Public Financing in Developing and Transition Countries

Roy W. Bahl
Georgia State University, rbahl@gsu.edu

Sally Wallace
Georgia State University, swallace@gsu.edu

Follow this and additional works at: https://scholarworks.gsu.edu/econ_facpub

Part of the Economics Commons

Recommended Citation
Public Financing in Developing and Transition Countries

ROY BAHL and SALLY WALLACE

The widespread adoption of fiscal decentralization laws during the past 25 years can be mostly tracked to economic efficiency gains and nation-building objectives. Subnational governments (SNGs) in industrialized countries account for about twice the share of total government expenditures as in developing countries. Transition countries also assign more expenditure responsibilities to SNGs than do the developing countries. There has been little growth in the SNG expenditure or tax shares over the past three decades. We confirm the basic hypotheses that the SNG expenditure share is significantly higher in countries with higher incomes, larger populations, and a lower degree of corruption.

INTRODUCTION

Among the developments in public finance and budgeting over the last 25 years, those in the developing and transition countries are some of the more dramatic changes. The political and economic shifts from planned states to new market economies and the push for economic growth called for new tax policies, new relationships between the private and public sector, new systems of budgeting, and new relationships among levels of government. The focus of this paper is on the latter, intergovernmental fiscal relations, with an emphasis on trends in developing and transition countries. The theory that the decentralization of fiscal decisions can lead to better governance has gained great currency in the past 25 years. In the developing and transition countries, there has been widespread adoption of fiscal decentralization laws. In many industrialized countries, the interest in fiscal decentralization has deepened. In this review paper, we outline the reasons for this political enthusiasm, track the progress of fiscal decentralization over the past quarter century, present some empirical work that addresses the question, “Why do...
countries decentralize?" and discuss the reasons why this policy direction might or might not accelerate. Our concern in this analysis is with the fiscal role of subnational governments (SNGs). We define SNG finances as the sum of provincial (state) and local government taxing and spending.

**WHY DECENTRALIZATION? THEORY AND RHETORIC**

The appeal of fiscal decentralization as a policy strategy is broadly about the political economy of governance, and about the economic and political gains and losses that can march along with this approach to reform. Underneath this political motivation is an underlying set of country-specific factors that make decentralization a more or less desirable policy reform. If one is to understand the reasons why fiscal decentralization has been such an important policy topic over the last quarter century, one must begin by understanding what has moved so many countries to adopt this governance strategy. We try and answer the question, “Why decentralization?” by referring first to the underlying theory about what the gains should be, and second to the rhetoric that has accompanied decentralization programs in countries around the world.

*The Theory*

The theory of fiscal decentralization is drawn from economics. Most students of this subject begin with Oates’ decentralization theorem, “in the absence of cost savings from the centralized provision of a [local public] good and of interjurisdictional externalities, the level of welfare will always be at least as high (and typically higher) if Pareto-efficient levels of consumption are provided in each jurisdiction than if any single, uniform level of consumption is maintained across all jurisdictions.”¹ The story is a compelling one: local voters will be happier if they choose the level and mix of government services to be provided. The more diverse the preferences within a country, the greater the efficiency gains from assigning these functions to local governments.

In theory, revenue mobilization might also increase as a result of decentralization, for two reasons.² First, if the local population is successful in getting the package of service they want, they might be more willing to pay. Second, because local governments have a comparative advantage in assessing and collecting some taxes, overall revenue mobilization might be increased by decentralizing certain taxing powers.

The theoretical underpinnings for decentralization were developed in a context of governance in industrialized economies. Bahl and Linn make the case that the efficiency gains from fiscal decentralization may not be captured as fully in developing countries,

---

for several reasons. First, the absence of open elections at the local level in some countries limits the extent to which the local population can reveal its preferences for public services. Second, local governments may not be able to reach desired levels of spending or revenues because of their limited administrative abilities. Finally, there are legal constraints, i.e., local governments may not have been assigned the “right” expenditure responsibilities or adequate taxing powers.

\textit{The Rhetoric}\textsuperscript{4}

Few countries choose to get carefully focused on the question of “Why decentralization?” Many countries never take the step of developing a White Paper that specifically identifies the problems that might be resolved with fiscal decentralization. But there is almost always a “rhetoric”—delivered in speeches, policy papers, in the press, by interest groups, donors, and the government—from which one might tease out the underlying reasons.

In fact the justification varies from country to country. Various advocates will see decentralization as primarily an economic, political, social, management, or even a military strategy. The way these national leaders see it will pretty much drive the way they design it. This 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 real impact of successful decentralization.

In many cases, the rationale for decentralization matches up well with the problems that the country is facing, suggesting that fiscal decentralization policy is more than a political strategy. Russia’s fiscal decentralization developed shortly after the breakup of the Soviet Union and looks very much like one designed to head off separatist movements. South Africa’s movement of decision-making power to over 800 local governments is exactly what one would have expected in the aftermath of apartheid. Indonesia’s decentralization followed the economic chaos that came with the Asian crisis, and was a reaction to what was perceived to be overcentralization.

Many would like to believe that fiscal decentralization is an effective strategy for stimulating economic development. Intuitively, the argument is reasonable. The government closest to the local or regional economy is in the best position to decide on 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 in

\textsuperscript{3} Even with local elections, the introduction of decentralization policies may be more likely when the party system is organized at the state versus the central level. See Eliza Willis, Christopher Garman, and Stephan Haggard, “The Politics of Decentralization in Latin America,” \textit{Latin America Research Review} 3, no. 1 (1999): 7–55.

\textsuperscript{4} For a more detailed discussion of these same arguments for fiscal decentralization, see Roy Bahl and Jorge Martinez, “Sequencing Fiscal Decentralization” (Washington, DC: World Bank, July 1, 2005), especially Annex A.
mind in her 1961 book, Development from Below, which was one of the early arguments for stronger local government in developing countries.\(^5\) Whatever the reason, the search for empirical evidence on the relationship between decentralization and economic development has not produced conclusive evidence.\(^6\) The absence of statistical proof is not damning of the economic development argument, and may be because of the problems with separating the impacts on economy from the impacts on everything else. In this context, McNab develops the interesting point that the effects of decentralization on economic development are indirect, i.e., decentralization impacts technical efficiency, income inequality and corruption, which in turn affect economic growth.\(^7\)

The growing number of countries with democratically elected SNGs clearly has stimulated interest in fiscal decentralization. Those interested in the politics of policy development might argue that this factor has been paramount in stimulating at least the rhetoric and probably the demand for fiscal decentralization. And, it is not all rhetoric. Elected politicians at the SNG 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). Even in China, provincial leaders (who are appointed by the central government) lobby for a greater flow of resources to their provinces. Tanzi makes the same argument with respect to the centrally appointed prefets in France and Italy.\(^8\)

It should be recognized that politically driven decentralization processes do not guarantee that government fiscal decisions will end up being made closer to the people. The current cases of India and Spain demonstrate that most of the fiscal powers on the expenditure and revenue sides of the budget can remain at the state or provincial level, with these governments acting as centralized regimes toward their local governments.

Another important part of the rhetoric is that centralization is an inefficient management approach, especially in large countries. Fiscal management, i.e., supervision of a substantial part of the budgetary affairs of every SNG, can be costly and can lead to poor public service outcomes when countries are very large. It can also create significant ill will on the part of local officials and their constituencies who feel burdened by the central bureaucracy. A relatively few central officials cannot make the important fiscal

---


decisions for every local government, on a case-by-case basis. There are just too many complications and too many special circumstances for this to be a viable approach in large countries. China and India have populations in excess of one billion, and China has nearly 60,000 SNGs, while India has nearly a quarter million; Brazil has a land area greater than 8.4 million square kilometers; Indonesia is composed of 6,000 inhabited islands and Russia has 11 time zones. How could such countries be managed efficiently from a national capital, by a relatively few senior officials? Yet, as late as the mid-1990s, the budget of each of the 89 regional governments in Russia 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, the combination of a poor transportation and communications network can make the national capital very remote. In Nepal, for example, many of the 4,000 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 some degree of uniformity in the government services delivered, and in the revenue-raising powers given to SNGs. But there is a resentment of enforced uniformity, and various regions within countries have pushed hard for autonomy to choose a package of services that better fits their demands. Countries with interregional variations in language (e.g., India, Sudan), ethnic background (e.g., Indonesia, Nigeria), or climate and terrain (e.g., Russia) are 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. Local populations apparently can recognize the potential economic efficiency gains.

There has been an undercurrent of sentiment against big government in the last two decades, and a loss in confidence in the ability of the public sector to adequately and efficiently serve the population. Some of this sentiment has taken the form of a push to privatization of what heretofore had been seen as public sector activities. As Tanzi9 points out, the enthusiasm about placing greater reliance on the market has been accompanied by the parallel view that less power should be in the hands of the central government. This sentiment has made fiscal decentralization an easier sell in the last two decades.

Another explanation for the increased demand for fiscal decentralization in recent years is the improved management and administrative capacity of local governments. The rap on SNGs has always been their inability to recruit quality staff to deliver services effectively, or to manage money. Although many of the same criticisms are leveled today, there can be no doubt that great numbers of provincial and local governments have “grown up” in terms of their management and administrative capacity. Affordable microcomputer systems, improved education, and the greater relative attractiveness of

---

9. Tanzi, Ibid.
employment in the SNG sector have all contributed to this. When SNGs feel ready, they bring pressure for more fiscal autonomy and this is a factor contributing to the increased demand for fiscal decentralization.

Once countries reach a certain threshold, decentralization policy gains a significant amount of momentum. Local elections, improved administrative capacity, and “local nationalism” can make the demand for fiscal decentralization irresistible. If it is not given in a formal way, it may be taken using “backdoor” approaches. A good example is Chinese local governments who were denied formal taxing powers but levied informal (often illegal) taxes, which were kept in off-budget accounts. Local governments did take on more fiscal autonomy on the revenue and the expenditure side, and this was in response to a demand for local services that higher level governments were unwilling to fund. But this “backdoor” approach brought inefficiencies in terms of how the funds were raised and in terms of spending from segmented, extra budgetary accounts. 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 rhetoric has to do with service delivery. The level and quality of local public services provided in most developing countries is appalling. “The job is not getting done anyway, let’s try another approach” is an argument that gets great deal of sympathy and support. There seems to be a feeling in some camps that more local control over expenditure decisions can make things better. The Inter-American Development Bank, commenting on the policy agenda for Latin America, put it this way: “Policy makers in the region are becoming aware of the potential offered by externalities and interdependence existing between fiscal decentralization, the effectiveness of social spending, and greater local political participation.” There are at least intuitive arguments to support this. SNGs are better positioned to determine the location of capital investments, they may be able to better control the performance of employees working at the local level, and they might be better at maintaining the local public capital.

Local voters feel more likely to be “heard” by local politicians and bureaucrats than by central politicians and bureaucrats. It is also true that the local population is more aware of the decisions made by local bureaucrats than they are of decisions made by central government officials, and hence are more likely to hold local officials accountable for services provided. Khemani reports results for India that show local voters holding local officials more accountable for economic performance than they do officials of

---


higher-level governments.\textsuperscript{13} There is, of course, the risk that decentralization will fail to improve the level and quality of public services, but the risks associated with doing nothing are often perceived as a worse alternative, a continuation of the dismal performance of the centralized approach to service delivery.

Finally, decentralization may be a part of the strategy to hold countries together, or of a strategy for nation building. Some countries have been formed out of unnatural partners and have dissolved when the opportunity arose, e.g., Czechoslovakia and Yugoslavia. In some cases, the fall of strong central regimes has prompted a call to move governance away from the central level and has stimulated fiscal decentralization initiatives. Indonesia, South Africa, and Russia are cases in point. Other troublesome partnerships have played to special autonomy measures to try and hold the country together. Nigeria, the Philippines, and Sudan fall into this category. We also may note that even in the case of reunifications, decentralization plays an important role as in Vietnam, Germany, and China-Hong Kong.

This survey suggests that countries express their interest in fiscal decentralization in many different ways. Likely this has to do with the political selling of fiscal decentralization. In fact, however, most of the rhetoric about the benefits of fiscal decentralization can be tracked to two rationales: economic efficiency gains and nation building. The decentralization theorem, it seems, is an important guide for thinking about devolving budgetary powers to SNGs.

THE EMPIRICAL EVIDENCE

The great number of countries pursuing some form of decentralization policy indicates the popularity of this development strategy. We turn now to a discussion of the actual implementation of decentralization policy, as measured by fiscal data. As will be shown below, the evidence about the progress is mixed.

\textit{Trends}

The most commonly used comparative measure of fiscal decentralization is the SNG share of total government expenditures. This measure ignores the degree of discretion given to SNGs, but it does show the extent to which the financing of government services is passed through their budgets.\textsuperscript{14} Although this measure is flawed as an indicator of the


\textsuperscript{14} The point that the subnational government expenditure share is a measure that overstates true fiscal decentralization is developed in some detail in Robert D. Ebel and Serdar Yılmaz, “On the Measurement and Impact of Fiscal Decentralization,” in Public Finance in Developing and Transitional Countries: Essays in Honor of Richard Bird, eds. Jorge Martinez-Vazquez and James Alm, Studies in Fiscal Federalism and State-Local Finance (Cheltenham, UK: Edward Elgar, 2003), 101–119.
extent to which SNGs influence resource allocation, it is suggestive of the importance of the SNG sector in government finance.

This expenditure decentralization ratio and an analogously defined tax decentralization ratio are reported in Table 1.15 The results presented here are not surprising in showing that SNGs in industrialized countries account for about twice the share of total government expenditures as in developing countries. Industrialized countries are characterized by more stable economies, less regional inequality, and more developed infrastructure, and these are all factors that encourage the choice of more fiscal decentralization. Transition countries assign more expenditure responsibilities to SNGs than do the developing countries, but they give relatively little fiscal discretion to the lower-level governments.

What is surprising is that on average, there has been little growth in the SNG expenditure or tax shares over the past three decades. This time pattern holds true for both industrialized and developing countries.

Although some countries have greatly decentralized their fiscal structures over this time period, the average performance suggests a quite stable level. Recent research has shown that there has been little change, on average, in the claim of intergovernmental transfers on the tax revenues of those higher-level governments making the transfers.16

We can say less about the decentralization of taxing powers because the International Monetary Fund’s (IMF) Government Finance Statistics (GFS) Yearbook, from which these data are drawn, appears to misclassify transfers as local taxes in some country cases. Definitional problems not withstanding, these data show that the SNG tax share is about twice as high in industrialized than developing countries, and that there has been little change in these shares in the past 30 years. These is no evidence of a significant movement to shift the locus of taxing powers to lower-level governments.

**Intercountry Variations**

Why do some countries choose to decentralize their financing structure more than others? Researchers have studied this question over the past 25 years and have reached similar conclusions about the determinants of cross-country variations in the expenditure decentralization ratio.

The statistical approach followed is more or less the same in all of these studies. The dependent variable is the expenditure share of SNGs, and data on this variable are taken

---


<table>
<thead>
<tr>
<th></th>
<th>1970s</th>
<th>1980s</th>
<th>1990s–2000s</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Developing Countries</td>
<td>OECD Countries</td>
<td>Developing Countries</td>
</tr>
<tr>
<td>SNG tax as a share of total government tax</td>
<td>10.68 (43)</td>
<td>17.91 (24)</td>
<td>8.87 (33)</td>
</tr>
<tr>
<td>SNG expenditure as a share of total government expenditure</td>
<td>13.42 (45)</td>
<td>33.68 (23)</td>
<td>12.09 (41)</td>
</tr>
</tbody>
</table>

Sample sizes are given in parentheses.

SNG, subnational government; OECD, Organisation for Economic Co-operation and Development.
from the *IMF Government Finance Statistics Yearbook*. The independent variables are specified to match the theoretical expectations about the determinants of expenditure decentralization. Various studies have used cross-sections of data for a given year or an average over a span of years, or have used panel data.

Most of the results in previous studies square with theoretical expectations. The size of a country, measured either as population or land area, seems to be a significant determinant of the degree of expenditure decentralization. Per capita gross domestic product (GDP), usually standing as an index of economic development is associated with a higher level of decentralization. The extent to which a country is at war or is threatened by war appears to be associated with more centralization. Some researchers have found that ethnic diversity drives up the level of decentralization, a result that squares with theoretical expectations, and others have found a positive effect of urbanization.

In this analysis we update the empirical work from the newer issues of *GFS*, specify the model in a slightly different way than has been done in the past, and use a more extensive data set than has been the case in some studies. We simulate a cross-section by using average values of these data for the period covering the 1990s to the present.

The dependent variable, as in previous studies, is the expenditure decentralization ratio. By 2002 (the latest year for which data are available), this ratio ranged from 70 percent in China to less than 3 percent in a number of developing countries. The sample includes 87 countries and is comprised of transition, developing, and industrialized nations. This large sample allows us to compare the determinants of decentralization among countries with a variety of underlying differences in economic and political institutions.

We specify five determinants of expenditure decentralization. Population size and land area are used as independent variables to measure the size effect, and a positive association with expenditure decentralization is expected. Per capita GDP (in US$) and a dummy variable for developing countries are used to measure the level of economic development, with an expected positive marginal effect in each case. We use ethnic fractionalization as an index of population heterogeneity and expect a positive relationship with expenditure decentralization. Transparency International’s index of corrup-

---

19. A very good review of the literature is provided by Letelier, Ibid., 155–183.
tion is an independent variable with an expected negative relationship with the expenditure decentralization ratio, i.e., we expect more corruption to be associated with less decentralization.\textsuperscript{23} We argue that decentralization is less likely to be a policy strategy in centralized countries where corruption is entrenched. We introduce a dummy variable for transition countries to control for differences in the functions of government.

The results of this estimation, presented in Table 2, confirm the basic hypotheses about the determinants of fiscal decentralization. The expenditure share is significantly higher in countries with higher incomes, in large countries, and in countries with a lower degree of corruption. The results are robust with respect to alternative measures of country size or income level. We also find that, cetera paribus, the SNG expenditure share is higher in transition countries. Between 40 and 50 percent of the cross-country variation can be explained.

\begin{table}
\caption{Ordinary Least-Squares Estimates of the Determinants of Expenditure Decentralization\textsuperscript{b}}
\centering
\begin{tabular}{lcc}
\hline
 & Equation (1) & Equation (2) \\
\hline
Constant & $-2.89$ & $1.30$ \\
 & (2.10) & (1.82) \\
Per capita & 0.21 & \\
GDP (in US$)\textsuperscript{a} & (2.62) & \\
Dummy variable for less-developed countries & -0.88 & (2.83) \\
 & & \\
Population\textsuperscript{a} & 0.32 & 0.21 \\
 & (6.25) & (4.53) \\
Land area\textsuperscript{a} & & \\
Ethnic fractionalization & 0.32 & -0.05 \\
 & (0.80) & (0.13) \\
Corruption & -0.43 & -0.89 \\
 & (2.76) & (1.11) \\
Transition country & 1.05 & 0.19 \\
 & (5.37) & (0.60) \\
Dummy variable & & \\
$R^2$ & 0.47 & 0.40 \\
$N$ & 86 & 87 \\
\hline
\end{tabular}
\begin{flushleft}
\textsuperscript{a}In logarithms. \\
\textsuperscript{b}Expenditure decentralization is defined as the subnational government share of total government expenditures. GDP, gross domestic product.
\end{flushleft}
\end{table}

\textsuperscript{23} Transparency International, \textit{Global Corruption Report} (Berlin: Transparency International, 2005). We calibrate the corruption index so that a larger number implies more corruption.
THE CONSTRAINTS TO DECENTRALIZATION

The trend of decentralization in developing and transition countries is not necessarily what one might expect. The more-or-less constant expenditure share of SNGs in developing countries over the past three decades raises the question about why countries have not decentralized more than they have. In fact, there are some significant constraints to fiscal decentralization that have held back the growth of SNG finance, and that may continue to constrain fiscal decentralization. In the case of transition countries, the limited time frame of the data does not allow us to say much about changes in the level of decentralization. We may note, however, that the level of expenditure decentralization is much higher than that in developing countries, and is more on par with the decentralization level in Organisation for Economic Co-operation and Development countries.

The economies of less-developed countries tend to be more exposed to external shocks, e.g., movements in international financial markets, or changes in world prices for a primary export product or in energy prices. In such cases, central governments will want to hold on to the major instruments of fiscal policy so as to have flexibility in controlling the overall level of the deficit. If SNGs play a larger role in the fiscal system—as, for example, accounting for a larger share of expenditures, taxes, or borrowing—the central government will have less flexibility to deal with fiscal imbalance. There is also the issue in many countries of SNGs not facing a hard budget constraint (and/or being subjected to an overassignment of expenditure responsibilities) and passing their deficits to higher-level governments. Brazil and Argentina are the cases most often cited as the example of fiscal decentralization compromising macroeconomic stability.

This same argument could be made in transition countries, especially in the early 1990s as a result of the fall of the Soviet Union. The centrally planned economies of countries such as Ukraine, Kazakhstan, Uzbekistan, Kyrgyzstan, Georgia, Armenia, and the like were especially vulnerable after the dissolution of the Soviet Union. Theoretically, we might expect that this would have led to high levels of centralization to allow the government control of the levers of the economy. However, aside from cases such as Latvia, Estonia, and the Czech Republic, the dismal fiscal condition of the central government and high level of public expenditures resulted in an off-loading of expenditure responsibilities to the SNGs.

Some research disagree with the proposition that macroeconomic stability is a constraint to the enactment of fiscal decentralization program. If business cycles are regional, some SNGs may even be better positioned to absorb external shocks than are


central governments. Some would go so far as to say that in certain circumstances SNGs can play a role in stabilization policy.  

Another constraint to substantial decentralization has to do with infrastructure planning and service delivery. In developing countries the basic system is not yet in place—trunk roads, power grids, ports, universities, etc.—and this pushes infrastructure decisions to a higher-level government, which is more capable of accommodating externalities. Moreover, there is the fear that the delivery of infrastructure—construction and maintenance—is beyond the reach of many provincial and local governments. At least in the poorest countries, this argument supports continued centralization. Some of this capacity did exist at the lower levels of government in centrally controlled economies such as the Russian Federation. Therefore, this constraint to fiscal decentralization was not as pronounced in many transition countries.

A third constraint is equalization. Most developing and transition countries face greater inequalities among regions than do industrialized countries. Because they have access to the more productive tax bases, central governments are in a better position to accommodate these inequalities through the tax-transfer system than are SNGs. Moreover, fiscal decentralization, if it includes significant local government taxing powers, is inherently counterequalizing in that it favors wealthier jurisdictions. In practice, the counterequalizing fears associated with overassignment of taxing powers to local governments has not materialized in most countries, either because taxing powers have not been handed down to any great extent or because compensating equalization transfers have been introduced. In any case, central governments do not appear to have used their fiscal discretion to pursue regional equalization.  

Prud’homme, however, reports on several cases where a centralized fiscal system led to fiscal redistribution among the regions.

A fourth constraint is bureaucratic. Central control of finances means that line ministries are responsible for much of the portfolio of service delivery, or at least for identifying targets for spending and disbursing funds. Under a decentralized system, the SNGs will assume this responsibility and the control of the central bureaucracy will be dramatically reduced. Those bureaucrats, who will lose power, and perhaps even jobs, form a powerful lobby for centralization. This pull to centralization holds for developing, transition, and industrialized countries.

It is commonly argued that fiscal decentralization in the form of greater expenditure assignments to SNGs in developing countries (and more recently in the case of transition countries) would compromise the quality of public services delivered. A number of


arguments have been made in support of this proposition:29 (a) the quality of SNG civil servants is weak because career opportunities are more limited than at the central level; (b) public expenditure management systems (e.g., treasury, accounting, and auditing) are weak; and (c) opportunities for bribery and nepotism are likely to lead to waste. These are old arguments but still powerful constraints to decentralizing policy.

A relatively new issue in this literature is the relationship between decentralization and corruption. One school of thought is that decentralized systems are more corrupt, in part because local politicians are more susceptible to pressures from local interest groups.30 If local voters are not sophisticated enough to hold local officials accountable, corruption will go unchecked. This suspicion may be more perception than reality. Tumennasan argues that the greater accountability of local government officials and interjurisdictional competition are deterrents to corruption, and estimates a negative relationship between decentralization and corruption.31 Fisman and Gatti32 and Gurgur and Shah33 reach a similar conclusion. Nevertheless, the fear that decentralization breeds more corruption is often enough to cause countries to hold on to centralized fiscal systems.

CONCLUSION AND FUTURE IMPLICATIONS

Fiscal decentralization has become entrenched as a part of development strategy in much of the world. Transition countries have adopted decentralization as a natural part of the switch from planned to market-based economic systems. With only rare exceptions is fiscal decentralization abandoned once it gains some momentum. However, as we point out in this paper, it has stalled in developing and developed countries in the last quarter of this century, and it has stalled at the very time that the hype has been greatest. By the early 2000s, the average share of government expenditures made by SNGs was about the same as in the 1970s in developing countries. The same may be said for industrialized countries, but the level is about twice as high. The share in many transition countries, while exploding in the 1990s, has also plateaued.34

What might the future hold? Are there factors at work that suggest that SNG fiscal shares will now begin to increase? Or to fall? Of course, futures are not predictable, and

30. Ibid., 201–219.
31. Bayar Tumennessan, “Fiscal Decentralization and Corruption in the Public Sector” (Ph.D. dissertation, Georgia State University, Andrew Young School of Policy Studies, Economics Department, 2005).
34. We emphasize that these are averages and hide the cases of some countries where there were significant increases and others where the subnational government fiscal share fell.
one cannot see with any degree of certainty the major changes in attitudes toward
governance that are coming. However, one could argue persuasively that the next quar-
ter century will not see changes of the magnitude of the last quarter century: e.g., the
breakup of the Soviet Union, the end of apartheid, or the replacement in many countries
of long-time central government domination with democratic governance. As fiscal de-
centralization is often driven by big events such as these, we might speculate that major
impetuses for enhanced provincial and local government finance will not be on the scene.
On the other hand, there probably will be significant international financial disruptions,
China and India’s continued emergence on the world economy will have ripple effects,
and many countries will remain in the throes of internal strife. And, as has been discussed
in this paper, all of these factors provide an impetus for various types of fiscal federalism
reforms and for more fiscal decentralization.

There are factors that might suggest a continued stall, and hold some countries from
decentralizing further. Continued struggles with fiscal balance may cause some central
governments to continue to exercise caution in committing large vertical shares to SNGs.
Trade liberalization and international competition will limit tax-policy choices, and
pressures to maintain budget balance will continue to argue for reducing subsidies of all
kinds. Social needs and infrastructure needs might continue to crowd out decentrali-
zation, by raising its opportunity cost. In other words, there could be more pressure than
before for central governments to hold on to their revenue collections. This pressure will
be especially great in the poorest countries.

On the other hand, there are five factors that suggest an increase in the financing share
of SNGs. First, the issue itself will not go away. Most of the reasons why countries argue
a decentralization strategy, as surveyed in this paper, go back to the issue of economic
efficiency gains, i.e., getting government fiscal decisions closer to the people. Higher-level
governments have been responding to the call by SNGs for more say about the tax and
expenditure decisions that affect them. Moreover, there is evidence of concern about
whether the electoral processes for local officials give local constituencies enough voice.
Second, the “determinants” analysis carried out in this paper and that from earlier
studies suggests that fiscal decentralization is a strategy that goes hand in hand with
economic development. As income rises, so does the share of fiscal activity managed by
SNGs. As the GDP gap between the rich and the poor countries closes, so will the fiscal
decentralization gap.

A third reason to expect increases in the fiscal share of lower-level governments is the
possibility that more taxing powers will be passed down, particularly to those SNGs with
the administrative wherewithal to administer a tax system. This increased provincial and
local taxing power could roll out into increased spending by these governments as locals
reacted to their newfound power to tax and choose their expenditure mix. Fourth, SNGs
have increased their capacity to both deliver services and administer certain types of taxes.
With a current groundswell of reaction against big government, central governments
might be more willing to pass at least more spending responsibility to state and local
governments and “get them on the learning curve” with respect to delivering local services.
Finally, there is the issue of the flypaper effect with respect to central government taxes, i.e., central government taxes have “stuck where they hit.” The rate of central revenue mobilization increased in many countries, but the rate of pass through to lower level governments did not. Much of the increase in the revenue mobilization of the past quarter century, particularly that in emerging economies, has been because of the introduction of the VAT and to ensuing rate increases in the VAT. These revenues were guarded by most central governments, and until recently, the VAT was thought of as unsuitable as a provincial-level tax. Central governments in most countries were wary of committing a large share of this revenue bonanza to SNGs.35 The next round of VAT adjustments will more likely be base broadening and administrative cleanup, and there may be less hesitance to pass a guaranteed share of revenues through to SNGs.

---

35. There were exceptions to this general rule, and some countries have earmarked a percent of value-added tax (VAT) collections for revenue sharing with lower-level governments.