | ↗ | 25 | 37 | ↗ |
| Australia | 47 | 49 | | 20 | 27 | ↗ |
| Brazil | 30 | 38 | ↗ | 23 | 25 | |
| Canada | 61 | 60 | | 39 | 44 | ↗ |
| Chile | 2 | 9 | ↗ | 2 | 5 | |
| Colombia | 25 | 33 | ↗ | 16 | 18 | |
| France | 18 | 19 | | 6 | 13 | ↗ |
| Germany | 44 | 40 | | 34 | 30 | |
| India | 45 | 49 | | 27 | 25 | |
| Indonesia | 11 | 15 | | 3 | 3 | |
| Iran | 1 | 5 | | 1 | 6 | ↗ |
| Malaysia | 18 | 14 | | 13 | 8 | ↘ |
| Romania | 16 | 10 | ↘ | 12 | 6 | ↘ |
| South Africa | 25 | 41 | ↗ | 4 | 11 | ↗ |
| Spain | 10 | 34 | ↗ | 5 | 12 | ↗ |
| Sweden | 44 | 34 | ↘ | 28 | 32 | |
| Thailand | 17 | 8 | ↘ | 5 | 5 | |
| United Kingdom | 33 | 28 | ↘ | 15 | 8 | ↘ |
| United States | 45 | 44 | | 33 | 36 | |
| Zimbabwe | 26 | 25 | | 24 | 15 | ↘ |

Note: Data are for all levels of government other than central government. Data include transfers from central government to subnational governments. Arrows indicate changes of 5 percentage points or more. Where data for 1974 or 1994 were unavailable (indicated by italics), data for the closest available year were used. Data for Germany for 1974 refer to the pre-unification territory. Source: IMF, GFS various years.

How to think about decentralization

As the above has made clear, what constitutes the best structure of intergovernmental arrangements will be highly country-specific. The „one-size-fits-all“ approach is as fruitless here as in other aspects of public sector reform. But a number of important analytical tools are available to guide reformers. The clearest, and most important, is

that public goods and services should be provided by the lowest level of government that can fully capture the costs and benefits (*'subsidiarity'*)¹³.

Applying this rule in practice is no simple matter. Table 2 gives an illustration of some of the demand and supply characteristics of goods and services which will be relevant to such decision. For some local goods, such as those with common property characteristics, organizations below the level of local government - such as forest or water user associations or NGOs - may be the most appropriate institutional mechanism for delivery. More generally, where preferences or demands are heterogeneous, local governments can better match supply to suit local tastes. Decentralized service provision can also enhance efficiency and inter-jurisdictional competition in supply, providing consumers (at least in theory) with the option to exit to other jurisdictions. Yet where there are economies of scale in the provision of services, or inter-jurisdictional spillovers on the supply side – as in the construction and maintenance of interurban highways, for example – or minimum standards (primary schooling) and other consumption externalities on the demand side, centralized control is likely to be preferable¹⁴.

Table 2: Demand and supply factors influence the level at which public goods are provided

| <i>Level of public provision</i> | <i>Demand-side factors</i> | <i>Supply-side factors</i> |
|----------------------------------|---|--|
| Local | Variation in local taste (street lighting, zoning) Common property (urban roads, waste disposal) | Potential for competition between jurisdictions (police protection, road maintenance) |
| National | Spatial consumption externalities (control of epidemics) Equity concerns (minimum standards for primary education) | Economies of scale (defense) Cross-jurisdictional externalities (interurban highways) |

Matching services to local preferences can lead to lower transactions costs (particularly information costs), efficiency gains, and incentives to local economic development¹⁵. But even where a service might, in principle, seem a candidate for local provision, the benefits and costs of decentralization will vary by setting. And

¹³ On *'subsidiarity'* in decentralization policies see Simon, Stockmayer, and Fuhr 1993.

¹⁴ Cf. on this debate Prud'homme 1995, and McLure 1995; more broadly Ostrom, Schroeder, and Wynne 1993 on options for decentralizing infrastructure services.

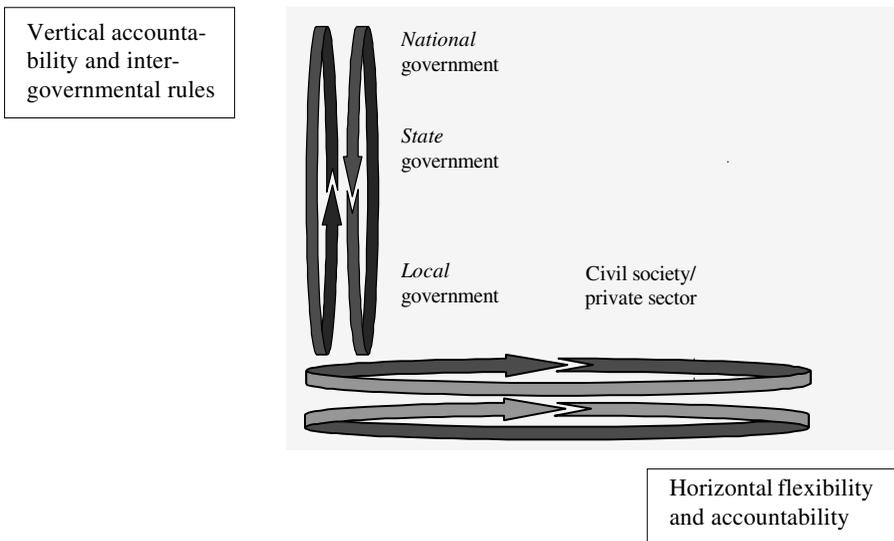
¹⁵ See more broadly on this subject: Stiglitz 1977, Oates (1972: 3-21).

experience suggests that it is unlikely to work unless there are effective institutional arrangements to foster accountability at the local level, and fiscal restraint between local and national governments. This is best explained in terms of two separate but interrelated sets of relationships facing local governments, both of which need to be considered in gauging the scope for decentralization.

The first are *horizontal* relationships between local government and citizens, NGOs, and private businesses. Institutional arrangements can create, or effect such relationships, for example in local elections or referendums, providing incentives for cooperation, accountability, and local government performance.

The second set of relationships is *vertical*, between levels of government. Most countries have institutional arrangements that define the role and functions of each tier of government, particularly in intergovernmental fiscal relations. Vertical rules *and* horizontal incentives are essential if local governments are to perform their functions well (Figure 1). The next section discusses some of the ways in which horizontal relationships can encourage local governments to enhance responsiveness, mobilize resources, improve service delivery, and stimulate private sector development.

Figure 1: Vertical rules and horizontal incentives shape the capability of local governments



The benefits of improved local accountability and incentives

Citizen participation. In theory, decentralization can strengthen and complement the measures to broaden participation in development. Like them, it can help guard against majoritarian tyranny by moving government closer to people and facilitating local definition of issues and problems, especially by minority groups. The contrasting situations of Oaxaca and Chiapas, two of the poorest states in Mexico, provide a telling example of these effects at work. Each has similar resource endowment and development potential and a high percentage of poor and indigenous populations, but the outcomes of antipoverty programs are generally regarded as good in Oaxaca, while neighboring Chiapas has a bad record. The difference seems to come from the degree of participation in policy decisions and implementation. Oaxaca has a long tradition of participatory mechanisms for indigenous populations and the poor. In Chiapas the denial of such options, coupled with widespread official corruption, has led to poor services and rising tensions, including armed conflict since early 1994¹⁶.

Where public office is contested and people can participate and decide on representatives at different levels of government, the number of political choices citizens can make also increases, thus stimulating competition between governments. Local participation can also mean greater confidence in and acceptance of policy decisions by constituents. Decentralization can therefore increase local options for policy-making while holding local officials accountable for what they do and how they do it.

Recent evidence from Latin America, particularly Colombia, suggests that once local policymakers are held accountable for their actions and made aware that their jobs depend to a large extent on citizens' assessments of their performance, they tend to be much more concerned with the quality of their staff and tools they have to run their offices effectively. In Porto Alegre, Brazil, an innovative process of public investment planning and management was launched in 1989 to mobilize citizen groups to take part in the process of municipal budget formulation. In 1995 some 14,000 people were engaged in the budget formulation process through assemblies and meetings. Indirectly, an estimated 100,000 people were linked to „participatory budgeting“ through local associations and popular organizations¹⁷.

Environmental problems in Troyan, Bulgaria have compromised the city's natural beauty, economic prosperity, and community well-being. The Troyan Environmen-

¹⁶ World Bank/IDB field research in 1996; report 'Mexico. Southern States Initiative' (Washington DC: The World Bank/ Country Department II). On Oaxaca see in particular Fox and Arranda 1996; on Chiapas Harvey 1995.

¹⁷ See World Bank 1995a on Colombia; Merino 1994 with case studies on Mexico; Campbell and Fuhr (forthcoming) with case studies on Valledupar/ Colombia by Alberto Maldonado, and on Puerto Alegre/Brazil by Zander Navarro. For a particularly interesting case of municipal reform with a variety of new participatory arrangements see (on Ceára/Brazil) Tendler 1997.

tal Action Project was created to improve the environmental management capacity of the municipality by introducing a risk-based planning model that integrates comparative risk assessment with participatory decision-making methods. The overall goal of the project was to engage citizens in a participatory process that identified, analyzed, and ranked environmental problems and lead to the design and implementation of environmental action strategies to address priority problems¹⁸.

In a pioneering case in Recife, Brazil, where the introduction of low-cost condominium sewers in low-income neighborhoods changed the relationship between the state agency and the sewer users, it took two years for public officials, working intensively and in multidisciplinary teams with residents, to figure out how to make the condominium sewer system work¹⁹. Even once the process was better understood, successful implementation took another four to six months in each neighborhood. An evaluation of the project showed, that by fostering an active and vocal constituency, the scheme not only generated considerable savings, it also put in motion mechanisms for accountability that were critical for good local agency performance.

Better administrative capacity and better mobilization of local resources. If people can choose and/or articulate their concerns effectively political competition imposes some discipline on governments. Incompetence is usually punished and performance is likely to be rewarded. In addition to providing better chances for accountability, participation thus critically influences behavior within local public institutions. Increased local participation has provided important incentives for decision makers to adopt innovative strategies in administration and management.

Before electoral reform in 1986, mayors and governors in Colombia were largely appointed. Reform completely changed the incentives facing policymakers. Instead of being rewarded for their execution of set policies, officials were held accountable for their performance by voters. Within a few years, mayors' behavior changed dramatically. Capacity building and strengthening of core governmental functions, particularly in financial and human resources management, became the areas most frequently addressed. Incentives to mobilize local resources often developed subsequently²⁰.

In Quito, Ecuador, a prolonged fiscal crisis in the late 1980s provided incentives to mobilize local resources in several areas. Rejecting an internationally financed offer to update its municipal cadasters through high-tech aerial photography the city

¹⁸ Information provided by World Bank staff (Bulgaria country department), and Agenda 21 information. Similar lessons for urban environmental management (also urban environmental assessments) through better citizen participation e.g. in Curitiba/Brazil and Colombia (cf. Tlaiye and Biller 1994, and Partridge 1994).

¹⁹ There is ample literature on the benefits of participation in urban water and sewage management, see e.g. Serageldin 1991 on Recife, and other cases.

²⁰ Results of field research for Campbell and Fuhr (forthcoming). On this issue in decentralization in Colombia cf. in particular Collins 1988, Wiesner 1992, and World Bank 1995b.

government opted for a low cost home-grown alternative. Local civil servants were involved in updating cadasters by visit and revise activities, while the budget office designed a simple but very effective integrated financial management system that allowed for close monitoring of urban revenues and expenditures. Relying entirely on local staff and knowledge Quito's local government not only achieved a full consolidation of its budget within three years, it also exported its adapted financial management tools successfully to neighboring countries.

Similar approaches to improve financial and human resources management are top priorities in local governments in many industrial countries, including successful cases such as Neuchâtel, Switzerland (organization and management reforms); Delft and Tilburg, Netherlands (information management, results orientation, and performance management); Duisburg, Germany (human resource management); and Hämmenlinna, Finland (organizational reforms and performance management)²¹.

Local service provision. Many governments have responded to fiscal crises, the availability of new technologies and citizen concerns by decentralizing service provision, especially in education and health, to local authorities. In many cases, this has given rise to new and often creative arrangements between local governments, NGOs and local businesses. While relatively little comparative evidence is available to evaluate the relationship between decentralized governance and service quality, some recent examples from Latin America and Asia are illustrative. In the 1980s, the primary education system in the state of Minas Gerais in southeastern Brazil, faced many of the problems common to education systems in developing countries: high repetition rates, low graduate rates and low achievement scores. Contributing to these problems were overregulated and centralized management, inadequate funding and poorly trained teachers. In the 1990s, a series of measures including autonomy to elected boards in each local school (composed of teachers, parents and students over sixteen), and grants from central government based on enrollment and special needs, have produced some encouraging early results: including a 7 percent increase in achievement scores in science, 20 percent in Portuguese and 41 percent in mathematics²².

In Teocelo, Mexico, decentralization has created opportunities to organize resources for health in a more efficient way by identifying the population's needs and designing strategies to foster participation through community organization and health education. Coverage of the population increased in both preventive and curative care, the quality of services improved enormously and infant mortality rates fell. In

²¹ There is an international network for better local government ('Cities of Tomorrow') financed by the German Bertelsmann Foundation with international research, analysis of good practice cases, and an annual award. Cf. Bertelsmann Foundation 1993.

²² Cf. on decentralization in the education sector: Fiske 1996, Bray 1996, Winkler 1997. Information on Minas Gerais/Brazil provided by World Bank staff (Alcyone Vasconcelos), and Guedes et al. 1997.

addition, users of health facilities reported that the attitude of health personnel and the quality of services had improved greatly²³.

A self-help initiative in Karachi, Pakistan focused on upgrading the neighborhood sanitation system. With small investments of less than US\$40 per house, the Orangi Pilot Project, founded and assisted by an ex-civil servant with support from the BCCI foundation and strong involvement of the community, has worked lane by lane since 1980. Since then some seventy percent, or 6,300 lanes, have been linked to the sanitation system. Neighboring alleys still have garbage-strewn open sewers²⁴.

Local economic development. Local private sector participation can also play a crucial role in decentralization, shaping incentives at the local level. As mentioned earlier, entrepreneurs strongly influenced the pace of development and intergovernmental relationships in industrial countries. Property-owning classes which had command over local resources exercised considerable pressure on public entities. To spur expansion, private actors and public officials were encouraged to cooperate. Many of these growth processes began in local environments. Members of the business community often participated in local parliaments (cf. Stein 1957). Provided that rent-seeking is minimized by effective competition policies – a function for higher levels of government – a strong local private sector may promote better administrative performance. And local governments that provide and maintain credible frameworks for local economic development end up promoting private investment that, over time, increases local government revenues²⁵.

World over there are many examples of local governments affecting local economic development and decentralized institutional arrangements contributing to growth. The small cities of Greenville and Spartanburg, South Carolina, have the highest foreign investment per capita in the United States. They are host to 215 companies, from eighteen countries, seventy-four of which are headquartered there. Visionary decision makers with a strong private sector approach to local development have established a solid base of innovative small and medium-size enterprises that employ a workforce whose skills are regularly upgraded (Kanter 1995).

On the other side of the world, the city government of Wuhan, in central China, decided in the early 1990s to transform the old city and build a new one on a large scale. To this end, they relaxed controls on foreign investment in two development zones, opened a third, passed local regulations to supply foreign investors with a legal foundation, strengthened the management of real estate and land rentals, and undertook several infrastructure investments to improve the hard environment for foreign investment. As a result, in 1992 alone the number of foreign projects approved for the city was more than two and a half times the total for the previous eight years

²³ Information on Teocelo provided by World Bank staff (Armin Fidler).

²⁴ See the report in Time (11 January 1993).

²⁵ On relationships between small and medium-sized enterprises and local governments in Japan see e.g. Kitayama 1993.

with a threefold increase in total capital. Not satisfied, the city government organized a huge investment promotion mission in 1993 that garnered agreements worth US\$5 billion from Singapore and Hong Kong²⁶.

Effective networks between regional and local government entities and local businesses have been established in Andalusia, one of the poorest regions in Spain. Founded by the regional parliament, the Institute of Industrial Promotion of Andalusia (IPIA) seeks to promote small- and medium-size locally owned industrial enterprises. By involving the stakeholders of a key set of industries in formulating and implementing a competitive strategy and establish links to public and private financial institutions. The strategy has been extremely successful in enhancing the competitiveness and expanding e.g. the marble industry in Macael (Barzelay 1991).

Despite such encouraging cases, experience suggests that successful decentralization may be short-lived, or difficult to replicate unless there are effective rules for intergovernmental collaboration. Horizontal incentives for improved performance tell only part of the story. In education, for example, higher levels of government may be needed to prevent fragmentation and to minimize differences in the quality of education in different communities. And in the health sector, the appropriate allocation of responsibilities across levels of government is rarely clear-cut. Immunizations, tuberculosis surveillance, and vaccine storage all need strong effective management from higher levels of government. In addition, localities may not provide the right framework for policy formulation and implementation.

Consequently, the impetus should be, not rigidly pushing functions down to communities and municipalities and artificially separating levels of government, but finding the *right balance* between the roles of different governmental levels to ensure that high-quality services are provided in a timely manner. As the following sections describe, the search must take place within a framework of credible rules, and incentives provided by such rules.

The pitfalls of decentralization

In many cases decentralization is not the result of any carefully designed sequence of reforms. Often it has occurred in politically volatile environments in which the level of trust is low and policymakers respond unsystematically to emerging demands from below. Such weak policy frameworks can lead to serious economic problems, including loss of macroeconomic control, regional disparities and inequalities in service provision, and misallocation of resources as a result of local capture. The lesson, for all governments, is that there must at any given time be *clear rules* specifying the range of responsibilities for each level of government.

²⁶ Specific information provided by a World Bank study on Wuhan/China (by D. Solinger) and by World Bank country economist for China (Vikram Nehru). On the subject of 'market-preserving federalism' that currently boosts local performance, particularly in China's coastal provinces see e.g. Montinola, Qian, and Weingast 1995.

Macroeconomic dimensions of intergovernmental finances

Macroeconomic control is regarded as a function of the central government. Centralization, or strong central guidance, in budget and financial matters was critical in ensuring sound public finances and a reliable framework for economic development in most industrial economies. Because decentralization increases the number of actors and budgetary accounts, countries facing serious budgetary and inflationary pressures are confronted with additional challenges and risks in embarking on decentralization. Intergovernmental fiscal relations mainly affect the macroeconomy through three channels: the assignment and sharing of tax bases and expenditures, the match of tax and expenditure decisions, and levels of subnational borrowing. Each channel provides a specific set of incentives for government decision makers²⁷.

Assignment and sharing of major tax bases and expenditures

Serious macroeconomic imbalances can occur if major tax bases are inappropriately assigned. In India, for example, important tax bases have been assigned to subnational governments while the central government, with a growing public debt and pension liabilities, has but a small and inefficient tax base, consisting mainly of income, foreign trade, and excise taxes. The sharing of major tax bases also has the potential to reduce the magnitude of deficit reduction at the central government level. This happened in Argentina in the early 1990s when increased tax revenues following a tax reform had to be shared with provincial governments. Provincial governments essentially took a free ride on central governments' tax efforts and used the extra revenue to expand their civil service.

Expenditures with national benefits and costs - national public goods - should be the responsibility of the central government. These include the costs of economic stabilization and redistribution. But many local expenditures also affect income distribution, such as residential zoning laws in industrial countries and the provision of health and housing subsidies in transition economies and many developing countries. In addition, because the benefits of local public expenditures tend to be concentrated in the jurisdiction of subnational government, while the costs are spread across the nation, subnational governments have an incentive to spend beyond their means and to shift the financing costs to other subnational governments. The effect on national fiscal policy can be severe.

Subnational borrowing

Borrowing by local governments can contribute to macroeconomic instability when the central government fails to impose hard budget constraints and there is no effective mechanism for monitoring debt obligations, particularly when there are multiple lenders. There is also the problem of asymmetric information on the part of borrowers

²⁷ See recent conference publications on the subject: Dillinger, Perry, and Webb 1999, Bird 1999, and Ter-Minassian 1997b and Tanzi 1995 for an overview.

(subnational governments) and lenders (central government and international capital markets). In China, for example, provincial governments are not allowed to run budget deficits and finance them through borrowing. But in the early 1990s all but uncontrolled borrowing by state enterprises at the subnational level contributed to economic overheating and imperiled overall stability (Box 1). In Brazil, the states have a debt exceeding US\$100 billion, close to the levels of total federal and central bank debt. Unless the growth of debt is curtailed, the federal government will have to reduce its own spending, raise taxes, or resort to inflationary financing to cover subnational indebtedness.

*Box 1: Pitfalls to avoid in intergovernmental relations: the experiences of Brazil and China*²⁸

Democratization and constitutional revisions in the 1980s increased the amount of resources under subnational control in Brazil and the degree of local autonomy in their use. Local governments now account for half of total public spending.

Although decentralization shifted resources downward, there was no corresponding clarification and expansion of local responsibilities. Subnational governments were not prepared to assume new tasks, and were neither required to perform specific functions nor prohibited from performing functions already performed by other levels of government. As a result local governments used much of their windfall to increase staffing and launch questionable new projects. There is scant evidence that the overall efficiency of public sector spending improved. Decentralization also increased the fiscal deficit as major states used their improved political autonomy to extract federal resources: by the mid-1990s nearly a third of the growing federal deficit was due to subnational debt.

Brazil's experience shows that political and fiscal decentralization do not guarantee improvements in public sector efficiency and may threaten macroeconomic stability. To achieve its objectives, fiscal decentralization must be accompanied by a corresponding decentralization of expenditure responsibilities, state and municipal governments' institutional capacities should be improved, and the federal government should impose hard budgets in its fiscal and financial relationships with subnational governments.

China's experience in the early 1990s demonstrates the pitfalls of decentralization that is not accompanied by parallel reforms and macroeconomic safeguards. Since 1978 central authority over investment and allocation decisions had been gradually decentralized to provincial governments, enterprises, financial institutions, and even households. This was a crucial element of China's economic liberalization and a key factor in the economy's impressive growth over the past two decades. At the same time, however, three consequences of decentralization undermined the central government's control over macroeconomic aggregates:

- Government revenues as a share of GDP declined precipitously. In contributing to increased industrial competition decentralization helped lower the profits of in-

²⁸ Information for Box 1 was provided by William Dillinger and Vikram Nehru.

dustrial state enterprises, previously the main source of tax revenues. Increasingly autonomous local governments reduced revenues even further by granting tax exemptions to improve the after-tax earnings of the state enterprises under their control.

- The growing autonomy of local governments made it difficult for the central government's investment planning system to control the investments of provincial governments and state enterprises under their control. Since tax revenues at the provincial level had declined and were inadequate to cover these investments, local branches of the state banks were usually prevailed on to lend for these projects.
- Local branches of the Central Bank were given discretionary authority over 30 percent of the Central Bank's annual lending to the financial system. When local branches of the state bank needed additional resources to support investments by local governments and state enterprises, they turned to the local branch of the Central Bank for an infusion of liquidity.

The resulting overheating of the Chinese economy in 1992-93 posed considerable risks to stability. Inflation climbed to its highest point in several decades. Real GDP growth reached an amazing 14.2 percent in 1992 and 13.5 percent in 1993. Eighty percent of growth came from growth in investment, most of it by state enterprises under the supervision of provincial governments.

The authorities responded quickly with a combination of measures. The most important of these were administrative restrictions on investments by provincial governments and state enterprises and a reassertion of authority by the Central Bank over lending to state banks. These measures and others helped navigate the economy to a soft landing. By 1995 inflation had fallen below 7 percent, while GDP growth had been maintained at around 9 percent.

All three channels can lead to undesirable macroeconomic outcomes. But some of the channels are quantitatively more important in some countries than in others. Whether they generate macroeconomic instability will depend on the relative importance of each channel, the relative strength of central and local government policy-making and implementation and the central government's overall macroeconomic objectives, such as growth and price stability.

Regional disparities and inequalities in service provision

Rough national equality in living standards and in access to public services is an overarching goal – even a constitutional mandate – in many countries (Fuhr 1999). Centralization allows the national government more discretion to counter regional income disparities by managing regional differences in levels of public service provision and taxation. With decentralization, an equal outcome can no longer be guaranteed, or at least, may be difficult to achieve. And wealthier local governments and regions may benefit disproportionately from being given greater taxing power.

In China, for example, provincial disparities in real per capita incomes have been growing in recent years²⁹. Per capita income in the richest province, Guangdong, is now four times greater than that in the poorest, Guizhou. Some provinces on the southern coast, such as Fujian, Guangdong, and Hainan, have done better than the western, interior provinces largely because of their central location for transport and communications and their proximity to Hong Kong. These natural advantages have been reinforced by official policies that favor coastal provinces, including tax breaks to foreign investors locating in special economic zones near the coast, large allocations of credit (relative to population) through China's government-directed banking system, and registration requirements that discourage the poor from migrating to the booming coast.

In Russia income inequality across *oblasts* is high. Regional inequalities as measured in per capita expenditures were estimated to have risen to 1:7 by 1992, with better-off regions having disproportionately high budgetary expenditure allocations and rural areas relatively ill-served. Subnational taxation or sharing of federal revenues from natural resources on an (origin) derivation basis could create even larger fiscal disparities among subnational governments (McLure 1994: 188-191). Both Russia and China's experiences highlight the need to design appropriate equalization schemes to deal with rising inequality during periods of accelerated growth or macroeconomic stabilization.

Resource misallocation as a result of local capture

Economic and financial distortions may also arise from subnational governments' ability to exploit weaknesses at the center. In the absence of agreed intergovernmental rules, local units may benefit from sources of income (rents) that have not been formally distributed under an appropriate fiscal decentralization scheme³⁰. In Poland, for example, the development of self-government at the local level has seen many local authorities begin to act like pressure groups, with a strong inclination to extract more benefits from the government for local clienteles. As a consequence inequalities have risen among jurisdictions, leading to new forms of social conflict (Letowski 1993).

In Pakistan decentralization has been accompanied by the subtle politicization of intergovernmental relationships. Provincial governments, which have expanded their roles in the provision of education and other local public services since the 1960s, have increasingly adopted intrusive, centralist behavior toward municipal governments. Instead of being encouraged to assume new tasks and responsibilities, municipal governments are being denied opportunities to succeed while Pakistan's intermediate level of government benefits from a halfway approach to decentralization.

²⁹ World Bank (1995c: Ch. 2), Agarwala (1992: 18, 73), and Ma (1996: 5-30, 42).

³⁰ E.g. for Brazil see World Bank (1995d: 45).

Industrial countries with decentralized mechanisms have a strong legal framework which ties subnational governments to credible rules and, often, mechanisms to counterbalance negative outcomes such as fiscal transfer policies and equalization schemes, hard budget constraints, and limitations on local borrowing. Some countries have experimented with participatory mechanisms (for example, blue-ribbon commissions) which bring stakeholders together and provide options for feasible and manageable policies within a mutually agreed timeframe.

Lessons for successful decentralization

Ideally, policymakers would embark on decentralization by gradually phasing in the reassignment of expenditure authorities and responsibilities and the reassignment of revenue authorities in ways that are compatible and consistent with previously defined expenditure needs and responsibilities. At the same time, they would develop a system of intergovernmental grants to cover fiscal gaps between expenditures and revenues at the local level and to correct imbalances in efficiency and effectiveness, preferably with built-in incentives for local resource mobilization³¹. So much for the ideal. The real-life business of designing a successful decentralization program tends to be more complex.

Assigning expenditure and revenue authority

Assigning expenditure and revenue authority brings a slew of problems. Information on the true distribution of benefits and taxes - within and between jurisdictions - is imperfect. And economies of scale in revenue collection and in the production of services may partly negate the efficiency advantages of a decentralized system. In addition, the costs of alternative options for service production are often unknown. Possible tax and expenditure assignments are shown in Table 3. Since there may be limited country specific experiences in such assignments, careful experimentation can help. The outcome of such process may, eventually, be rules that - while remaining credible and accepted - need to be flexible, and to be adjusted over time.

³¹ See e.g. on these issues and policies Shah 1994, Winkler 1994, Ter-Minassian 1997a.

Table 3: Possible tax and expenditure assignments by level of government³²

| <i>Central government</i> | <i>State government</i> | <i>Local or provincial government</i> |
|---|--|--|
| <i>Revenues</i> | | |
| Value added tax | Individual income tax | Property taxes |
| Individual income tax | Surcharges on national taxes | Vehicle taxes |
| Corporate income tax | Retail sales taxes | User charges |
| Excise taxes | Excise taxes | Licenses and fees |
| Natural resource taxes | Property taxes | |
| Customs duties | Vehicle taxes | |
| Export taxes | | |
| <i>Expenditures</i> | | |
| Tertiary health care (control of infectious diseases, research) | Secondary health care (hospitals, curative care) | Primary health care |
| University education | University and secondary education | Primary and secondary education |
| Roads and highways (intercity) | Roads and highways (intercity) | Roads and highways (intracity) |
| Public transportation (intercity) | Public transportation (intercity) | Public transportation (intracity) |
| Natural resources management | Air and water pollution | Air and water pollution |
| Defense | Natural resources management | Solid waste disposal, water, sewerage, fire protection |
| | Police protection | Land use regulation and zoning |
| | | Housing |
| | | Cultural policy |
| | | Promotion of tourism |
| | | Police protection |

³² Information and summary table provided by Roy Bahl (cf. Bahl 1994).

Designing intergovernmental grants

Intergovernmental grants are important sources of revenue for many subnational governments. Between 1970 and 1992 grants from the central government financed 64 percent of expenditures by local governments in Brazil. In South Africa, grants from central government to newly elected provincial governments account for about 90 percent of total revenues of the provincial governments³³. By their nature intergovernmental grants tend to divorce local spending from local resources, and the benefits of providing local public services from the costs. The separation of benefits and costs and the limited ability of local governments to mobilize revenues for themselves can reduce the transparency of the local budget-making and the accountability of local governments to local citizens, leading to inefficient and inequitable delivery of public services. Clearly, then, any system of intergovernmental grants in developing countries will need to be designed extremely carefully.

There is no blueprint for the optimal system of intergovernmental grants, but a good system of intergovernmental grants should have certain characteristics. Above all, it should be predictable and transparent, and provide sufficient incentives for mobilizing local resources³⁴. Systems that are based on a solid consultation process with stakeholders are more likely to be sustainable than the one simply imposed 'from above'. Although, in most instances, it is the national and federal government that will play an important role in ensuring that rules for intergovernmental grants are developed, and employed effectively.

Agreeing on the right approach

Clear-cut rules are essential for imposing restraints on actors at each level of government. Equally important seems to be the *process* by which rules are agreed on. While in principle, rules could be imposed from the top-down to restrain arbitrary action of all participants, experience suggests it is difficult to force agreement and that the result may not be sustainable. This is especially true of developing and transition economies. Lessons from a variety of countries indicate that key policy decisions are more likely to be sustained when they are based on a broad consensus among stakeholders. Thus, decentralization is more likely to be successful with institutional settings and processes that allow for articulation of interests and consensual policy-making, for example, as spelled out in the European Charter of Local Government of 1985.

In the absence of agreed-on guiding principles, what can governments committed to decentralization do to get the process started? There are some country models. In the early 1990s the government of Uganda established a consultative process with different stakeholders – community groups, agricultural producers, government

³³ Data extracted from IMF (various issues) Government Finance Statistics (GFS); on Brazil cf. World Bank 1995d.

³⁴ Cf. in particular Shah 1994, Winkler 1994.

representatives – to decide on the best way to proceed with decentralization. The result was a decision in favor of a staged and gradualist approach. Other countries have opted for commissions made up of informed leaders from different levels of government, ministries, academia, and sometimes unions and business associations, drawing on foreign advice where necessary. South Africa's recent experience is interesting in this respect. The new constitution calls for a fiscal commission to deal with the intergovernmental structure of the country. The president, in charge of setting up the commission, provided different representatives with a constitutionally guaranteed forum for articulating their interests. Although too early to judge its success, the process created a widespread sense of expectation, and demands to design appropriate measures of decentralization (Swilling 1996).

Commissions may serve short-term interests well. Over the longer term, however, more durable solutions may be needed to allow for formal representation of sub-national governments' interests in national policymaking and legislation. Second chamber institutions, such as the 'Bundesrat' in Germany, have often been used in this context. Such arrangements provide an institutionalized mechanism for articulating interests from below while providing the means to develop the widely accepted and credible rules for intergovernmental collaboration which are essential to sustainable decentralization. They also help different tiers of government adjust to emerging needs over time (cf. Fuhr 1999: Ch. 5).

...and ensuring the institutional ground is ready

In principle, bringing policymaking and implementation closer to the communities they serve and involving citizens in shaping policies lead to accountability and improved local checks and balances. But as the discussion of the potential for macroeconomic instability shows, government actions at the center can be undermined by local activities if there is no strong pattern of fiscal restraint and enforceable rules that control tiers of government as well as intergovernmental relations. In most federalized systems effective checks and balances between lower and higher levels of government have evolved over a long period of time. What history tells us, paradoxically, is that unless states have achieved a certain level of centralization and effective rules - for overall macroeconomic control and sound policymaking - decentralization may be difficult to implement and may create imbalances. Decentralization, whether through process or design (or both), can create additional momentum for development, but only if these conditions are met.

Any strategy of decentralization must begin with an assessment of institutional capacity and capability at the various levels of government (Table 4). Where there is weak central government capacity to manage overall fiscal and monetary policies, to enact and enforce credible rules guiding intergovernmental affairs, or to provide a framework for bringing stakeholders together, successful decentralization will be hard to pull off. Strongly polarized relationships between or within tiers of government and extremely weak organizational capacity at the subnational level will also be

cause for concern. In these circumstances policymakers would do well to postpone decentralization, or eschew broad strategies in favor of a more carefully staged or sectoral approach³⁵. Decentralization might begin, for example, with priority areas as education, health or infrastructure. Strong monitoring mechanisms could provide opportunities for learning and for gradually phasing in new policies. Countries that have better capabilities at the central and local levels have more options to play with – but their preferences will vary. What may be important in one country (say, decentralized service delivery) may not be desired (or desirable) in others.

Table 4: Matching decentralization strategy to government capacity

| <i>Local government capacity</i> | <i>Central government capacity</i> | |
|----------------------------------|--|---|
| | Low | High |
| Low | Cautious decentralization strategy with pilot testing | Deconcentration of some priority services |
| | Delegation of some key functions to NGOs and communities | Delegation of some service functions to NGOs and communities |
| | Massive institutional strengthening at both levels, particularly in public finances (most Sub-Saharan African countries) | Targeted strengthening of local entities during transfer of responsibilities (e.g., Hungary, Mexico, Thailand) |
| High | Separatist or secessionist tendencies | Delegation or devolution of functions according to government priorities and preferences as well as articulated needs (most industrial countries) |
| | Delegation or devolution according to priorities of governments (e.g., Santa Cruz province, Bolivia; parts of former Soviet Union) | |

³⁵ Such multi-level policy assessments – and options for policy advice – are currently part of a joint research project with GTZ (the Potsdam team includes Christoph Reichard, Astrid Harnisch, Frank König, Heiko Nitzschke, Heike Scherff, and Kristin Vorpahl).

Strategic options for phasing-in decentralization

The evidence presented in this paper has shown that decentralization is part of a broader strategy to improve the capability and effectiveness of the public sector. Such strategy encompasses mechanisms to increase openness and transparency, to strengthen incentives for participation in public affairs, and, where appropriate, bringing government closer to the people and to the communities it is meant to serve. Building public sector capability in this way will take time, and careful attention to the potential dangers: efforts to open up government to a broader array of needs and interests will not improve effectiveness, or accountability, if they help to shut other groups further out. But the experience of governments the world over suggests some clear starting points:

- Work to ensure broad-based public discussion and evaluation of key policy directions and priorities. At a minimum this means making available information in the public interest and establishing consultative mechanisms such as advisory councils, deliberation councils, and citizen committees to gather the views and preferences of affected groups.
- Encourage, where feasible, the direct participation of users and beneficiary groups in the design, implementation, and monitoring of local public goods and services. Enhance the capacity and efficiency of local organizations and institutions rather than replace them.
- Where appropriate, adopt a carefully staged or a sectoral approach to decentralization in priority areas. Introduce strong monitoring mechanisms and make sure that sound intergovernmental rules are in place to restrain arbitrary action at central and local levels.
- At the local level, focus on the processes (and horizontal incentives) for building accountability and competition. Where local governments are weakly accountable and unresponsive, improving both horizontal and vertical accountability will be a vital first step to achieving higher state capability.

There are always some dangers inherent in a strategy of greater openness through decentralization. More opportunities for voice and participation increase the level of demands made on the state, which can increase the risk of gridlock or of capture by vocal interest groups. And if there are no clear-cut rules to impose restraints on different tiers of government and incentives to encourage local ('vertical') accountability, the crisis of governance that afflicts many centralized governments will simply be passed down to lower levels. Such obstacles on the path to reform of the state are not insurmountable. The first step toward decentralization will be making the objectives of reform clearly intelligible to citizens and the business community. Such process orientation in communication and consensus-building will have a double benefit, increasing the support for reform as well as arming the government with a better sense of how to do it right.

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