2007

Benefits, Costs and Rules of Decentralization

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

24.
Benefits, Costs and Rules of Fiscal Decentralization

Roy Bahl

Contents

Benefits, Costs and Rules of Fiscal Decentralization

To bring all these briefing notes together—a final note that provides a set of operational guidelines for the decentralization dialogue and the practicalities of policy implementation.

The growing interest in fiscal decentralization in Kosovo is part of a worldwide pattern. In fact, it is the rare place that does not put strengthening of subnational government on its development policy agenda. The purpose of this briefing note is to address two of the overarching aspects of decentralization: the cost and benefits and the set of problems surrounding its implementation.

Some Benefits and Costs[1]

What are the major advantages to be gained from investing more fiscal powers in local governments? The first, and most important, are the welfare gains that come from moving government closer to the people. This is the economic efficiency argument that drives the thinking of most economists who work on this subject (Oates 1972; Musgrave 1983). The argument is straightforward. Let us assume that people's preferences for government services vary, e.g., because of religion, language, ethnic mix, climate or economic base. Let us assume further that people have sorted themselves so that those with like preferences live in the same region. 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 and 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 that they want.

The potential benefits from decentralization, then, include: (a) more accountability on the part of government officials because they are on the hook for service delivery to the local population that elected them, and (b) more willingness on the part of the local population to pay for services, because they get what they want. If one advocates fiscal decentralization, one must believe this story, as it is the primary argument. Some further argue that successful fiscal decentralization addresses several of the problems common to developing countries: revenue mobilization, innovation in economic decision-making, accountability of elected officials, capacity development, and grassroots participation in governance.

A second important benefit is the promise of increased revenue mobilization. This happens because decentralization can broaden the aggregate tax base by reaching the traditional income, consumption and wealth tax bases in ways that a central government cannot.[2] The instruments

1 This note draws on Bahl 1999. For more lengthy discussions of the pros and cons of fiscal decentralization, see Bahl and Linn 1992; Litvak, Ahmad and Bird 1998; Bird and Vaillancourt 1998; Tanzi 1996; Martinez 1997; and Dillinger 1994.

2 In this essay as well as throughout this volume, no final political status for Kosovo is presumed. Thus in many cases "central" government can be thought of as referring to a relationship between a highly autonomous provincial government and "sub-provincial" local governments. However, if Kosovo were to gain independence, it should then be noted that one of the key tools of macroeconomic stabilization—*viz,* monetary policy—would likely rest with the supranational European Central Bank.

available at the subnational level for this purpose include payroll taxes, levies on the sales or assets of firms, licenses to operate, betterment charges and property taxes. If this hypothesis is correct, subnational government taxes are not raised at the expense of reductions in central level taxes. Furthermore, the claim of subnational governments on central revenues *via* intergovernmental transfers are reduced by increased local revenue mobilization.

There can also be costs associated with fiscal decentralization and perhaps this is why not all places choose this policy route. Heading the list is macroeconomic control.[3] Central governments would like the flexibility to respond quickly to changes in the economy, for example, to raise taxes or cut expenditures to deal with a deficit. 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.

A second cost of decentralization is that the center will lose some control over infrastructure development because local governments will have some discretionary spending power. The net result of fiscal decentralization 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 of goods and services. Fiscal decentralization could therefore lead to a lower rate of spending on infrastructure, perhaps jeopardizing national growth.

Another line of thinking is that national priorities for capital investment do not conform to local government choices. The national government is interested in investments in infrastructure that have regional and national benefits; for example, irrigation, national roads, and power. Subnational governments will be focused on capital investments with regional and local benefits.

A fourth point is that revenue centralization gives 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. Moreover, if the local governments are not given independent taxing powers, the fiscal disparities to be equalized will be smaller. However, just because the central government has more funds to allocate, it does not necessarily follow that they will allocate these funds on an equalizing basis. In fact, most countries do very little equalization through their grant systems.

3 More detailed discussions of this topic may be found in Bahl and Linn 1992; Prud'homme 1995; Ter-Minassian 1997; Tanzi 1996; and Spahn 1997. A reading of these papers shows that there is anything but uniform agreement on this point.

Implementation Rules for Fiscal Decentralization

There is no one right way to do fiscal decentralization. Much depends on the policy objectives that the government most wants to achieve. It follows that the success of any fiscal decentralization policy will be hostage to the implementation plan. The following are twelve rules, more or less generic, that might be used to guide fiscal decentralization.[4]

Rule #1: Fiscal Decentralization Should Be Viewed as a System

Intergovernmental fiscal relations must be thought of as a system, and all the pieces in this system must fit together.[5] Thus, implementation should begin with a design of the comprehensive system, and should lay out the plan for each element of the system. A little reflection will lead one quickly to the conclusion that fiscal decentralization involves a lot more than fiscal matters. In fact, the electoral system and civil service arrangements are arguably as important as the taxing and spending components. The other key pieces are subnational government revenue-raising power, borrowing powers, expenditure assignment, and budgetary discretion. A "one-off" piecemeal reform, encompassing only one element of the system (e.g., the sharing of nationally levied and collected revenues) or a transfer system is not likely to lead to success (see "Sequencing Fiscal Decentralization Reform" in this volume).

Getting all the pieces on the table is the first part of the rule; making the pieces fit together is the second. For example, Indonesia's recent "big-bang" decentralization in 2000 considered both expenditure assignment and revenue assignment, but the planning was done by two different ministries, with little coordination. There did not seem to be a concern about making the two sides of the budget fit together.

Rule #2: Finance Follows Function

The second rule is to get the correct order of reform. First should come the assignment of expenditure responsibility (function) to local governments, and *then* the assignment of revenue responsibility (finance) should be determined. The key for this sequencing is that one cannot establish the level of subnational government revenues required independent of an estimate of expenditure needs. If one begins this process by fixing revenues, the correspondence between expenditure assignment and revenue allocations is lost. Moreover, it becomes difficult to sell a hard budget constraint if the process begins with an insufficient revenue assignment.

Rule #3: There Must Be a Strong Central Ability to Monitor, Evaluate and Lead Decentralization

Places such as Kosovo that are in transition out of the legacy of Socialism are for the most part characterized by highly centralized systems of government and tend to remain centralized for

4 These rules were first developed in Bahl 1999.

5 In this briefing note, *intergovernmental fiscal relations* refer generally to the division of fiscal powers and responsibilities among levels of government. *Fiscal decentralization* refers to an intergovernmental system where the balance of power moves more toward the subnational government sector than has been the case.

quite some time. If control by the center reflects political resistance to relinquish powers to a new group of bureaucrats, it will likely thwart fiscal autonomy such that the promised benefits of a decentralized society will be lost. But, if the control exercised is in the form of oversight and consists of monitoring, evaluating and leading, then the payoffs may be high. The following are some examples of the appropriate types of such oversight:

- Establishing and maintaining a uniform structure of subnational government accounts that are regularly and properly audited.
- Setting disclosure requirements with respect to debt financing of capital improvements and enforcing rules-based borrowing limits (Joumard and Kongsrud 2003).
- Monitoring the fiscal performance of local governments, and identifying those in financial difficulties as well as those exerting weak revenue mobilization efforts.
- Annually reviewing the performance success of government finance instruments (transfers, subsidies, local taxes) combined with a willingness to make needed policy adjustments.
- Confirming compliance with the terms of conditional grants, expenditure mandates and taxing limits.
- Providing technical assistance to local governments; the smaller local governments, in particular, are likely to require assistance in areas such as accounting, treasury, tax administration, data processing and project evaluation.

Typically, central and provincial governments in transition countries are not up to these tasks because they do not have sufficient administrative capacity to lead the development of local government finances. Two ingredients necessary to this job are (i) a fiscal analysis unit, probably best located in the finance ministry with adequate staff to continuously monitor local government finances; and (ii) an extensive data system that will allow quantitative monitoring and evaluation. Placement within the finance ministry affords the opportunity to coordinate activities with those responsible for other fiscal control measures, e.g., tax policy and borrowing.

Another option is to create an independent unit whose primary duty is policy research and advice. South Africa's permanent Fiscal and Finance Commission is such a unit. Uganda's Local Government Finance Commission is also permanent, but India's central and state finance commissions are only constituted every fifth year. Most countries, however, do not have such units.

There are also problems with the availability of a comprehensive data system to support the work of the fiscal analysis unit. A census of government finances that systematically reports actual financial outcomes for every subnational government is essential information if the performance of the intergovernmental system is to be monitored, analyzed for its strengths and weaknesses, and forecasted. Yet, it is not common in transition countries to have an up-to-date information system that describes the finances of subnational governments in detail. Rarer yet is a fiscal analysis model that is used to track the performance of local government finances.

Rule #4: One Intergovernmental System May Not Fit All Subnational Governments

Many believe that there must be a uniform intergovernmental fiscal system under which all subnational governments must operate. Certainly there are good arguments for this. If all subnational governments have the same expenditure responsibilities and revenue-raising powers, management of the system is much easier. Moreover, there is no hint of political favoritism as ad hoc differentiation among local units is not permitted.

However, there is another view, that uniformity may not be a necessary—or desirable—condition for effective decentralization. For example, a better route may be to begin fiscal decentralization with the larger local government units and to let the smaller ones "grow into it." Subnational governments have very different capabilities to deliver and finance services, and certainly different capabilities to borrow. It may be necessary to set up a system where these differences are explicitly recognized, i.e., where different local governments are given different financing powers and expenditure responsibilities (Bird and Ebel 2006). Places that are in the lower tier of capability could rely more heavily on grants; while more developed places could rely more heavily on local taxation and could borrow to finance capital outlays.

Rule #5: Fiscal Decentralization Requires Significant Local Government Taxing Powers

Voters will hold their elected officials more accountable if local public services are financed to a significant extent from locally imposed taxes and charges, as opposed to the case where financing is primarily by central government transfers. The local tax must be visible to local voters and large enough to impose a noticeable burden. Minor taxes and nuisance taxes will not do the trick.

Rule #6: Governments Must Keep the Fiscal Decentralization Rules That They Make

The fiscal decentralization plan is usually made by ministry officials, where lawyers draw up the decentralization laws, and training is then provided to local officials. In short, it is the higher level of government that makes the rules by which the new system will operate. Very often, these rules take the form of implementing regulations, rather than laws or constitutional imperatives. But, the higher level does not always keep the rules that it makes. For example:

- The promise of budgetary discretion is often followed by the imposition of unfunded expenditure mandates on local governments and/or an under funding of agreed upon transfers.

- The reassignment of expenditure responsibilities to subnational governments is made, but without the reassignment of commensurate revenue support.

- The abolition or capping of subnational government revenue-raising powers without an offsetting reduction in expenditure responsibility is a common problem. A good example occurs when a higher level of government puts a cap on a local tax. This compromises local revenue efforts and undercuts local self-government autonomy.

Rule #7: Keep It Simple

Subnational government administrative systems often cannot handle complicated intergovernmental fiscal arrangements. The same may be said of the central government systems necessary to monitor and evaluate intergovernmental fiscal arrangements. Simple fiscal decentralization structures will require the local governments to allocate fewer resources to administration, and will lower the monitoring and evaluation costs facing the central government. Complication is often introduced into the intergovernmental fiscal system by well-meaning policy analysts, because they do not properly take into account the capability of the administrative system to handle these refinements.

This is not to say that simplicity alone should drive intergovernmental reform. Indeed, there are complications that cannot and should not be avoided, e.g., disclosure requirements for local government borrowing, uniform accounting systems that follow accepted principles, and prescriptions for audit procedures. But the basic rule is to protect simplicity by limiting the number of objectives to be accomplished by each policy instrument and to be mindful of the administrative capacity of the local and central governments to administer (enforce) the system being designed.

Rule #8: The Design of the Intergovernmental Transfer System Should Match the Objectives of the Decentralization Reform

There are many different kinds of intergovernmental transfer systems, with many different types of impact on local government finances. Some stimulate local spending; some are substituted for local revenue effort; some are equalizing; and some lead to more local government fiscal autonomy than others. Countries often enter into grant design without fully exploring the alternatives and their differential impacts. Intergovernmental transfers have two dimensions: the size of the distributable (or "divisible") pool, and the distribution of this pool among eligible local government units. Some have referred to the divisible pool dimension as having to do with the *vertical fiscal balance* between the central and subnational governments, and the allocation dimension as having to do with *horizontal fiscal balance*. Both dimensions must be part of the policy design.[6]

6 Bahl and Linn 1992, Chapter 13.

Rule #9: Fiscal Decentralization Should Consider All Levels of Government

There is an inter- as well as intra-governmental dimension to intergovernmental fiscal relations. In some countries, provincial governments are too large to allow a level of citizen participation that insures voter preferences will matter, or that accountability of government officials will result. In such cases, fiscal decentralization must be carried through to the lower level of government. One must take care, however, to not overly fragment (make too many small) general purpose governments (Bird, Ebel, and Wallich 1995).

Rule #10: Impose a Hard Budget Constraint

A hard budget constraint implies that those governments that are given autonomy will be asked to balance their budgets without recourse to any end-of-year assistance from the central government. This is another of those rules that higher levels of government must keep; and local governments must believe that they are "on their own." Enemies of the hard budget constraint include fiscal measures such as the following:

- deficit grants, i.e., year-end grants to cover revenue shortfalls;
- bailouts on delinquent debt; and
- direct coverage of year-end shortfalls on certain items of expenditure.

Many "post-socialist" transition governments prefer to hold to a paternalistic approach to intergovernmental fiscal relations. The fiscal year begins with a vertical imbalance between local government expenditure needs and revenue authority, and perhaps even an uncertain level of grant distribution from the center. A year-end budget deficit is, in effect, planned, and deficit grants are a guarantee that local governments come to depend on. This was the case of Budapest for the first four to five years of its "self-governance" until, recognizing the dependency trap, the city undertook a policy to aggressively utilize their legal spending, tax and regulatory powers (Pallai 2003).

Rule #11: Recognize That Intergovernmental Systems Are Always in Transition and Plan for This

Some elements of a fiscal decentralization program will be short-lived, e.g., their relevance may diminish with economic development. There are many examples of this: disparities among regions within a country change; the quality of the basic infrastructure changes; priority areas for investment change; and the technical capacities of local governments change. Central governments must incorporate some degree of flexibility into their fiscal decentralization plans in order to adjust to such changes. How does a government do this while keeping a transparent structure to the intergovernmental fiscal system? The following are some possible answers to this question.

- Establish, as Kosovo has, an intergovernmental grants commission that reviews the allocation of intergovernmental transfers every few years, and recommends changes in the system. This approach, which must be expert and transparent, gives local governments enough certainty to plan their finances over a multi-year period and at the same time provides flexibility to accommodate change.

- Allow for changes in the local tax structure to capture changes in economic structure. As some local areas develop and urbanize, it may be possible to piggyback onto central and provincial taxes, broaden the tax base so as to pick up non-traditional sectors (e.g., the self-employed, small shops), or to use special benefit taxes such as tolls or special land assessments. These advances in tax structure should be encouraged.

- Provide for explicit "graduation" provisions for local governments. There should be a specified period for review to determine whether any given local government could graduate to the next highest class of local fiscal autonomy.

Rule #12: There Must Be a Champion for Fiscal Decentralization

It seems a paradox that fiscal decentralization can be such a popular policy in transition countries, but then have few enthusiastic champions. For decentralization to succeed there must be a strong *internal* champion that understands the costs and benefits of establishing such a program.

One can use ad hoc reasoning to try and identify the centers of strong support for decentralization policy. Such a categorization is presented in a "stylized" manner in Table 1. The strongest supporters are listed in the top cells of the table and the weakest in the bottom cells. Decentralization is a grass roots movement, which means that voters and elected politicians, including the president/prime minister, should be natural champions. But, if decentralization conflicts with macroeconomic stabilization policy, that support will be less firm. Hyperinflation or recession offers far more of a threat to re-election chances than does the absence of a good decentralization program.

Parliament will embrace programs that voters embrace, and therefore is a potential champion of decentralization. However, members of Parliament may also be particularly interested in how programs benefit their own constituency (and their popularity); hence they may be less enthusiastic than policy analysts about the need for transparency.

Though local governments can be expected to favor decentralization, the rich and poor among them may take very different views on the preferred version of decentralization. The more well-off local areas will favor increased fiscal discretion and a *laissez-faire* approach to fiscal decentralization while the poor will opt for a redistributive system based on a guaranteed revenue flow.

Table 1. Strong, Weak and Ambivalent Supporters of Fiscal Decentralization

Potentially Strong Supporters	Comments
The People and Their Elected Representatives	Demand for more participation in governance at the local level.
The President and/or Prime Minister	Decentralization is a popular policy with the electorate. However, the president/PM must also be very mindful of stabilization concerns with decentralization, since inflation and unemployment are usually the greatest danger to his/her political standing.
The Parliament or Congress	Decentralization is a popular policy with the electorate. Parliament would like to identify with specific local projects that they could "bring home," therefore, they may favor a less transparent and less structured system.
Urban Local Governments	"Give us the autonomy to tax and spend." Urban local governments are often most concerned with how their autonomy is circumscribed, and how their access to their tax base is limited.
External Donors	Donors provide encouragement and some technical assistance to get the process underway, but external assistance is no substitute for in-country champions and capacity development.
Potentially Weak Supporters	
Ministry of Finance	Would propose strict limits to decentralization in order to continue to wield the main fiscal tools for stabilization policy purposes.
Ministry of Economy	Would like to control the type of investment made, as well as the regional distribution of investment. Typically interested in programs with big externalities vs local benefit programs.
Line Ministries	Would like to control the standards of public service delivery, and often would like to hold an approval or sign off power.
Ambivalent Supporter	
Ministry of Local Government	Would favor a greater guaranteed share for local governments, but would like to control the distribution of those resources.
Weaker local governments	Would like a guaranteed transfer of resources from the urban and wealthier local governments to the rest. More interested in a transfer system than in a local taxing system.

Finally, some of the external donors and advisors will champion fiscal decentralization. The World Bank and the Inter-American Development Bank tend to see decentralization as part of a development strategy that will lead to a more satisfactory and balanced growth, and promote decentralization as a country strategy. The IMF takes a more cautious and qualified view because of its concern with any policy that might promote fiscal instability. These external advisors can play an important catalytic role. When they bring funding as the carrot, they oftentimes catch the attention of government officials and stimulate the government to begin looking harder at the decentralization issue. But unless the government itself is enthusiastic, the harder look will not lead to meaningful policy reform and in fact will be quickly forgotten when the money is gone. The implementation stage is never reached.

There are three major detractors of fiscal decentralization policy. The finance ministry as the keeper of the tools to address macroeconomic instability will not want to give up its control over these tools. Typically, the ministry of finance will favor an ad hoc over a transparent regime. If this ministry is on record as favoring decentralization, it will tend to be a very controlled form of decentralization. One might look for the following features in such a program:

- limited freedom for local governments to set tax rates for any major taxes;
- strictly controlled borrowing powers;
- budget approval by higher level government, or stringent expenditure mandates;
- an ad hoc system of intergovernmental transfers, that would give the central governments some flexibility to withhold full distributions in hard times; and
- centrally controlled wage and salary rates for local government employees.

The ministry of economy could be a significant opponent. This ministry will be interested in a system that allows central rather than local direction of investment. If investment decisions are decentralized to any significant extent, it will compromise national planning on the distribution of capital expenditures by function and by location.

And, the line ministries often oppose decentralization on grounds that seem more paternalistic. Their view is that the local governments do not have the technical capacity to deliver services or to plan resource allocation; hence there must be strong central direction. Line ministries, if they are persuaded on fiscal decentralization, will be more comfortable with conditional grants and mandated expenditure requirements.

Concluding Comment

Despite the rhetoric, fiscal decentralization is often held back. Until recently the advantages of centralization and the political power of the centralists have been too strong. But the world has changed, and the case for decentralization is becoming more irresistible. It may be slowed by an unstable world economy, as most new policies will be, but its time may have come. Governments around the world are increasingly elected on a platform of citizen participation in governance; economic development has eroded some of the arguments in favor of fiscal centralization; and the service delivery capabilities of local governments have improved dramatically. Moreover, some view granting local autonomy as better than separatism as a policy direction. The enemy now is poorly conceived decentralization policies. Design must match objectives, and implementation must face up to the many dimensions of decentralization.

References

Bahl, Roy W. 1999. *Implementation Rules for Fiscal Decentralization*. Atlanta, Georgia USA; Georgia State University. Available at http://aysps.gsu.edu/publications.

Bahl, Roy W. and Johannes Linn. 1992. *Urban Public Finance in Developing Countries*. New York: Oxford University Press.

Bird, Richard M. and Robert D. Ebel. 2006. *Fiscal Fragmentation in Decentralized Countries: Subsidiarity, Solidarity and Asymmetry*. Cheltenham, UK: Edward Elgar.

Bird, Richard M., Robert D. Ebel, and Christine I. Wallich. 1995. *Decentralization of the Socialist State*. Washington, DC: World Bank.

Bird, Richard M. and Francois Vaillancourt, eds. 1998. *Fiscal Decentralization in Developing Countries*. Cambridge: Cambridge University Press.

Dillinger, William. 1994. *Decentralization and Its Implications for Urban Service Delivery*. Urban Management Programme Series 16. Washington, DC: World Bank.

Litvack, Jennie, Junaid Ahmad and Richard M. Bird. 1998. *Rethinking Decentralization in Developing Countries*. World Bank Sector Study Series. Washington, DC: World Bank.

Martinez-Vazquez, Jorge and Robert McNab. 1997. "Fiscal Decentralization, Economic Growth, and Democratic Governance." A Report Prepared for the USAID Conference on Economic Growth and Economic Development. Washington, DC, October. Available at http://aysps.gsu.edu/publications.

Musgrave, Richard A. 1983. "Who Should Tax, Where and What?" In *Tax Assignment in Federal Countries*, ed. Charles McLure, Jr. Canberra: Centre for Research on Federal Financial Relations of the Australian National University.

Oates, Wallace. 1972. *Fiscal Federalism*. New York: Harcourt, Brace, Jovanovich.

Pallai, Katalin. 2003. *The Budapest Model*. Budapest: OSI/Local Government and Public Service Reform Initiative.

Prud'homme, Remy. 1995. "The Dangers of Decentralization," *World Bank Research Observer*.

Spahn, P. Bernd. 1997. *Decentralized Government and Macroeconomic Control*. Paper Prepared for the International Institute of Public Finance, 53rd Congress, Kyoto, Japan.

Tanzi, Vito. 1996. "Fiscal Federalism and Decentralization: A Review of Some Efficiency and Macroeconomic Aspects." In *Annual World Bank Conference on Development Economics*, ed. Michael Bruno and Boris Pleskovic. Washington, DC: World Bank.

Ter-Minassian, Teresa, ed. 1997. *Fiscal Federalism in Theory and Practice*. Washington, DC: International Monetary Fund.