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Sequencing Fiscal Decentralization Reform

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Sequencing Fiscal Decentralization Reform

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Sequencing Fiscal Decentralization Reform

Drawing on international experience, a set of process steps a newly decentralizing country may consider as it implements a plan for public sector reform.

While there is extensive knowledge about how to design fiscal decentralization policies, considerably less is understood about how a decentralization program should be sequenced and implemented. Countries embarking on decentralization often struggle with decisions about its essential components, the order of introduction of decentralization policies and activities, the number of years necessary to fully implement a program, and the components of the transition strategy. This note argues that the sequencing of decentralization is an important determinant of its success. The consequences of a poorly sequenced decentralization program can range from minor delays and complications to macroeconomic instability, and, even, to chaotic situations with failed public services.

If sequencing matters, what is the best way to proceed? While it is recognized here that no one process or model fits all decentralizing systems, by drawing on the experiences of other places that have undertaken fiscal decentralization reform one can develop a stylized approach to sequencing decentralization (Bahl and Martinez-Vazquez 2005). Such an approach serves as a reasonable baseline against which to compare the ideal sequence to that of real world practice where politics and administrative constraints matter and change final outcomes. This briefing note lays out six identifiable steps (Figure 1).

Step 1: National Dialogue

Ideally, the fiscal decentralization process begins with a national dialogue involving key stakeholders. This debate might be in the context of an election cycle or part of a discussion led by an appointed, broadly representative commission to consider a change in the pattern of governance. The momentum for decentralization may originate from the “bottom up” such as a citizens-movement, or from a centrally led “top-down” initiative; or, from both directions (e.g., the Japanese “integrationist approach” as discussed in Iqbal, Muramatsu and Kume 2001). Regardless of where the pressure originates, some form of discussion about the desirability of decentralization is an important first step. This process is already underway in Kosovo and serves as the context for these briefing notes. The national discussion should focus on the basic goals of the decentralization program and the options available for structuring decentralization. It should not, however, dwell on details. The reason that the decentralization dialogue is important is that for decentralization to be sustainable, key political and administrative stakeholders and citizens alike must buy into the desirability and general outlines of the strategy.¹ Ideally, this national debate will involve the

¹ “Sustainability” here refers to political consensus and sustainability. This concept is different from, but complementary and reinforcing of, the conditions for achieving fiscal sustainability. See Bird, 2003.

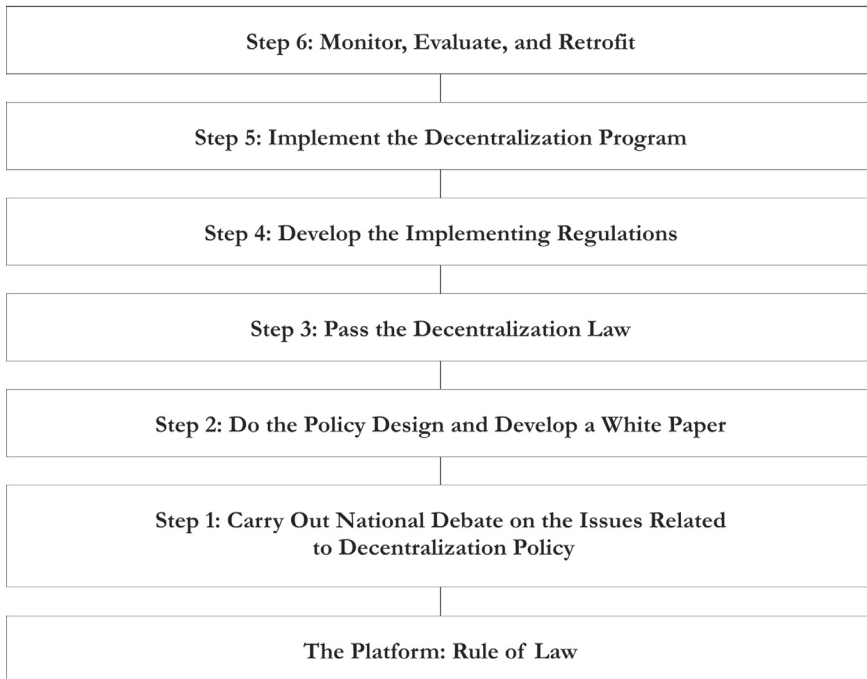
main political parties, will have some degree of formality (as in the case of a national commission), and will be transparent. A further important ingredient for the success of fiscal decentralization is a coalition of strong advocates. These advocates will keep decentralization in the center of the national debate and work to develop the coalitions necessary to effect a decentralization policy.

Step 2: Design of the Fiscal Decentralization Program

The design of the fiscal decentralization program should culminate in a *comprehensive policy paper* that lays out the framework for the fiscal decentralization. While the national consensus might be centered on the broad idea of bringing government closer to the people, the “white paper” would lay out the plan for accomplishing this. It would outline the main components of the fiscal decentralization program, provide a timetable for implementation, and serve as the basis for writing the law(s). Fiscal decentralization is a policy that is designed to achieve certain objectives, and therefore, it is critical that the objectives be clearly specified before the program is designed. This policy framework paper must be specific enough, and comprehensive enough, to guide the development of the law and the implementation. At the same time, it must also be recognized that, for example, as the country’s fiscal architecture changes (see briefing note on Fiscal Architecture) what was the “right design” in the first year of the program, over time, may no longer fit changing circumstances—thus the argument for establishing a continuing policy development and research process, along with institutions, public and private, to support that process (Yilmaz, Hegedus, Bell 2003). The design phase must follow the national discussion that gives the mandate for decentralization policy.

What if decentralization goes forward without such a policy paper? Two major problems are almost certain to occur. First, without a roadmap for the decentralization strategy, government policymakers will “make it up as they go.” This can lead to a fragmented decentralization strategy, pieces of which do not fit together. The other problem with not having a documented framework is that changes to policy in the years that follow may not be consistent with the overall goals of the fiscal decentralization program.

Figure 1. Sequencing Fiscal Decentralization: A Normative Approach



Step 3: Draft and Pass the Decentralization Law(s)

The drafting and passing of the decentralization law naturally follows from the national mandate and from the policy framework paper, and gives legal standing to the implementation of the fiscal decentralization measures. The laws must be clear and true to the policy design. The decentralization laws might stand alone, or some elements of the decentralization program might be introduced into the constitution (Basta Fleiner 2002).²

On this matter, there are two further comments. First, there may be (should be) more than one law. For example, Hungary has enacted not only a general Law on Local Self-Government that lays out the basic structure for intergovernmental reform (See the note, “Legal Framework and the European Charter,” and also Peteri 2002), but also supporting laws on local elections, the sorting out of intergovernmental functional responsibilities, regulations on service delivery revenues, borrowing, debt and bankruptcy, asset management, and the capital city (Pallai 2003). Second, recognizing that there is great merit in providing constitutional protections for decentralization and local governance, it is also true that great care must be taken to keep constitutional language broad—that is, to draw a bright line between ensuring protections vs. loading down a constitution

² It is most important that Constitutions address broad principles and not become cluttered up with details that are appropriately statutory and regulatory. Constitutions are difficult to change and thus do not readily fit the changing economic, demographic and institutional realities of governance (see briefing note on Fiscal Architecture)

with what is properly a matter of statute and might prevent future reforms.

Recognizing that the “right mix” of laws and constitutional protections may vary from country to country (and/or province to province since just as there are national constitutions there may also be provincial constitutions), a most important factor in getting a successful decentralization in place is to include in the law key elements of the policy design. These key elements include that of: (i) expenditure assignment and authority; (ii) revenue assignment and authority; (iii) design of the intergovernmental transfer system; and (iv) provisions for fiscal discipline. To summarize:

Expenditures: finance follows function. It is important to get correct the order of reform as regards how much should be spent by subnational governments, and how much revenue should be given to subnational governments. There is a conventional wisdom to the ordering. First comes the assignment of expenditure responsibility to subnational governments, after which the assignment of revenue-raising powers and central government revenue shares is determined. The logic behind this finance-follows-function rule is straightforward: one cannot establish the required level of subnational revenues independent of having a reasonably clear sense of the bundle of services one expects a local government to deliver and then pay for. With that said, it is also true that to argue that finance follows function should not be taken as counsel for delaying a policy of mobilizing local “own” revenues. Recent empirical evidence indicates that simultaneous decentralization of tax and spending powers reduces the overall size of the public sector (Ehadie 1994) and improves overall macroeconomic performance (Ebel and Yilmaz 2003).

The significance of local revenue autonomy. It is important to a complete decentralization that subnational governments have independent sources of revenue. If all financing is from revenue sharing and other forms of transfers from higher-level governments, there is a danger that the lower-level government will become a spending agent for the center, with little accountability and operational efficiency (Martinez-Vazquez and McNab 1997).

Design of the intergovernmental transfer system. An important sequencing question has to do with the design and implementation of intergovernmental transfers. The correct order of policy formulation is to first ask which of the many possible objectives should the intergovernmental transfer system accomplish, and only then design the reformed system. The major issue is that different types of transfers have different objectives, and it is important to sequence grant design according to these objectives. One goal is to reconcile the difference between the assignment of expenditure responsibility and the assignment of revenue-raising powers. This goal of vertical balance is arguably the first task to tackle in designing the transfer system. The second step in grant system design is to implement conditional grants for those functions of national/regional importance where it is feared that without central assistance under-provision might occur. Finally, equalization grants should be designed to address the horizontal imbalances that result after designing the first two components of the transfer system (see briefing note on Intergovernmental Transfers).

Subnational governments must face a hard budget constraint. Fiscal discipline, a key element of a successful decentralization strategy, should be introduced at the start of the program. If subnational governments are not forced to operate with balanced budgets, they become accustomed to looking to higher-level governments to cover their shortfalls. A hard budget constraint implies that those

local governments that are given autonomy will be asked to balance their budgets without recourse to any end-of-year assistance from the central government. Without a hard budget constraint, the moral hazard is that subnational governments will consciously overspend knowing that their losses will be made good. Furthermore, a soft budget constraint will tend to discourage own tax effort and encourage inefficient and even wasteful spending. As many countries have learned, it is difficult to break the culture of soft budget constraint (see briefing note on Subnational Borrowing).

Step 4: Adopting a Set of Implementing Regulations

In the discussion above, it was recommended that the dialogue of Step 1 be broad and avoid becoming bogged down in details. But, of course, details matter, and thus it becomes important to develop **implementing regulations that spell out how the fiscal decentralization will be put in place**. Thus, for example, whereas the policy framework paper and the law on decentralization might call for the transfer of civil servants from central to subnational governments, the implementing regulations would address the detail of this transfer of how government officials, central and local, put the new system in place. It is in this step that one distinguishes between the content of laws and regulations. The law should include those things that are understood to be relatively long term as decentralization policy. For example, provisions for the election of local officials, basic expenditure and revenue assignments, the fundamental structure of the equalization grant, and the civil service status of local and central government employees are not likely to change over time—or at least should not change frequently—and, therefore, properly belong in the law. However, other factors, such as the weighting parameters in the intergovernmental grant formula, provisions for revenue-sharing rates, and administrative arrangements may change with economic development and other variable circumstances, and belong with the implementing regulations rather than the law.

Getting the implementing regulations out of sequence can be quite disruptive of the decentralization program. If these are written before the policy framework paper is completed, then the regulations themselves become an important part of the decentralization policy. This is the “make it up as you go” approach, which was cautioned against earlier. The implementing regulations in this case would be written by different government ministries following more or less their own preferences and the different pieces are unlikely to fit any unified strategy.

Step 5: Taking on the Set of Implementation Tasks

Implementation of a decentralization program involves more than simply passing a set of laws with respect to the intergovernmental fiscal relationship. It also involves developing a strategy for implementation and a significant amount of planning and fail-safe provisions in order to accommodate any failures in the early stages of decentralization. This planning is part of the design phase of the sequencing. Actual implementation comes after the implementing regulations are complete. Several issues need to be considered:

Using asymmetric decentralization. Uniformity is not a necessary condition for effective decentraliza-

tion. In fact, a better route may be to begin fiscal decentralization with larger local government units and to let the smaller ones “grow into it.” Subnational governments have very different capabilities to deliver and finance services. Accordingly, 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 arrangements as well as differing expenditure responsibilities (Bird and Ebel 2006).

Building capacity. An often important constraint to the implementation of a newly decentralized system of government is lack of administrative capacity of local governments. When decentralization takes place and the administrative capacity is not in place, what may follow is poor performance in service delivery with all sorts of inefficiencies, waste, corruption, and lack of accountability. Systemic failure of local governments to deliver services is in the long term the worst enemy of decentralized governance—sooner or later the “solution” found will be to recentralize the public finances. That said, the lack of subnational administrative capacity should not be allowed to become an excuse for delay of the decentralization strategy. Governments, central and subnational, must be allowed to build capacity in a “learning-by-doing” manner.

Contingency funds. Like most other government policies, decentralization policy is designed and implemented in a context of limited information and therefore there is always the risk that things may not turn out as expected. For this reason, it is important to provide the implementation process with contingency funds to cover unforeseen circumstances.

“Big bang” versus gradual implementation. A gradual implementation of reform is thought by many to be more desirable than a hurried “big bang” approach. There are two good reasons why this might be preferred: (a) limited available information does not allow for predictions on how reform will work out in comparison to how it was planned and (b) the cost of reform can be substantial, and gradual approaches allow this to be spread out over a number of years (IMF 2000). In short, gradual approaches carry much less risk, and thus it is probably best to argue in favor of gradualism in its implementation. However, the type of gradualism being proposed here must not be seen as a substitute for a comprehensive blueprint for decentralization reform. A gradual implementation approach should be based on an explicit plan with goals and the institutional changes necessary to achieve them.

Transition measures: bold harmless versus “cold turkey.” Many forms of fiscal decentralization reform imply that there will be winners and losers among the subnational governments. Sometimes, politically and/or economically powerful subnational governments may effectively veto the reform unless their concerns about the losers under the new system are taken into account. Usually, neither the local government service delivery system nor the local political system can withstand large one-time shocks without causing turmoil in the delivery of essential services. Some form of phase-in of the new system is called for.

Step 6: Monitoring and Evaluation

The final step in the sequencing consists of a well-designed and operational system of monitoring and evaluation by the central (state) government and a well-designed accountability system across all governments. Many developing and transition countries may be characterized as having very centralized systems of government, which are likely to remain centralized for quite some time. A plausible scenario in such countries is that fiscal decentralization will be to a large degree controlled and regulated from the center.

In some cases, the control will reflect hesitancy on the part of the higher-level government to relinquish powers to a new group of bureaucrats. But in other cases, regulation and oversight can be seen as a needed feature of the fiscal decentralization structure. The following are some examples of the latter: As subnational governments move toward debt financing of capital improvements, central governments will be called on to establish disclosure requirements and enforce borrowing limits. The center must monitor the fiscal performance of local governments and identify those in financial difficulties as well as those exerting weak revenue mobilization efforts. The success of central government financing instruments (transfers, subsidies, local taxes) should be monitored annually and fine-tuned periodically. Another example is the need for the center to ensure compliance with the terms of conditional grants, expenditure mandates and taxing limits. Moreover, there is need for the center to provide technical assistance to local governments in several areas. Smaller local governments, especially, require assistance in areas such as accounting, treasury, tax administration, data processing, and project evaluation.

The steps outlined above might be thought of as a normative approach to ordering the elements of a sustainable fiscal decentralization strategy. This sequencing allows each step to build on the necessary prerequisites, and therefore could minimize the chances for failure of the system to accomplish its objectives. In the real world, however, there are important constraints that steer countries away from such an optimal sequencing. And sometimes, these departures are in the best interests of getting the job done. But clearly, while some departures may be admissible in terms of the costs and disruption involved in the decentralization process (for example, getting the implementation started without complete implementing regulations), some other departures may be too costly (for example, decentralizing borrowing powers without providing for a hard budget constraint for subnational governments).

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