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Opportunities and Risks of Fiscal Decentralization: A Developing Country Perspective

Roy Bahl

Since the 1980s, the rhetoric of fiscal decentralization has taken root in developing countries. Most developing countries now place the strengthening of subnational government on the development policy agenda. Despite all the pronouncements, plans, and even political promises, however, there has been no rush to grant state and local governments significant taxing powers and increased expenditure autonomy. Perhaps economic conditions have not been right for countries to adopt all-encompassing decentralization schemes, perhaps political freedoms were too new in some cases, or perhaps the idea still takes some getting used to. Whatever the reason, signs that countries are now ready to move forward with implementing fiscal decentralization continue to appear.

Many analyses attest to the efficacy of fiscal decentralization as a policy strategy.[1] Most existing research focuses on evaluating decentralization experiences from around the world and looks for the links between theory and practice. Much less attention has been given to implementation strategies (Bahl 1999b). This chapter offers some guidelines for both design and implementation—beginning with a discussion of the rationale for fiscal decentralization—by analyzing objectives, opportunities, and risks that should lead the design of a decentralization program.

1. Among them are Bahl and Linn (1992); Bahl and Martinez-Vazquez (2006a, b); Bird and Vaillancourt (1998); Dillinger and Webb (1999a, b); Litvack, Ahmad, and Bird (1998); and Tanzi (1995).

What Is Fiscal Decentralization?

"The empowerment of people by the empowerment of their local governments" is offered here as a working definition of fiscal decentralization. The key term is "local government." Fiscal decentralization is about a central government passing budgetary authority to subnational governments through the power to make taxing and spending decisions. In this chapter, fiscal decentralization means transferring fiscal power to any level of government below the center, such as states or provinces, cities or districts, and even fourth-tier local governments.

What is not included in this definition of fiscal decentralization? The deconcentration of decision making and service delivery powers within a ministry would not count. Deconcentration decentralizes administration and management, and even some decision making. Although deconcentration could be used to gain inputs about needs and demands particular to a local area, higher-level government retains the dominant voice in local planning committees, even when elected local officials are given a seat on such committees. Deconcentration of this kind does not empower the local population. Nor would we count the delegation of service delivery powers to community interest groups or nongovernmental organizations (NGOs). Although these units may be locally based, they are not empowered by vote of the entire community, nor are they accountable to the local population. To be sure, the community-centered, informal organization approach can enhance the probability of successful decentralization by providing a lobby voice for local interest groups. Often, it can enable an otherwise disenfranchised group to gain a voice in governance. In no way does it substitute for representative local government, though. Another version of "private decentralization" would allow community groups (neighborhoods) to select their own package of public services. In developing countries, this approach might draw significant resources away from the local government budget and compromise its ability to allocate resources according to voter preferences.[2]

One gray area to consider is where subnational governments are not elected, as in China. In this case, local populations cannot use the vote to hold central officials accountable. Subnational governments, however, are empowered with some budgetary discretion, and the appointed political leadership does respond

2. In some higher-income countries, the decentralization of decisions regarding collective goods might extend even further, as it has with private community associations in the United States. These associations, governed by officers elected by the community group, ensure that the preferences of very small groups of homeowners are honored by covenants. Approximately 20 percent of the U.S. population now lives in some form of community association. Nelson (see chapter 13) argues that these community associations are fast replacing traditional local governments in parts of the United States as the unit responsible for delivering some local services. Governments in some less developed countries are attracted by the community development model. In Pakistan, for example, community groups exercise a degree of control over a share of the budgetary resources of the general local government.

to local preferences. In fact, China is a good case in point. In the significant intergovernmental fiscal reforms enacted since the 1980s, the central government was constrained in its choices by the need to appease the coastal provinces (Bahl and Martinez-Vazquez 2006b). Moreover, provincial-level officials regularly act in the self-interest of their provinces, such as by enacting protectionist policies, even when provincial policies might compromise national objectives.

A second gray area is the case of local governments with limited budgetary discretion. In many developing and transition countries, central governments limit local revenue powers and impose expenditure mandates to such an extent that even elected local governments become little more than spending agents of higher-level governments. Still, these local governments do have some discretion, they are technically accountable to the local population who elects them, and they have the potential to assume a greater degree of autonomy.

Why Fiscal Decentralization? The Rhetoric

There seems to be no uniform rhetoric about why a nation should adopt a fiscal decentralization strategy. The justification varies from country to country, and, not surprisingly, it usually matches up well with the problems the country is facing. Fiscal decentralization is often more a remedy than a development strategy. Russia's fiscal decentralization looks very much like one designed to head off separatist movements, and South Africa's transfer of decision-making power to more than 800 local governments is exactly what one would expect in the aftermath of apartheid. Advantages and disadvantages aside, various advocates see decentralization as primarily an economic, political, social, management, or even military strategy. The way these national leaders see it will drive the way they design it, which also explains why the rhetoric in support of fiscal decentralization is so varied and perhaps even why there is such a gap between the rhetoric and the reality of successful decentralization.

Many would like to believe that fiscal decentralization is an effective economic development strategy. Intuitively, the argument appears reasonable. The government closest to the local or regional economy is in the right position to decide matters such as the best regulatory environment for local business, the right infrastructure investments to make, the proper structure of taxation, and, in general, the enabling environment best suited to develop the local economy. Lady Ursula Hicks had this argument in mind in her 1961 book, *Development from Below*. Martinez-Vazquez and McNab (2000) develop the interesting point that the possible effects of decentralization on economic development are indirect, that decentralization directly affects technical efficiency, income inequality, and corruption, which, in turn, affect economic growth. The search for empirical evidence on the relationship between decentralization and economic development has not been conclusive, however (Davoodi and Zou 1998; Lin and Liu 2000; Martinez-Vazquez and McNab 2000; Zhang and Zou 1997, 1998).

The growing number of countries with democratically elected governments clearly has stimulated interest in decentralized government. Those interested in the politics of nation development would argue that this factor has been paramount in stimulating at least the rhetoric of and probably the demand for fiscal decentralization. It is not all rhetoric. Elected politicians at the subnational government level push hard for some powers to shape budgets, although they are much more enthusiastic about having power to spend than they are about having power to tax.

Centralization may be an inefficient management approach, especially in large countries. Fiscal management—that is, supervision of some part of the budgetary affairs of every subnational government—can become costly and lead to poor public service outcomes. It is especially troublesome in large countries. A relatively few central officials cannot make the important fiscal decisions for every local government on a case-by-case basis. There are too many complications, too many special circumstances, for this approach to be viable. China and India have populations in excess of one billion, and China has 58,545[3] subnational governments and India 237,687.[4] Brazil has a land area in excess of 8.4 million square kilometers, and Indonesia comprises 17,500 islands, of which 6,000 are inhabited. How could Russia, a country with 11 time zones, be managed efficiently from Moscow by a relatively few senior officials? As late as the mid-1990s, though, the budget of each of the 89 regional governments was being approved in Moscow on the basis of face-to-face negotiations. Some form of decentralized governance would seem an imperative in large countries.

The problems with centralized control are not limited to large countries. Even in small nations, poor transportation and communications networks can make the national capital very remote. In Nepal, for example, many of the 4,053 local governments are several days' journey from Kathmandu.

Fiscal decentralization is a strategy that sells because people want different things from their local governments. Centralization, on the other hand, implies a degree of uniformity in government services and in revenue raising. Enforced uniformity creates resentment, however, and various regions within countries have pushed hard for autonomy to choose a package of services that better fits their demands. Countries with variations among regions in language (India, Sudan), ethnic background (Indonesia, Nigeria), or climate and terrain (Russia) are usually good candidates for fiscal decentralization. Even countries that are relatively homogeneous in population mix and climate may be pressured for different service standards in urban and rural areas, or in regions with different economic bases.

3. China has 151 prefectures and 185 prefecture-level cities; 1,903 counties and 279 county-level cities; 56,027 townships, towns, and city districts.

4. India has 3,609 urban local bodies, 474 zilla parishads in rural areas, 5,906 panchayat samitis, and 227,698 gram panchayats.

Another explanation of the increased demand for fiscal decentralization in recent years is the improved management and administrative capacity of local governments. In the past, the issue with local governments was their inability to deliver services effectively or to manage money. Although many of the same criticisms are leveled today, many local governments are "growing up" in terms of their management and administrative abilities. Affordable microcomputer systems, improved education, and the greater relative attractiveness of employment in the subnational government sector have all contributed to this change. Indonesia's local governments have taken on significant increases in expenditure responsibility, South Africa's urban local governments are nearly self-sufficient in financing their budgets, and the state governments in Brazil and Argentina play important roles in their federal systems. When subnational governments feel ready, they bring pressure for more fiscal autonomy.

Some attribute the current interest in decentralization to the consideration that the time for local autonomy has come. Local elections, improved administrative capacity, and "local nationalism" have made the demand for fiscal decentralization irresistible. If it is not given in a formal way, local autonomy may be achieved through "backdoor" approaches. A good example is Chinese local government officials who were denied formal taxing powers but who levied informal (often illegal) taxes that were kept in off-budget accounts. Local governments did take on more fiscal autonomy on the revenue and the expenditure side in response to a demand for local services that higher-level governments were unwilling to fund. This backdoor approach, however, created inefficiencies in how the funds were raised and in spending from segmented, extrabudgetary accounts (Bahl 1999a; Wong, Heady, and Woo 1995). It may be far better to structure a program of fiscal autonomy than to have it taken on an ad hoc basis.

Perhaps the most compelling argument has to do with service delivery. The level and quality of local public services provided in most developing countries is poor. "The job is not getting done anyway, so let's try another approach" is an argument that gets a great deal of sympathy and support. In many camps, there is a belief that more local control over expenditure decisions can make things better. Intuitive arguments support this belief. Subnational governments are best positioned to determine the location of capital investments. They can recognize benefits, they may better manage the performance of employees working at the local level, and they have a greater stake in maintaining local public capital. Local voters feel more likely to be "heard" by local politicians and bureaucrats than by central politicians and bureaucrats.

Finally, decentralization may be a part of the strategy to hold countries together or may be a strategy for nation building. Some nations have been formed out of unnatural partners and have dissolved when the opportunity arose, such as Czechoslovakia and Yugoslavia. In cases such as Indonesia, South Africa, and Russia, the fall of strong central regimes has prompted a call to move governance away from the central level and has stimulated fiscal decentralization initiatives.

Other troublesome partnerships have played to special autonomy measures in attempts to hold the country together, as in Nigeria and Sudan. Even in the case of reunifications as in Vietnam, Germany, and China–Hong Kong, decentralization plays an important role.

The Benefits

The design of a program of fiscal decentralization that has a chance for success must move from rhetoric to an identification of the potential benefits and costs of this policy and to the possibilities for realizing these benefits and costs. The main reason the rhetoric of fiscal decentralization has not been translated into a widespread growth in the relative importance of local government finance is that the benefits and costs have not been properly understood or accepted. Implementation plans for fiscal decentralization are almost always flawed.

EFFICIENCY GAINS

Rhetoric is necessary to popularize the concept of decentralization and perhaps make it more politically acceptable. It is, however, often based on impressionistic evidence. What is needed in the national debate about fiscal decentralization is a more structured approach to capturing the benefits of fiscal decentralization.

What are the major advantages to be captured? The first, and most important, is the welfare gains that come from moving government closer to the people. This economic efficiency argument drives the thinking of most economists who work on this subject (Musgrave and Musgrave 1984; Oates 1972). The argument is straightforward. Let us assume that people's preferences for government services vary, for example, because of religion, language, ethnic mix, climate, or economic base. Let us assume further that people living within a country or even a city have sorted themselves so that those with like preferences live in proximity. If subnational governments respond to these preferences in structuring their budgets, decentralization will result in variations in the package of services delivered in different regions. People will get what they want, so the welfare of the population will be enhanced.

Under the same circumstances, but with a centralized system, service provision would be more uniform and people in different regions would get less of the service mix they want. The potential benefits from decentralization, then, include (1) more accountability on the part of government officials because they are responsible for service delivery to the local population who elected them; and (2) more willingness on the part of the local population to pay for services because they get what they want.

For advocates of fiscal decentralization, this scenario is the primary argument. True believers can point out that successful fiscal decentralization at once attacks several problems that face developing countries: revenue mobilization, innovation in economic decision making, accountability of elected officials, capacity development at the local level, and grassroots participation in governance.

This view of the benefits of decentralization makes it easy to believe that welfare gains exist even if they cannot be measured.[5] Whether the conditions necessary are in place to capture these benefits is another story. Even if gains do materialize, are they large enough to warrant the possible disruption of the national public financing system?

To capture the gains from fiscal decentralization, a number of conditions must be met. First, regional and local legislatures must be accountable to the regional/local population. If local political leadership is elected, does the electorate have the information and willingness to exercise the vote to ensure accountability? If these political leaders are appointed rather than elected (as in China), do they see their political success as being related to the satisfaction of the local population? The middle ground is a type of parliamentary system whose leaders are elected by and possibly more accountable to the party than to the local population.

Second, the chief officers of the regional/local government must be accountable to their legislature. If they are appointed by the center/state, their first accountability will be to a higher level of government, and local programs may not be delivered according to local preferences. The mayor's directive about enforcement of property tax penalties for failure to pay may have a hollow ring if the chief local tax collector is appointed by the state or central government.

Third, subnational governments should have some independent taxing powers. Provincial and local governments should have the ability to set at least the tax rate. This power is important if the local population is to hold the political leadership accountable. Local voters will subject politicians to a much tougher test if voters pay for services than if services are financed primarily by a transfer from the center.

Fourth, subnational governments should be responsible for some important government services. The issue here is that the local voters should care about the quality of services delivered. In most cases, states and provinces are assigned services that affect the quality of people's lives, so this criterion is satisfied. In the case of local (third-tier) governments, this assignment of important responsibilities is not always the case. When local governments are given responsibility for little more than housekeeping functions, the local population will be less likely to raise strenuous objections about the quality of services delivered.

Fifth, subnational governments should have adequate discretion over the level and composition of expenditures. If a higher-level government mandates

5. Indirect evidence that the efficiency gains are being captured includes increased satisfaction with local public services, changes in the mix of service provided to better satisfy local preferences, electoral results, and increased compliance with local taxes and user charges.

the expenditures, the subnational government has little ability to respond to citizen preferences. Excessive mandates can be a major impediment to fiscal decentralization. In some cases, mandates are necessary for achieving overarching social goals, such as guaranteed quality of education or equalization in the distribution of resources among local (third-tier) governments.

The efficiency gains that might be captured with fiscal decentralization are far from automatic. A structure must be in place to allow the subnational government to capture these gains. In fact, these necessary conditions are often missing.

REVENUE MOBILIZATION

In developing and transition economies, state and local governments are assigned relatively little independent taxing power. The higher-level government may fear the tax base competition, the prospect that increased state and local government tax collections will be accomplished at the expense of lower central government taxes.

That decentralization can increase overall revenue mobilization in a country by broadening the aggregate tax base is, in fact, a more reasonable hypothesis. If this hypothesis is correct, subnational government taxes would not be raised at the expense of reductions in central-level taxes. In addition, the claim of subnational governments on central revenues via intergovernmental transfers would be reduced by increased revenue mobilization at the subnational government level.

The argument behind this hypothesis is that subnational governments have the potential to reach the traditional income, consumption, and wealth tax bases in ways that the central government cannot. Typically, central governments rely on a combination of company income tax, individual income tax, value-added tax, and excise taxes. In most developing countries, however, these taxes have a high entry threshold. Small firms and most individuals are "underrepresented" in the tax base. In fact, local governments can broaden the overall tax base with a variety of tax instruments and administrative measures, and they do so in many countries.

In developing and transition countries, most individual income taxes are collected through withholding from workers in the formal sector. The threshold is set high enough that only a small fraction of the population is included in the tax net. In Indonesia, a country with a population of more than 200 million, the income tax base includes only about 1 million people. Even when their income is above the threshold, self-employed workers often escape taxes because of administrative difficulties, and overall collection rates tend to be quite low. The problem is identifying self-employed workers (informal sector) and determining their tax liability. The self-employed taxpayers play "catch me if you can," and the central government often sees the cost of the chase to be greater than the revenue rewards. Local governments, though, with a better knowledge of the local economy, can identify the tax base more easily. Given the paucity of local government resources, the revenue returns are potentially lucrative. Subnational government payroll taxes, levied in a simple way, can augment the national revenue take. These taxes might be justified as a kind of user charge for the provision of local public services.[6]

The company income tax is usually focused on large firms. In market economies, smaller firms are covered, but typically under an alternative form of company tax. In transition economies, private businesses and collective enterprises—very rapidly growing sectors—are often outside the tax net for administrative reasons.

The value-added tax (VAT) has a very high threshold and typically excludes most enterprises from the tax base. Most VAT revenues are collected from a small number of firms, and it is administratively inefficient to focus heavily on the "hard to tax" for the little revenue they generate. The situation in Guatemala, where 97 percent of VAT revenues are collected from one-third of the VAT-paying firms (Bahl, Martinez-Vazquez, and Wallace 1996), is not atypical. These high thresholds for central taxes, however, leave a significant taxable capacity unreached. Ample taxing room can be found in this situation. Subnational governments may levy a variety of taxes on the sales or assets of these companies, or even charges for the privilege to operate. Included are asset taxes on businesses, property taxes, gross sales taxes on small firms, and narrow-based retail sales taxes.

In general, the high thresholds set for central government taxes can be attributed to two factors. First, the lack of familiarity with the local tax base makes it very difficult to identify the small taxpayers and to maintain a tax roll. Second, the revenue gains from bringing small taxpayers into the net are small. A local government policy analyst, however, might propose another view. The analyst might point out that the local governments do have familiarity with the local tax base. They oversee a variety of licensing and regulatory activities, and they track property ownership and land-based transactions. They have ample opportunity to identify businesses in their community and gain some knowledge about the real property assets and scale of operations. A convincing case could be made that the potential revenue from these activities may be quite large when compared with the overall size of the local government budget.

In particular, a strong case could be made for the real property tax as a local government revenue source. Familiarity with the tax base gives local governments a comparative administrative advantage, and it offers the opportunity to connect tax payments to the benefits of local services provided. In addition, central governments often do not want this tax. Further, the property tax can, in theory, give local governments access to a large and growing tax base. Still, elected officials may be hesitant to levy such an unpopular tax on the local voting population.

6. Subnational governments often fail to gain access to broad-based taxes for two reasons: (1) the center is unwilling to give up or share the revenue base; and (2) the subnational government is wary of taking on responsibility to enforce these taxes.

REGIONAL BALANCE

Another argument posits that if fiscal decentralization goes far enough, a better size distribution of regions (cities) would result. The traditional theory of migration holds that an individual's decision about movement, say from a rural to an urban area, is determined by his or her assessment of the probability of finding employment in the urban versus rural area and by the difference in the expected wage. Business and individual location decisions are driven by the quality of public services available and by the cost of these services.

A problem in developing countries is that local governments, even in large metropolitan areas, are often financed primarily by intergovernmental transfers rather than local taxes. The tax price for local services in these cities is therefore low. If local governments were forced to raise a greater proportion of their own revenues, the marginal cost of living in cities (and probably in higher-income regions) would rise because residents and businesses would now pay the marginal cost of service provision. If the tax disparities among regions, and among urban–rural places, grew large enough, presumably some urban migration would be discouraged. Whether migration to more prosperous regions and to cities could be discouraged to any significant degree by greater tax and user charge differentials is a question that calls for more research.

NATION BUILDING

When citizens participate in their own governance, as in a decentralized system, a greater measure of national stability may be achieved. In countries where the ethnic or religious mix of the population has created divides, the threat of disharmony, or even civil war, is present. Part of this problem is due to different preferences for public services, and part is due to the desire for more self-governance.

Fiscal decentralization can offer a compromise between the status quo and secession in such cases. By enabling some degree of regional autonomy, the central government might satisfy the demand for more control over public services. This local autonomy might be achieved by a federal structure of government (Nigeria, India) or by special local autonomy laws (Indonesia, Philippines).

The Costs

The limited growth in fiscal decentralization may be explained by the costs of giving up the considerable advantages of fiscal centralization. It has long been argued by public finance theorists that fiscal policy to address stabilization and growth issues, and distribution policy, can be more effectively managed by central governments. Whether subnational government fiscal decisions seriously compromise the effectiveness of central government policy in these areas is controversial.

STABILIZATION POLICY IS NOT PROTECTED

Developing and transition economies are by their very nature unstable. Developing countries often depend on a small number of primary exports (agricultural or mineral). A change in world market prices can have devastating effects on such a country. Movements in world economic conditions can slow the rate of economic growth of "vulnerable" countries. World recession, for example, could slow the rate of foreign investment, reduce the demand for exports, discourage tourism, and so forth. Smaller countries are especially vulnerable. Their economies tend to be the most exposed, and even a natural disaster (hurricane, earthquake, drought, or epidemic such as AIDS) can have lasting and disastrous effects.

This volatility in economies is transmitted to the public sector, and it can even be magnified. Swings in world interest rates and real exchange rates directly determine the real cost of servicing foreign debt, sales taxes respond automatically to swings in consumption, and public expenditures move with inflation and unemployment. The Inter-American Development Bank (1997, 113–114) makes the interesting points that indirect tax revenues in Latin American countries are 2.5 times more volatile than in industrial countries and that public expenditures are four times more volatile. Faced with this potential for instability, central governments believe that, to implement effective stabilization policy, they must control a substantial portion of total government revenues and expenditures. The ministry of finance in virtually all countries would like to control (1) the tax rate and the tax base of all major taxes; (2) expenditure assignment and determination of the level of expenditures; and (3) borrowing by local governments. How can a program be put in place to control inflation and the size of the deficit when a significant percentage of national spending and taxation is in the hands of subnational government politicians who do not have a vested interest in pursuing stabilization policy? The situation is exacerbated when the subnational governments do not face a hard budget constraint and when they have borrowing powers.[7]

Central governments would like the flexibility to respond quickly to changes in the economy so as to raise taxes or cut expenditures to deal with a deficit, for example. If the government is locked into a fixed share of revenue allocated to local governments, the ability to cut the deficit by reducing expenditures is significantly reduced. The pressures from the International Monetary Fund (IMF) and the World Bank for more austere economic policy to bring about internal or external balance usually requires maintaining an acceptable level of the fiscal deficit and limiting the level of domestic credit. In a truly decentralized economy, both targets are more difficult to achieve than in a centralized economy. Decentralized countries are not inherently more unstable than centralized countries.

7. See Bahl and Linn (1992), Prud'homme (1995), Spahn (1997), Tanzi (1995), and Ter-Minassian (1997) for more detailed discussions. These papers show that there is anything but agreement on this point.

Whatever the degree of inherent instability of a country, the ability to control the fiscal sector would seem more limited in the decentralized system.

Finally, does borrowing by subnational governments compromise macroeconomic stability in developing countries? The case of Brazil, where state-level debt contributed to a national fiscal crisis and forced central government intervention, is the example most often mentioned (Ter-Minassian and Craig 1997). The problem, according to some, was an unwise decision to rely on market discipline to control the issuance of debt.

On the other hand, borrowing by subnational governments has not compromised the fiscal position in many other countries where it is allowed. This situation usually is attributed to the imposition of some form of control—either rule-based or direct administrative controls—over state and local government borrowing.

INFRASTRUCTURE INVESTMENT MUST BE CENTRALLY DIRECTED

Capital is short in most developing and transition countries, and subnational governments have a low savings rate. Some would argue that the net result of fiscal decentralization, then, could be a shift of resources from central governments that have higher rates of savings and investment to provincial and local governments that spend at a greater rate on consumption goods and services. With this conclusion, fiscal decentralization could therefore lead to a lower rate of spending on infrastructure, and national growth could be harmed.

Three points should be made. First, local governments have been assigned functions that are consumption-intensive (primary schools, provision of safe drinking water), and these expenditures contribute to economic growth. Second, even if there were a local preference for capital spending, central mandates (particularly for subnational government wage and salary levels) may drive the budgets of lower-level governments toward consumption spending. Finally, subnational governments lack access to revenues adequate to generate capital financing.

Another line of thinking poses that, in developing countries, national priorities for capital investment should trump those that conform to local government choices. The national government is interested in investments in infrastructure that have regional and national benefits, such as irrigation, national (interstate) roads, and power. State governments, especially large states in large countries, focus on capital investments with regional benefits, such as highways, universities, and hospitals. Local governments, on the other hand, are expected to place more emphasis on projects with local benefits, such as markets, small area water supply, municipal buildings, and recreation areas. Those interested in maximizing economic growth would argue that the big national infrastructure projects should dominate. Advocates of fiscal decentralization argue that overall welfare will be increased if local governments play a role in project selection. Also, a fear persists that local governments either cannot, or will not, build their facilities to proper standards and that they will not maintain them at adequate levels. The case for provincial involvement in capital project selection is stronger in countries where the provinces are large and have stronger service delivery capability.

EQUALIZATION POTENTIAL IS GREATER UNDER REVENUE CENTRALIZATION

Most developing and transition countries are characterized by significant interregional disparities in income and wealth. Poor regions within a country typically have a low taxable capacity and a high level of expenditure need. It usually falls to the central government to do something about equalizing the resulting fiscal disparities. One of the most common methods of addressing these disparities is a system of equalization transfers.

Revenue centralization provides a greater potential for equalization. In countries where the claim of local governments on the overall tax base is small, the central government can create a larger pool of funds for allocation among local governments on an equalizing basis. Just because the central government has more funds to allocate, however, does not necessarily mean that it will allocate these funds on an equalizing basis. In fact, most countries do very little equalization through their grant systems.

The decentralization of both revenue-raising power and expenditure responsibility can be a counterequalizing policy in developing countries. When local governments are given taxing powers, or more expenditure responsibilities and some borrowing authority, the higher-income places are best positioned to take advantage of these newfound powers. They have the fiscal capacity to tax and usually have a better ability to collect taxes, the technical ability to deliver more public services, and the repayment potential that enables borrowing to finance capital improvements. Under a fully decentralized fiscal system, one would expect a growing gap in well-being between rich and poor regions. This argument is more a hypothesis than it is based on hard research, in part because richer places always seem to do better, whether located in centralized or decentralized countries. Those who have studied the issue, however, tend to support the hypothesis that decentralized tax assignment leads to larger fiscal disparities because it allows local governments with a stronger taxable capacity to make use of their comparative advantage.

CENTRAL GOVERNMENTS ARE MORE COMPETENT

The superior ability of central governments to deliver public services and collect taxes is another argument for centralization. Central competency is believed to be superior for a number of reasons. It can be argued that the best and brightest government officials are drawn to that level where their opportunity for advancement is greatest. Moreover, they are drawn to "where the action is," and central governments in developing countries account for 85 percent of all government expenditures. Perhaps most important is that central officials have significant experience doing the job of service delivery and tax collection, and they are often well up the learning curve from local government employees.

On the other hand, no hard-and-fast evidence exists that central governments can deliver services for all functions at a lower cost or higher quality than can local governments. The experience in Indonesia offers perhaps the best form of transition. Central government employees who were already involved in providing the services were transferred to the jurisdiction of local governments and the quality—and cost—of these public services did not suffer.

CENTRAL GOVERNMENTS ARE LESS CORRUPT

Another argument against stronger local government is the corruption that is bred from the "closeness" between elected local politicians and the local political power structure. Both Prud'homme (1995) and Tanzi (1995) present this view. Another line of reasoning, making the same point, is that the probability of successful stealing is increased by weakening central authority and monitoring. Various students of corruption place the blame on the greater number of contacts with public officials in developing countries, on lower-paid public officials having more incentive to steal than higher-paid central officials, and on voters at the local government level who have not yet learned to use their power to monitor and discipline their employees.[8]

The case that corruption and decentralization are inherently linked is, arguably, weak, however. Certainly, no good empirical evidence supports this contention. As suggested by Guess, Loehr, and Martinez-Vazquez (1997), the perception that fiscal decentralization and corruption are related may reflect only that localized corruption is more transparent.

Empirical work on the relationship between decentralization and corruption is inconclusive. Fisman and Gatti (2002), for example, find that corruption is lower in more decentralized countries; Treisman (2000) finds corruption to be higher in federal than in unitary countries.

Sequencing Fiscal Decentralization

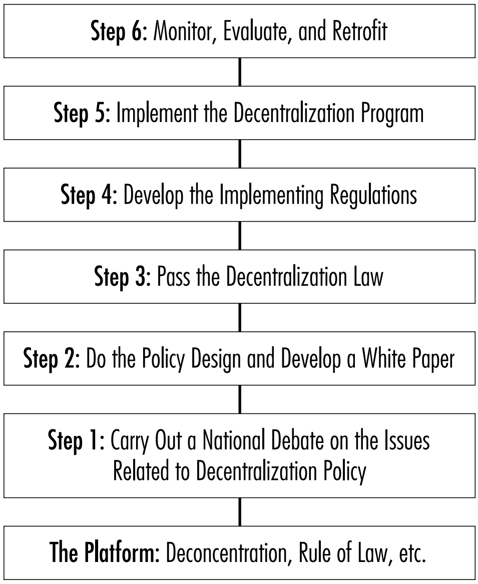
The success or failure of fiscal decentralization in developing countries results as much from implementation as from program design. In particular, when introducing decentralization policies and administration, sequencing is key.

Bahl and Martinez-Vazquez (2006b) have argued that there is an optimal pattern of sequencing that is applicable for most countries. Even before beginning the implementation, two prerequisites are necessary for success: a rule of law and an existing deconcentration of public service delivery. The former makes it possible for subnational governments to protest violations of the decentralization law, even those committed by the central government. The latter makes it possible to shift central employees to local status without having to train a new force of local public employees.

The sequencing of decentralization should begin with two important steps (figure 2.1). The first is to hold a national debate about decentralization, possibly in the context of an election or the report of a national commission. It is better to deal with objections up front, or else the national debate could disrupt

8. For a good review, see Martinez-Vazquez, Arze del Granado, and Boex (2007).

Figure 2.1
Sequencing Fiscal Decentralization: A Normative Approach



Source: Bahl and Martinez-Vazquez (2006b).

program implementation after it is under way. National discussion should culminate in a policy paper on fiscal decentralization that lays out the goals of the program and the strategy for achieving it. These steps make up the road map for the decentralization program. The policy paper would include matters such as the assignment of expenditure responsibilities, the nature of the intergovernmental transfer system, and the revenue-raising powers of subnational governments. Going forward without a policy guideline would be tantamount to adopting a "make it up as we go" strategy.

Based on this road map, the decentralization law can be written. This key document of the program will guide all else that is done in the implementation process. Although the law must contain the key features of the program, it must not be too specific because legal drafting cannot accommodate all the realities of administration that will arise.

The administrative phase begins with developing the implementing regulations that accompany the decentralization law. For example, the law may specify an equalizing grant program, but the implementing regulations may specify the exact formula to be used in distribution. The implementing regulations must conform with the decentralization law. If there are no implementing regulations, or if they are not clearly written, policy making would implicitly fall into the hands of bureaucrats. With these implementing regulations in hand, the program can be brought on line.

A final step in the process is to provide for monitoring and evaluation. Fiscal decentralization programs emerge and change over time, sometimes due to poorly formulated policy and sometimes due to the changing needs of the country. It is important to have in place a process for fine-tuning the structure. This process of gradual reformulation underlines the reasons why it is dangerous to include too much detail about decentralization in the constitution.

One problem with the stepwise approach to implementing decentralization proposed here is that it makes the process very transparent and vulnerable to criticism. It also requires time, especially at the stage when the program is being formulated, which gives the opposition time to organize their objections and their constituency. Another approach is simply to push ahead before opponents can get organized and to get the law written and adopted. The hope in this strategy, as was the case in the big-bang decentralization in Indonesia, is that once the law is written, there will be no turning back.

Is Fiscal Decentralization a Development Elixir?

It is easy for advocates to get enthusiastic about fiscal decentralization. It offers the opportunity to improve service delivery, increase the rate of revenue mobilization, involve citizens more closely in the process of governance, and help resolve conflict within disaffected regions.

In fact, fiscal decentralization is not a panacea for economic development problems. The potential effects are real enough, but developing economies often do not have the economic, institutional, and administrative wherewithal to capture these benefits. Moreover, the costs of decentralization can be too high for developing economies.

Countries around the world have moved only slowly toward the adoption of decentralized intergovernmental fiscal systems. Despite the advantages, no hard evidence shows a strong trend toward fiscal decentralization. Based on IMF *Government Finance Statistics*, which is one of only a few comparable data sources available, the subnational government share of public expenditures has remained at about 13 to 14 percent in developing countries since the 1970s.[9] The rather remarkable stability in the subnational government expenditure share is reported in table 2.1 for developing countries and for Organisation for Economic Co-operation and Development (OECD) member countries.

These results are not all surprising. The costs of decentralization are extremely high for less developed countries. Subnational government finance is

9. Here, decentralization is measured as the subnational government share of total government expenditure in the country, that is, subnational government expenditures in the numerator and total central plus subnational government expenditures in the denominator.

Table 2.1
Fiscal Decentralization Indicators

	1970s		1980s		1990s to 2000s		
	Developing Countries	OECD Countries	Developing Countries	OECD Countries	Developing Countries	OECD Countries	Transition Countries
Subnational government tax as a share of total government tax	10.68 (43)	17.91 (24)	8.87 (33)	18.18 (23)	10.61 (28)	18.39 (21)	22.41 (23)
Subnational government expenditure as a share of total government expenditure	13.42 (45)	33.68 (23)	12.09 (41)	31.97 (24)	12.97 (54)	32.68 (24)	30.32 (24)

Note: Sample sizes are in parentheses.
Source: Bahl and Wallace (2005, 91).

a type of luxury good whose benefits come only slowly to low-income countries. The political costs are also very high. Central bureaucracies are firmly entrenched, often since independence, and difficult to move. Even at the local level, the traditions of central control seem inviolate. Local voters, at whom these benefits are aimed, often have not yet learned enough about their power.

What to make of all this divergence between the rhetoric and the outcomes? Is decentralization an interesting idea that just hasn't caught on? Perhaps not. The trends presented in table 2.1 are deceiving. The period studied coincides with the introduction and growth of value-added taxes in developing countries. Because the VAT is such a revenue productive central government tax in most countries, the existence of a "flypaper effect" suggests that there would have been an increased share of spending at the central level. That subnational governments held a constant share of expenditures is evidence of continued support for decentralization as a development strategy.

Two other dimensions of fiscal decentralization make its success difficult to evaluate. First, the primary objectives may vary from country to country. Holding off dissolution may have driven the Russian design, whereas involving new voters in governance may have been paramount in South Africa. A global evaluation of fiscal decentralization programs is likely to be less accurate than a series of country case studies. Second, program design may be flawed in some countries, and implementation is always complicated. The result is that fiscal decentralization goes slowly, and its effects take time to show up.

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