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Fiscal decentralization in developing countries: an overview

RICHARD M. BIRD AND FRANÇOIS VAILLANCOURT

Recent years have seen worldwide interest in fiscal decentralization. Developed countries are reshaping their intergovernmental fiscal structure to be more in tune with the realities of the “post-welfare state” (Bennett, 1990; Wildasin, 1997a).¹ The countries in transition in eastern and central Europe are busily setting up new systems of local and intergovernmental finance (Bird, Ebel, and Wallich, 1995). Many developing countries are also turning to various forms of fiscal decentralization as one possible way of escaping from the traps of ineffective and inefficient governance, macroeconomic instability, and inadequate economic growth in which so many of them have become mired in recent years.² Each country does what it does for its own peculiar reasons, but when so many countries in so many different circumstances do somewhat similar things, there is likely to be more at work than meets the local eye. The principal purpose of this book is to take stock of the progress, problems, and potentials of fiscal decentralization in developing countries by bringing together a set of studies from a variety of countries around the world.

Decentralization in developing countries sometimes seems to be viewed as either a panacea or a plague – either a cure for all the ills of such countries or an addition to their already heavy burdens. Some argue for decentralization on grounds of improved economic efficiency, some on grounds of cost efficiency, some in terms of improved accountability, and some in terms of increased resource mobilization.³ On the other hand, others argue that none of these virtuous outcomes is likely to be achieved in countries in which citizen preferences are unlikely to be reflected in budget outcomes and the institutional capacity of existing subnational (state and local) governments is close to nil.⁴ From this perspective, decentralization seems likely to result in increased costs, lessened efficiency in service delivery, and probably greater inequity and macroeconomic instability (Prud’homme, 1995).

In general terms, it is not difficult to defend and elaborate either side of this controversy. With respect to efficiency, for example, the standard

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economic view is that the existence of different tax-spending packages in different jurisdictions, coupled with individual mobility, is sufficient to ensure that there will be efficiency-producing interjurisdictional competition in service provision (Tiebout, 1956). Similarly, empirical evidence from a number of countries supports the proposition that locally controlled services are likely to be provided at lower costs than centrally provided ones (Campbell, Peterson, and Brakarz, 1991). On the other hand, reaping these benefits appears to require the prior existence of such rare conditions in developing countries as significant local administrative capacity and locally responsive and responsible officials with substantial discretionary financial control (Bahl and Linn, 1994).

Interesting as such generalities may be, they largely miss the mark. The essence of decentralization is that it does not occur *in general* but rather in a particular country – in a country with its own history and traditions and its own specific institutional, political, and economic context. Moreover, as the various case studies in this book demonstrate, decentralization has taken many different forms in different countries at different times, and even exactly the same variety of decentralization may have very different effects under different conditions – compare, for example, the decentralization in Morocco with that in Tunisia (Vaillancourt, this volume), two countries similar in language, religion, and colonial administrative legacy.

As the ten case studies that constitute the bulk of this book illustrate, economic theorists are theorizing about fiscal decentralization, applied economists are attempting to measure its effects in various dimensions, and policy economists are busily flying around the world dispensing advice about it. But just what is meant by fiscal decentralization? What advice does the academic literature suggest should be given? And how does this advice relate to what is actually taking place in the real world? In this first chapter we attempt both to answer these questions to provide some general background to the case studies that follow and also to draw some general conclusions relevant to these questions from those case studies.

In the next section, we discuss what fiscal decentralization is and why it is a matter of policy concern. We then provide a brief quantitative overview of the extent and nature of fiscal decentralization in the countries covered in this volume and, for comparison, in a few others as well. But numbers alone cannot depict adequately the complex institutional reality that constitutes fiscal decentralization in any country. The third section of this chapter therefore sketches briefly some of the important patterns of fiscal decentralization to be found in the world, referring to some of the key points developed in more detail in the country analyses that constitute the bulk of this book. Finally, in the concluding section of the chapter, we

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draw some general lessons from the very diverse experiences recounted here with respect to both the substance and the process of fiscal decentralization in developing countries.

Fiscal decentralization: what and why?

Four questions are addressed in this section. First, how do we define “fiscal decentralization” and assess its success? Second, what macroeconomic questions are associated with decentralization, and, in particular, how should subnational borrowing be managed? Third, how do local managerial capacity and local taxation impact on decentralization? Fourth, what do theory and experience suggest are necessary and sufficient conditions for “successful” fiscal decentralization?

Definition and assessment

Three varieties of fiscal decentralization may be distinguished, corresponding to the degree of independent decision-making exercised at the local level.⁵ First, *deconcentration* means the dispersion of responsibilities within a central government to regional branch offices or local administrative units.⁶ Second, *delegation* refers to a situation in which local governments act as agents for the central government, executing certain functions on its behalf. Third, *devolution* refers to a situation in which not only implementation but also the authority to decide what is done is in the hands of local governments.⁷

How one assesses decentralization clearly depends in part upon whether what has occurred is best characterized as deconcentration, delegation, or devolution. It also depends upon whether one views decentralization from the top down or from the bottom up (Bird, 1980). The approach to fiscal decentralization from the *bottom up* generally stresses political values – improved governance in the sense of local responsiveness and political participation, for example – as well as allocative efficiency in terms of improving welfare (as in the decentralization theorem of Oates, 1972). The political literature is replete with passages praising the virtues of decentralization. Not only will it produce more efficient and equitable service delivery through making better use of local knowledge, but it will also, so we are sometimes told, lead to greater participation and democracy and hence result in more popular support for government, and presumably in improved political stability. When to these good qualities are added such further ascribed virtues as increased resource mobilization and reduced strain on central finances, greater accountability, and more

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responsive and responsible government in general, it is not surprising that some have seen decentralization to be *intrinsically* valuable.

Whatever the precise outcomes of adopting a decentralized (in the sense of devolved) system of decision-making, such outcomes are presumed, from this perspective, to be satisfactory simply because the process itself is intrinsically desirable. Local people may make wrong decisions from the perspective of the central government or of an outside observer, but if *they* make them, the decisions must, by definition, be assumed to be right for them. From this perspective, then, decentralization is intrinsically good because it institutionalizes the participation of those affected by local decisions. The results of a good process must themselves be good.

But matters may not seem so clear if one looks at the process from the top down, rather than from the bottom up. From the *top down* (the central government) the rationale for decentralization may be, for example, to make the life of the central government easier by shifting deficits (or at least some of the political pressures resulting from deficits) downward.⁸ Or it may be a desire on the part of the central government to achieve its allocative goals more efficiently by delegating or decentralizing authority to local governments, as appears to have been the case to some extent in Colombia (Bird and Fiszbein, this volume) and Indonesia (Shah, this volume). The goal of the central government may even be to increase the level of national welfare, as often assumed in theoretical discussion (for example, Boadway, Roberts, and Shah, 1993). Whatever the rationale, this top-down approach suggests that the main criterion for evaluating fiscal decentralization should be how well it serves the presumed national policy objectives.

An initial problem in analyzing fiscal decentralization in any specific setting is thus to determine whether a “good” fiscal decentralization is one which better achieves the goals of the central government (or improves national welfare as a whole, if one prefers) or one which frees local governments most from central dictates (or, if one prefers, improves local welfare most). Decentralization may have many virtues: it may, for instance, improve accessibility, local responsibility, and the effectiveness of government. But it is not likely to yield, for instance, precisely the same expenditure pattern the central government would choose to implement except in the extremely unlikely case that the goals of central and local government precisely coincide. In a geographically heterogeneous society, this is simply not possible. Conflicts between central and local governments as to what should be done are inevitable, even if each government tries faithfully to serve the interests of its (different mix of) constituents.

The choice of perspective is thus essential in approaching issues of fiscal

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decentralization. The bottom-up perspective may be particularly appropriate for countries like India (Rao, this volume), South Africa (Ahmad, this volume) or Bosnia-Herzegovina (Fox and Wallich, this volume) in which heterogeneity among different territorial units on various dimensions is high, and to a considerable extent reflects political decisions intended to make the national state at least potentially viable. In most of the other countries covered in this volume, however, as in developing countries more generally (Bird, 1993), the top-down perspective seems more likely to be appropriate. In China, for example, Bahl (this volume) suggests that the recent reforms of taxation and intergovernmental finance were intended (1) to reassert macroeconomic control and (2) to secure adequate resources for the central government to achieve such objectives as developing important interregional infrastructure.⁹

Macroeconomic aspects of decentralization

The stringent conditions for successful decentralization have recently been emphasized with respect to developing countries.¹⁰ In particular, it has been argued that not only may decentralization fail to improve local service delivery, it may even risk national destabilization. This risk is greatest when revenues are decentralized without adequate steps being taken to ensure both that local revenue mobilization is maintained and that local authorities are capable of carrying out the corresponding expenditure responsibilities. Argentina in the 1980s is a commonly cited example,¹¹ but others are not hard to find in the transitional economies of eastern and central Europe (Bird, Ebel, and Wallich, 1995). As just noted, similar fears appear to have played an important role in the recent Chinese fiscal reforms (Bahl, this volume).

International experience indeed suggests that if countries decentralize more expenditure responsibilities than revenue resources, either service levels will likely fall or else local governments will press – successfully, it is usually assumed – for either more transfers, or more loans, or both. One of the clearest, and most analyzed, cases exhibiting this phenomenon is the Russian Federation (Wallich, 1994). On the other hand, if more revenues than expenditures are decentralized, it is often argued that local revenue mobilization may decline and again macroeconomic imbalances may emerge.¹² Countries such as Colombia, Argentina, and Brazil are frequently cited as bad examples in this respect.¹³ Even if both sides of the budget are decentralized in a balanced fashion, it is often feared that local governments may not have adequate administrative or technical capacity to carry out their new functions in a satisfactory fashion.¹⁴ Such problems

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may give rise to particular concern in developing countries where local governments are charged with important social and economic infrastructure investments (Bird, 1994a) – an aspect stressed in this volume in the chapter on Morocco and Tunisia.

In view of the apparent widespread concern about the destabilizing effects of fiscal decentralization, it may surprise some readers that some of the case studies in this book – see especially those on Colombia and South Africa – lend little support to the more dire predictions of macroeconomic disaster ensuing from fiscal decentralization. Nonetheless, such concerns continue to rank high in many countries, and care must clearly be taken to avoid unwanted outcomes in this respect. The key to unlocking this problem, we shall argue, is to ensure that decentralization is undertaken in such a fashion as to increase rather than decrease accountability.

Concern for macro imbalance lies behind the common recommendation that strict limits be imposed on the borrowing ability of subnational governments.¹⁵ Some fear that, unchecked, subnational governments, particularly those highly dependent on national transfers, may increase current expenditures well above their capacity to finance them out of current revenues and then close the gap through borrowing. Others argue that since macroeconomic stabilization is properly a national government task, it is important that the national government have full control over all the instruments of policy it needs to carry out this task properly, including borrowing – and particularly borrowing abroad.

Such arguments (or variants of them) have been made in many countries, and the result has often been the imposition of a variety of restraints on provincial and local borrowing, for example, limiting such borrowing to financing capital expenditures, limiting debt service to a maximum percentage of current revenues, or requiring prior approval of central government for borrowing (Bird, Ebel, and Wallich, 1995).

In fact, however, a properly designed local finance system would not appear to require any specific controls on debt beyond those imposed by a well-functioning private capital market – something which may not, of course, be considered to exist yet in many developing countries. With respect to foreign borrowing by subnational governments, however, there may be a special problem owing to the apparent assumption by many lenders that all “public” debt is (implicitly) guaranteed by the central government. A possible (partial) solution to this problem might be through “semi-privatizing” subnational borrowing as much as possible, for example, through “revenue bonds” which are guaranteed explicitly and solely by specific (related) revenue sources. This approach would have the additional virtue of increasing one of the potential advantages of

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decentralizing public borrowing in the first place – namely, risk diversification – by increasing the (so to speak) portfolio of public debt on offer, assuming (as seems not implausible) that the revenue streams attributable to different components of the public sector are not highly correlated.¹⁶

Imposing debt limits to prevent local governments from making fiscal mistakes may produce more perverse results than the public insurance of savings deposits so often condemned by economists. Like deposit insurance, debt limits and similar controls may be perverse precisely because they prevent market discipline from being applied (see Ahmad, this volume). Potential lenders to governments, unlike ordinary citizens choosing a bank in which to place their savings, can reasonably be expected to be capable and motivated with respect to finding out what risks they are running with their money. From this perspective, much of the concern about irresponsible local governments getting themselves into trouble seems like another instance of inappropriate and misconceived paternalism – the “father knows best” attitude so common with central governments facing the uncomfortable prospect of losing control as a result of decentralization. In life, children seldom learn to save unless they suffer the consequences of not having done so. And local governments are as unlikely to be well managed if they are saved from the possibility of making mistakes by the imposition of arbitrary limits as they are if they know they will always be bailed out by the central government.

If a national government wants to avoid macro problems arising from subnational debt, it can do so by not subsidizing such borrowing and by letting subnational governments that borrow too much go bankrupt. This is exactly what was done in Morocco, where the government changed the subsidy scheme for local governments from one of budget-balancing grants, in which both capital and interest payments on loans increase transfer receipts, to a formula-based equalization transfer which takes no account of borrowing (Vaillancourt, this volume). In addition, lenders were explicitly told not to count on financial bail-outs.¹⁷ The possible problems arising from misguided foreign borrowing, however, may require more careful national attention, for instance, requiring explicit prior approval from the central government before any such loans may be contracted.

Unless subnational governments are able, so to speak, to “save themselves” from fiscal crises by drawing on their taxing powers, however, their only options in practice in many countries may be bankruptcy or bail-out. In the end, the only way to reduce the moral hazard implicit in this situation may be by imposing strict limits on subnational borrowing. What needs to be emphasized, however, is that the root of the problem lies in the

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very limited taxing powers available to subnational governments that are expected and required to carry out a much wider range of functions than they can finance on their own without extensive reliance on central support (either direct through transfers or indirect through bail-outs).¹⁸ Unless local “ownership” of the tax base is extended considerably beyond the narrow limits existing in most developing countries (see later discussion) it may not be desirable to loosen borrowing rules.

The difficulty of envisioning, let alone carrying out, bankruptcy in the public sector provides good reason to require that there be fairly stringent conditions on all subnational borrowing – not for macro reasons, however, but in order to ensure local government accountability. Along the same lines, all local borrowing should be reported immediately and in a transparent fashion so that no one can shift hidden debts onto the next administration, and so that both local voters and the national government can have a better handle on what is going on. Moreover, since the only case for local borrowing – and it is a good one – is to finance capital investment, no borrowing should be permitted for other purposes, no matter how worthy.¹⁹

Finally, one matter that sometimes gives rise to concern appears to be largely a non-problem, namely, the ability of local governments to borrow on the basis of the increased cash flow as a result of transfers (or, for that matter, royalties). As long as the borrowing is not subsidized, why is this a problem? The portion of these transfers that is not specifically earmarked constitutes “own revenues” of local governments, and if some agency is willing to lend money based on this security it should be free both to do so and to bear the consequences if the loan goes bad. Of course, transfers make good security only if they are predictable, which has by no means always been the case in developing countries (Bird, 1990). Generally, transfers are more likely to be used for this purpose when they are enshrined in law (Tunisia) or, even better, in the constitution (Colombia, Argentina, South Africa), than when, as in Morocco, they are made by ministerial directive or, as in China, effectively negotiated on an *ad hoc* basis.

Local capacity and taxation

An essential ingredient in improving the life of the poor in many countries, both immediately and in terms of enhanced productivity in the long run, is the improvement of basic infrastructure – roads, water, sewerage, and electricity (World Bank, 1994). A number of countries have used inter-governmental transfers to guide and shape local investments in these areas, as emphasized, for example, in the chapter on Morocco and Tunisia.

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Similarly, in Indonesia, specific grants are provided for provincial and district road improvement (Shah and Qureshi, 1994; Shah this volume). The program is designed to provide minimum standards of road service across the nation and to facilitate the development of an internal common market. The grant allocation formula is related positively to indicators of poor roads and low motor vehicle registrations (proxies for road expenditure needs). As in the case of other Indonesian transfers, local discretion in the use of this grant is restricted, which may limit its effectiveness. The use of the grant is confined to the repair and upgrading of existing roads: new roads have to be financed from other sources. Projects for the repair of roads have to be approved by districts and then forwarded to the central government.

Some have been concerned that local governments subject to less detailed guidance and control than in this case may not have the capacity to handle such critical functions. Colombia, for example, has a much less “guided” system, which nonetheless appears to have been moderately successful in directing infrastructure investment to the poor (World Bank, 1996c). Under the so-called “coparticipation” system, local communities provide labor and local materials, and municipal governments contribute a portion of the cost. This fund not only fosters community involvement in identifying needs and choosing projects but also promotes community participation in the execution, operation, and maintenance of the works. Municipalities have to prepare projects which are then appraised by the fund against technical and environmental criteria. The other important requirement is that the beneficiaries should be low-income rural families. Projects may be carried out by any of a number of types of contractor (private firms, non-government organizations, state agencies, or universities), who compete to supply the works and services.

Although partial and preliminary, the evidence so far concerning local capacity to carry out such functions in Colombia is surprisingly encouraging. A recent study of a sample of sixteen municipalities found numerous beneficial results of decentralization in terms of the enhancement of local capacity in the areas of labor, capital, and technology (World Bank, 1995a). Colombian municipalities are, for example, increasing the skills of local bureaucracies through such means as competitive hiring, sharing the services of professionals among municipalities, training municipal employees, and rotating personnel through different departments in the same municipality. Capacity in terms of capital has also been increased. One municipality has totally privatized road maintenance; another has put private developers in charge of the construction of urban roads.²⁰ Computers have been introduced to monitor water and sanitation services

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in other localities. Municipalities have started to share certain equipment. They have also improved their technological capability in terms of internal organization, planning, and monitoring to ensure better management of municipal projects.

Underlying these improvements is a more basic change: Colombian municipalities have been moving to a “demand-driven” (bottom-up) approach to public services as opposed to the previous “supply-driven” (top-down) one. Increasingly, reflecting both the new liveliness of local politics and (with substantial variations from area to area) more extensive community participation, people are getting what they want, rather than what someone in the capital thinks they should want. In practice, emphasis has been put on roads, education, and water projects: these are the needs people perceive, and these are the needs that the newly empowered and responsive local governments are attempting to satisfy. Opinion surveys suggest that the resulting sectoral allocation of resources is consistent with community preferences, with most respondents indicating that they trust the local government more than the national government to deliver goods and services (World Bank, 1995a).

All this is most encouraging for believers in the potential allocative and democratic virtues of decentralization. As in such well-known Asian cases as the Orangi project in Karachi, Pakistan (Bird, 1995), such popular participation both reveals strong preferences for the project being built and tends to keep costs down. Depending on the precise nature of the project, such community involvement may also enhance substantially the effectiveness of “targeting” in terms of poverty alleviation. Participants in such communal work projects are in effect “self-selected,” being poor and willing enough to volunteer their major asset, their labor, without remuneration.

A recent review of experience with the social investment funds set up on roughly similar lines in a number of Latin American countries (Glaessner *et al.*, 1994) concluded that such funds have proved to be generally effective because

- (1) they have been demand-driven, thus requiring a high degree of local involvement,
- (2) their operations have been transparent and hence accountable,
- (3) they have been carefully targeted to low-income groups, and
- (4) they have been relatively autonomous in their operation, usually being run by private-sector managers and freed from much official red tape.

Most important is the direct involvement of the beneficiary groups in both the management of the fund, and in the selection, operation, and financing of projects. In particular, it appears to be critical to require cost-