Managing fiscal decentralization

Overview

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There is a danger that decentralization may be perceived by policy makers, especially donors, as the latest mantra – the magic potion to cure many governance problems. Decentralization is being promoted by well meaning interest groups, often reacting to highly centralized regimes, as well as by influential international agencies, particularly the staff in the multilateral banks. But does it work? What are the essential preconditions for the success of decentralization? These issues are addressed in this volume, with a set of general papers, followed by case studies of countries in particular regions – the European Union (EU); transition economies including China, and major developing countries in Latin America, Africa and Asia.

The case studies are designed to present a practitioners' perspective drawing on the experiences of officials from the concerned countries, or staff from the OECD, the World Bank and the IMF, who have been engaged in providing direct advice to particular countries (often in conjunction with the officials of the concerned countries). Countries often initiate the administrative or political process of decentralization, without due regard to the fiscal consequences. The questions raised in the country papers concern the sequencing of fiscal decentralization so as to ensure effective governance and public service delivery, without endangering macroeconomic stability.

General issues

The potential dangers of decentralization

Tanzi, in Chapter 2, poses some unfashionable personal views. He argues that if countries are not already committed to decentralization, they should consider alternatives to it and its potential pitfalls. Often decentralization is seen as a response to failed policies – the solution may be to improve the current policies, such as skewed or inefficient spending. Often privatization, and reducing the role of the state may be a preferable alternative – with a smaller government, there may be less or little to decentralize. In the extreme, if local preferences dominate especially in very large countries, then breaking them into smaller states may well be a solution. This has happened as in Yugoslavia and Czechoslovakia.

In any case, the potential dangers posed by decentralization should be clearly recognized – the growth in regulations, the impediments created to an effective internal market, and the likelihood that corruption might increase. Moreover, with the difficulty in clearly separating expenditure responsibilities, and the economies of scale in tax collection, it is likely that there will be a heavy reliance on transfers in decentralized countries. This may sap incentives for efficient management and create soft budget constraints. Decentralized countries such as India, Argentina and Brazil have impediments to the proper design and implementation of effective tax policies. Often tax sharing at different rates generates disincentives for efficient tax administration. Also, assigning significant revenue bases to subnational levels may considerably increase regional disparities.

More decentralized countries, generally, find it more difficult to provide transparent and comparable information on general government activities on a timely basis. Critically, considerable incentives to borrow at the subnational level, have created enormous macroeconomic difficulties in countries such as Brazil, and more recently in Argentina.

However, if the decision is taken to proceed with decentralization, *the proper design and establishment of the key institutions for decentralized governance becomes critical* – this includes tax administration, expenditure management and information generation, and effective design and implementation of transfer systems.[1]

Preconditions for decentralization

Albert Breton (Chapter 3) carefully examines the arguments and preconditions for decentralization (devolution in his terminology). He criticizes the two standard justifications for decentralization – that central governments provide uniform levels of goods and services and that decentralized governance provides a better matching of service delivery to citizens' preferences; and that the more junior a government the closer it would be to the people and, therefore, better able to meet demands. The first proposition is easily dismissed by showing that uniformity of provision may be desirable for certain types of services, and that central governments are perfectly capable of tailoring services to different needs of regions. The second proposition is based on the assumption that smaller jurisdictions reflect more homogeneous preferences than larger ones – this is refuted by juxtaposing the city of Toronto, with 120 different ethnic groups, against large provinces such as Newfoundland or Prince Edward Island. In Breton's view the case for decentralization lies in stimulating intergovernmental competition.

The preconditions for effective intergovernmental competition, not so much in terms of Tiebout mobility, which breaks down with multiple jurisdictions, but in terms of rank-order tournaments used by Salmon (see also Chapter 6), generate both vertical and horizontal benchmarks influencing voter preferences. Decentralization failures arise due to different transaction costs. *Information costs* would arise if oppositions and media at more junior levels of government are weaker than at higher levels. One may ask how junior levels of government would acquire information on local preferences and what they might do if they had this information. Similar failures would arise with local *political participation costs* – including the presence of large and influential families or cliques.

Coordination costs would arise by spillover effects, or the consumption of services by out of jurisdiction households or firms that do not pay for these. While some of these costs can be internalized, it is likely that the spillovers will change over time and across jurisdictions – thus some coordination costs are likely to be present at all times. Whether this is sufficient for centralization or not depends on the balance of marginal benefits against the marginal costs of centralization. Moreover, *diminishing supply costs* occur for many goods and services and for tax collection and bond finance. This places the smaller junior jurisdictions at a disadvantage and decentralization failure occurs. It may be possible to deal with such failures through means other than centralization, such as through purchase agreements, consortia of smaller jurisdictions or equalization transfers. *Dynamic instability*, or a "race to the bottom" occurs through destructive competition. Remedies for this include centralization, or harmonization – which is again destructive of competition. Thus, for each type of decentralization failure that might occur, there are remedies that could be adopted to ensure continuing intergovernmental cooperation, hence realize the potential benefits from decentralization. We note here that Breton is not persuaded by the distinctions between different types of decentralization used by several other authors in this volume.

Decentralization and corruption

There is a continuing debate between proponents of decentralization and others as to whether decentralization leads to more or less corruption. Gurgur and Shah of the World Bank in Chapter 4 present the positive case for decentralization. In attempting to identify the empirical drivers of corruption, they find that its main causes are lack of service orientation, weak democratic institutions, a closed economy and colonial past, internal bureaucratic controls and centralized decision making. They find that decentralization has a greater negative impact on corruption in unitary states than in federal countries, and conclude that decentralization supports greater accountability and reduced corruption.

This view may be juxtaposed against arguments by Tanzi (1995) and Prud'homme (1995) that decentralization could lead to greater corruption.

Decentralization and poverty reduction

Proponents of decentralization, especially in the multilateral development agencies, argue that decentralization is needed for poverty reduction – the argument links decentralization to greater participation by the poor in the political process in a decentralized environment.[2] More recent assessments recognize the importance of a well functioning state, and proper institutions before the participation of the poor can be assumed, as well as the risks associated with decentralization – "the problems of making decentralization work are major, urgent and difficult."[3]

Von Braun and Grote (Chapter 5) examine whether decentralization and poverty reduction might be correlated. They distinguish between political, administrative and fiscal decentralization. In an empirical analysis they find that smaller countries do better with poverty reduction than larger ones – but do not thereby draw the conclusion that large countries should be broken up. It is interesting to note that Egypt, a centralized country does better in terms of service delivery than a more decentralized country, India. In general, the empirical assessment suggests that political and administrative decentralization needs to precede fiscal decentralization otherwise participation and accountability cannot be assured. Political decentralization does appear to have a positive impact on poverty reduction, but the effectiveness of service delivery for health and education, for example, depends on institutional conditions and management capacities. These refrains are also echoed in the case studies for developing countries, especially in India and Africa (see e.g. Chapters 13 and 15 by Rao and Brosio, respectively). The South African case of measured decentralization (see Chapter 16 by Momoniat) is particularly interesting – as the key functions in education and health areas have not so far been devolved to the lowest levels.

If, as suggested in a comment at the conference by Paul Smoke (NYU), political decentralization in Africa is already underway, then the task should be to seek the fiscal underpinnings to make it successful.

The EU and Maastricht constraints

The EU countries reflect very interesting though opposing tendencies – with decentralization in countries such as Spain and Italy, juxtaposed against the problems of unification in Germany, to centralizing constraints associated with Brussels, relating to especially fiscal deficits and aggregate indebtedness.

Salmon (Chapter 5) presents an analytical assessment of the opposing trends. The forces of horizontal competition imposing market based disciplines in Europe are constrained by within-country redistributive tendencies. Countries themselves are subject to mobility-based competition. Salmon posits a 4-tier government, with the 4th tier at the municipal level together with the central or 2nd level as extremely important. The 3rd or regional tier is constrained by financial limitations, whereas "Brussels" or the 1st tier is far from a Federal Government, but is treated as a "supranational" administration.

The possibility of reassigning tax powers in favor of Brussels is not on the political agenda, although "harmonization" of taxation has been espoused by both the Commission and member countries. However, little has been achieved so far. This in Salmon's view is due not just because of the unanimity rule required for fiscal issues, but to the fact that France and Germany have not really wanted to make side payments to or compensate or cajole Luxembourg, one of the smaller states that benefits from the status quo. On the other hand, Maastricht treaty limitations on borrowing may actually increase the central government controls over the subnational levels, and also crowd out local borrowing, and adversely affect capital and infrastructure provision by local governments.

The conflicting tendencies in the EU are summarized in seven observations. (1) The realization of a "closer union" would lead to more bureaucracy in Brussels. (2) The "subsidiarity" principles in the Treaty of Rome should lead to greater decentralization, but the recent trends in Spain, Italy and to some extent in the UK have nothing to do with this principle. (3) The modest funds available in Brussels have led to the development of the regional level in only few countries, such as Portugal, Greece and Ireland, but have had limited impact in larger countries such as Germany and Italy. (4) Governments in Italy and France have decentralized largely because of the demonstration effects on electorates. (5) Governments at the 4th level may be better protected in unitary states than in federal ones – in Germany there has been a drastic consolidation of local governments forced by the Länder. (6) Given the importance of the regional (3rd) level *vis a vis* central governments in some countries, commitments by the latter to Brussels may not be acceptable to the former – opening the possibility of secession by the 3rd level from the 2nd, while remaining within the EU. (7) Finally, regarding the dilemma as to the sharing of responsibilities with higher or lower levels, Salmon feels that in facing challenges of greater mobility and expansion, countries in the EU should unify what must be unified, and allow the rest to diversify or be decentralized.

German unification

Opposing tendencies are also apparent within European countries. Spahn and Franz (Chapter 6) describe the strains of the unification of the West with the poorer East German Länder on the West German cooperative federalism model, which relied on consensus and uniformity of service delivery based on a high degree of interregional equalization. The current system is under revision because of a ruling of the Constitutional Court on the system of horizontal equalization, and increasing competition between governments, public entities and the private sector. While the Court may limit the degree of interstate financial redistribution, its emphasis on interjurisdictional solidarity may be interpreted, according to Spahn and Franz, as allowing financial bailouts that could generate negative incentives for efficient management of revenues and expenditures. These conflicting tendencies pose a dilemma for the future of fiscal federalism in Germany.

Asymmetric decentralization in Spain and Italy

Due to both political-economy considerations of keeping a "rich" region from seceding, and because of notionally differing capacities to manage or finance larger expenditures, countries such as Spain and Italy have opted to implement asymmetric decentralization. Davies, Giarda, Piperno and Vinuela (Chapter 7) contrast the similarities and experiences of Spain and Italy. Both countries were unitary states that have adopted asymmetric decentralization – although Spain has moved faster towards a federal structure from a highly centralized state. Both have had difficulties when national standardization, such as in the health sector, has led to central financing of subnationally managed activities, generating perverse incentives, deficits and reduced accountability.

With the decentralization in the 1980s in Spain, subnational debt was not amenable to central controls and began to pose substantial macroeconomic risks. However, with the Maastricht treaty and Spain's EMU membership, the situation changed drastically. The central government was able to re-establish controls, and enhanced coordination of central and subnational debt policies virtually eliminated regional deficits by 2000. However, apportioning deficits among different levels of government, given the overall constraints, still poses difficult choices.

In Italy, on the other hand, deficits in the richer regions may force adjustments at the center or on local governments to meet Maastricht conditions on overall general government deficits. It remains to be seen whether the conditions can effectively be met, and if not, whether the inherent EU sanctions are sufficiently credible.

Transition economies

The reform of the centrally planned economies, involving a move towards market mechanisms also led to greater subnational responsibilities, especially for social functions that were previously provided by state-owned enterprises or directly by central line ministries. Thus, some degree of decentralization was inevitable in the loosening of very tight central controls. The process is not unidirectional in that there might be more complicated forces at work that do not quite correspond to the "market-preserving decentralization" story that has been popularized with reference to China.[4]

Hungary and Slovakia

Dethier (Chapter 8) carefully examines the experiences of Hungary and Slovakia, the former being one of the most decentralized countries in Central and Eastern Europe and the latter the least. In both countries to some extent the drive for decentralization is based on expectation of EU accession, and the subsidiarity principle. Dethier assesses the appropriateness of tax and expenditure assignments, accountability and effective delivery of public services. Despite relevant legislation, accountability rests on reporting, monitoring and arms-length control mechanisms, but could be costly for the center and needs local skills. In general, decentralization of functions such as education increases administrative costs in both countries, bearing out one of Tanzi's unfashionable complaints.

Hungary is characterized by a very large number of local governments (over 3000) having more than doubled since the start of the decentralization process in 1990. Inappropriately designed expenditure and revenue responsibilities mean that many localities have virtually no source of financing other than "gap-filling" transfers – this affects the incentives to manage expenditures efficiently. Slovakia displays a similar fragmentation of local governments, although their powers are more limited – education for instance continues to be provided through the regional offices of the central government, on norm-based allocations. Further decentralization, as in Hungary, could further increase administrative costs.

A key difficulty in both countries is the failure to mobilize own-resources. Given the design of the transfer systems, there is little incentive to increase local taxation, and the revenue sharing only exacerbates horizontal inequalities – benefiting mainly the richer regions, leaving others even more dependent on transfers. With shared governance such as for education, this leads to a bargaining for resources and increased overall expenditures.

Dethier stresses the need for accountability and fiduciary responsibility. Despite increased democracy, and the theoretical possibilities due to decentralization, there was no change in local government behavior in Slovakia because of decentralization. And in Hungary, the absence of independent audits creates a severe lacuna. To increase accountability, Dethier argues for strengthening key elements of the policy and expenditure management frameworks simultaneously.

Dethier's themes are worth spelling out in detail as they recur frequently in many countries and regions. He recommends the following:

- clarify responsibilities of local governments, their own-financing powers and to consolidate localities where necessary;
- reform the system of transfers to generate incentives to manage expenditures and raise own-revenues efficiently;
- enhance effective local participation;

- generate systems of arms-length control without centralization, such as effective audit mechanisms; and
- introduce limits to borrowing.

Russia

With the weakening of the party chain of command after the dissolution of the Soviet Union, *de facto* decentralization in Russia outpaced the limited legal autonomy that was provided to regions and local governments. Lavrov, Litwack and Sutherland (in Chapter 9) examine the experience during the past decade and draw lessons, based on proposals of the Russian government as well as research conducted by the OECD. The paper juxtaposes the substantial degree of *de jure* control by the central government against the effectively decentralized reality on the ground.

The principal mechanisms for the *de facto* autonomy of subnational governments include: direct and indirect controls over enterprises and affiliated companies, some providing local public goods directly or subsidizing their provision; control over utilities; and also effective control over the locally based staff of the central agencies, including the tax administration and the treasury. The process was facilitated by weak central budget institutions, and the ability of the subnational governments to create extra-budgetary funds and maintain special accounts, effectively limiting the central information flows over subnational receipts and spending. This created loopholes that enabled avoidance of revenue-sharing while permitting full local control over the expenditures from these "hidden funds."

Centralized controls with weak institutions and imperfect information created incentives for local governments that were exacerbated by unfunded mandates and poorly designed "gap-filling" transfers. There was considerable scope for rent-seeking behavior and creative accounting. Inadequate financing, given the magnitude of responsibilities transferred to subnational levels, permitted the blame for poor service delivery to be deflected to the center. Also, wage arrears led to the need for federal government bailouts.

Since the legislation in 1993, permitting subnational borrowing, there has been a virtual explosion of subnational debt – narrow measures in official statistics put overall subnational debt at around 2 percent of GDP in 1999, but when a number of missing components, including arrears are taken into consideration, the figure rises to 8 percent. The arrears on loan guarantees reportedly increased from 35 percent in 1999 to 40 percent in 2000.

A number of recent reforms in the Russian intergovernmental system have been initiated. The power of regional governors has been circumscribed – making them more amenable to central control. A new federal hierarchy at the regional level has been created to better monitor and execute federal spending. A unified treasury is expected to generate information on all government spending and thus circumscribe the corruption and rent-seeking at subnational levels. Steps have also been taken to limit unfunded mandates, and eliminate mutual settlements and offsets. The government has also moved from a reliance on revenue-sharing to assign 100 percent of the VAT to the center, and assign income taxes to subnational governments. Also the transfer system has been streamlined and consolidated, with better equalization and targeting.

Lavrov, Litwack and Sutherland, however, feel that the limitations on subnational own-revenues may have been taken to an extreme. With the virtually complete assignment of social expenditure responsibilities to the subnational level, there is scope now for further "game-playing" by the local governments. They argue for a need for a proper delineation of responsibilities, commensurate with adequate own-revenue sources, to generate sound incentives at the subnational level. The strong message in this paper is that without a proper design of intergovernmental fiscal relations, decentralized expenditures may fail to boost economic efficiency, may lead to poor social service delivery in many regions, and may also jeopardize macroeconomic stability.

China – recentralization?

As in Russia, a process of recentralization has been taking place in China in the recent past. Economic reforms introduced in China by Deng Xiaoping in the 1980s were greatly assisted by the initiatives at the local level, especially those involving partnerships with industrial and commercial undertakings – leading to the characterization of "market-preserving reforms," and very rapid growth especially in the coastal region and in the larger cities and municipalities. While the process worked well for an initial period, the Chinese leadership recognized that it could not continue indefinitely for a number of reasons. First, China lacked a central tax administration, capable of administering a modern tax system, and reliance on local tax administrations, with relatively unclear revenue assignments, put the center at a disadvantage – with sharply falling declared revenues. Second, the relatively low share of central revenues meant that it could do little to counterbalance a growing disparity between different parts of the country. The differentials between coastal and interior provinces became quite marked. Third, growing contingent liabilities, on account of an aging population, recapitalization of the banking sector and reform of state-owned enterprises will require additional resources. All these issues point to an increasing need for *central government* revenues in the short-to-medium term.

Ahmad, Li and Richardson (Chapter 10) describe the reforms of 1994 which introduced a revenue-sharing system, more standardized tax policies and the bifurcation of central and local subnational tax administrations. Local governments were guaranteed transfers equivalent to pre-1994 levels, and it was assumed that growing fiscal space available to the center would be increasingly used for "equalization" transfers based, as in a number of advanced countries, on measures of expenditure need and revenue capacity. In the event, the coastal provinces generating much of the revenues demanded and received a larger share of "returned revenues" from the fiscal balance accruing to the center after 1994. The basis for the returned revenues has been rationalized given the responsibilities of the provinces for pensions, unemployment benefits as well as enterprise restructuring.

A further rationalization of tax policy and revenue-sharing has become due with China's entry to the WTO. This presents an opportunity to revisit the 1994 arrangement, and clarify the own-sources of revenues for all levels of government. Since 2000, China has initiated a major reform of its capabilities to track and account for expenditures through the establishment of a modern treasury and information system. Together with a reform of social responsibilities, redistribution to the poorer inland and western provinces, there is also now an opportunity to reform the system of special purpose and equalization transfers.

Developing countries

Given that decentralization is seen as a panacea for governance and service delivery problems in developing countries, we examine a range of cases from Latin America, Asia and Africa. Many developing countries have oscillated between military governments or centralized dictatorships, and popularly elected governments – some not surviving for very long. This pattern has been observed in Latin America, Africa (e.g. Nigeria) and in Asia, such as Pakistan and Indonesia. Post-military governments have tried to institute safeguards including decentralized institutions, often specified in the constitutions or basic laws.

Many constitutions promulgated in the 1980s or early 1990s in Latin America contain provisions relating to the lower levels of government, even in unitary states such as Colombia.[5] For instance, Colombia's 1991 constitution devolved social expenditures on education and health to lower levels of government, and provided guaranteed transfers to finance these expenditures. Ten years on, the transfers are actually provided to lower levels but the municipalities refused to take on the payment of teachers' wages – which continued to be borne by the center. Also the guaranteed transfers were used to leverage subnational debt – exacerbating Colombia's macroeconomic difficulties. The problems of subnational debt have been quite severe in both Brazil and Argentina, contributing in no small measure to the macroeconomic crisis in the latter in the past few years.

Since independence in 1947, India has had one of the most stable political systems among developing countries, but the process of decentralization to the subprovincial (panchayat) level only began for some functions during the 1990s, with relatively limited expenditure responsibilities and revenue capabilities. In contrast, the rapid decentralization in Indonesia since the fall of Suharto encompasses many risks, including difficulties associated with a struggle for natural resource (including oil and gas) revenues. This struggle for oil revenues has also marked difficulties in achieving a stable decentralized government in Nigeria. However, South African decentralization since the end of Apartheid has been measured and carefully sequenced. Many of the measures adopted reflect possible directions that might be adopted in other developing countries as a prelude to a well managed fiscal and political decentralization.

Brazil

As Tanzi (Chapter 1, this volume) points out, the inappropriate revenue assignments, for example, the subnational VAT in Brazil, cause difficulties – including distortions – and limit the ability of the central government to meaningfully redistribute or equalize across regions. The imbalances in assignment were combined with a right to borrow at municipal and state/provincial levels, including from their own banks, leading to an explosion of subnational debt. This process is described in Afonso and de Mello (Chapter 11). Subnational debt doubled as a share of GDP between 1995 and 1999, contributing to the stabilization crisis of the late 1990s.

A key element in the response to the latest stabilization crisis has been the promulgation of a Fiscal Responsibility Act, which acts as a *de facto* limit to subnational borrowing. State banks have been divested. Ceilings on borrowing are supplemented by procedures for non-compliance and sanctions. In the view of Afonso and de Mello, the key question that remains to be answered is whether the adoption of the new rules-based form of decentralization, with top–down coordination, leaves "little room for discretionary policy making at the subnational level." Indeed, most states are now so constrained that they spend more on their payroll than on social programs – and the situation will deteriorate as the states face growing pension liabilities.

Despite the recent restrictions on subnational policy making, the delivery of social services by municipalities (albeit financed by transfers from the center and the states) has been a relatively bright element of the Brazilian experience. However, to some extent, this has been due also to greater participatory decision making at the local level – such as with the management of schools. This indicates that improvements in service delivery can be achieved by micro-adjustments in management, or reduction in state interference, at a time when the overall ability of subnational governments to do as they please is considerably circumscribed.

Argentina

Argentina presents an interesting case where the imbalances in the intergovernmental fiscal relations have contributed directly to a macroeconomic collapse and the premature fall of an elected government. At the time the paper by Jimenez and Devoto was written, both were part of a team negotiating an adjustment program with the provinces, based on Fiscal Responsibility legislation, mirroring the Brazilian model, and for a period it seemed that it might succeed. In the event, the provinces balked at the implied inroads on their autonomy, contributing to the collapse of the central government and the prospective end of the currency board arrangement.

In Chapter 12, Jimenez and Devoto describe the genesis of the crisis that came to a head in December 2001. After the period of high inflation in the 1980s, the Convertibility Law in the early 1990s was meant to restore discipline and credibility. Certainly inflation was controlled, a new system of co-participation transfers to provinces promulgated, together with increased devolution of functions, including health and education and responsibility for pensions. However, the pressures on subnational finances remained, and several provinces transferred their pension systems to the new national system. Jimenez and Devoto also argue that the decentralization of health and education did not lead to gains in efficiency or equity.

Under the Argentine constitution, provinces have the right to borrow, although many provincial constitutions specified their own limits. Many of these limits were ignored, as provinces borrowed initially from their official banks (though this was restricted under the Convertibility Law), then towards the end of the decade from financial entities, private bond markets and arrears on wages and supplies. By the end of the decade, the parlous state of general government borrowing was evident. While many provinces were above their constitutional limits of indebtedness, there was ample capacity to borrow in some of the larger states, such as Buenos Aires. Given the overall unsustainable level of debt, austerity measures were needed across the board, including in provinces that had been reasonably prudent and in principle had retained a "safe margin" for additional borrowing. In the event, this across the board austerity was not acceptable to the provinces that matter.

In establishing a new stabilization package in Argentina, the redesign of intergovernmental fiscal relations will perforce remain one of the most contentious issues.

India

India has a federal constitution, with considerable powers and functions at the provincial level – this largely dates back to the Government of India Act of 1935, enacted by the colonial administration. However, most Indian provinces are larger in size and population than most member countries of the UN, and the central government wields significant powers – that were enhanced after independence given the importance of central planning. Local governments acted as agents of state governments until the constitutional amendment of 1992, which created (3,000) urban and (roughly 250,000) rural local governments. Urban local governments have more functions than rural *panchayats*. Rao, in Chapter 13, describes the recent decentralization as a very "top down" process.

Rao points out that a correct measurement of the general government deficit is considerably higher than reported, if the operations of the 3rd tier are incorporated. States have not been able to impose discipline on their local governments. The local governments lack resources to provide infrastructure and social services in a meaningful manner, and have resorted to various creative measures to finance expenditures. Indeed, the only meaningful attempts to play a significant role at the local level have occurred in Andhra Pradesh and Maharashtra, where local bodies have been able to borrow heavily.

Central transfers to the states have been largely of a "gap-filling" nature, contributing to fiscal indiscipline at the subnational level. A reconsideration of revenue-assignments, including differential sharing arrangements is under way – the center did not have an incentive to collect certain taxes if a large share was to be shared with lower levels. A reconsideration of revenue assignments is also needed at the local level, especially to replace the distortive tax on inter-regional trade, the *octroi*. In general, Rao finds that the functions at the local level are not substantial, nor are revenue-bases available at that level. He concludes that the institutional environment is not conducive to the success of decentralization at the local level in India at the present time.

Indonesia

Given the relatively slow pace of decentralization in India, with a mature democratic tradition, the relatively rapid pace adopted in Indonesia appears to be a knee-jerk reaction to almost 40 years of autocratic rule since independence. Relatively vague descriptions of functions to be transferred to the third tier from the central government in a rapid decentralization, with very weak expenditure management functions and institutions at all levels of government, mask a struggle over the control over natural resources and rents, and also reflect an attempt to bolster political support at the center by two relatively weak presidents who followed Suharto.

Ahmad and Mansoor (Chapter 14) point to the risks inherent in the rapid devolution of revenues and ill-defined functions. The resulting fiscal imbalances could endanger macroeconomic stability, in addition to jeopardizing effective delivery of social services. Weak central and local monitoring capabilities add to the difficulties and potential of capture by local vested interests. The absence of adequate own-sources of revenues reduces the possibilities of holding local governments accountable. Further, the sharing of oil and other natural resource revenues poses difficulties for stabilization, given relatively volatile product prices, and also exacerbates regional imbalances. Under these circumstances, effectively equalizing transfers will take on an increasingly important role, but cannot completely counteract significant imbalances in revenue and expenditure assignments.

Although local governments are permitted to borrow, using guaranteed transfers as collateral, the Sukarnoputri administration has wisely been cautious in the implementation of this provision. Nonetheless, considerable work is needed to ensure that the risks of the rapid decentralization are not realized.

African perspectives

As in Indonesia, the decentralization process in many African countries has been a reaction to a decade or more of fairly centralized dictatorial rule, often by military administrations, encouraged by bilateral donors and NGOs, as well as a bandwagon demonstration effect. Brosio (Chapter 15) provides a broad ranging survey of various aspects of decentralization across Africa (excluding the Maghreb and the Arab north of the continent).

Decentralization is being pursued by both unitary and federal states (e.g. South Africa and Nigeria, respectively), and in some countries does not go much further than expressions of intent. He finds that expenditure management institutions are weak, especially at the local levels as well as the center, in many countries. Frequently, too many administrative layers have been created, with very weak taxing powers at the local level, and virtually no revenue sources at the regional level. Fiscal responsibility at the subnational level remains weak, given the overwhelming importance of transfers and revenue-sharing arrangements. Countries with natural resources, such as Nigeria, continue to face difficult tradeoffs between macroeconomic stability, and the appetite of lower levels of government for additional resources, bringing to the fore the latent struggle for control over natural resources that led to civil war in the 1960s.

There is a danger that the weak institutions in many African countries will be overburdened, especially as well meaning donors insist on decentralization to achieve poverty-reduction goals. Surveys from Ghana, for instance, show a great deal of disillusionment among citizens with the priorities and performance of their locally elected officials.

South Africa stands out as a country that has approached the decentralization process in a deliberate and well-sequenced manner. Brosio points out that here too, the revenue assignments at the lower level may be inadequate as more functions are transferred, but recognizes the many advantages of the South African experience relative to that in many other developing countries – this issue is taken up further by Momoniat in Chapter 16.

South Africa

Momoniat describes the carefully-sequenced South African experience with decentralization and also draws useful lessons from this experience for other developing countries.

In a 3-tier administration, local governments are responsible for electricity, water supply and sanitation and local roads and infrastructure. These expenditures are largely financed through the property tax and user charges, although transfers from the center (roughly 5 percent of total inflows) and borrowing (11 percent) also play a role.

Provinces have virtually no own-revenues, and the possibility of imposing a surcharge on the income tax has not been used so far. However, much of the key social spending – for example, on health and education and welfare is carried out by the provinces, with financing from the center through transfers, mainly through the unconditional equalization grants system.

Considerable effort has been placed by the center in developing budget formulation and management capacities at the provincial level – this is to be followed by a similar exercise at the local level. The development of provincial expenditure management functions and joint intergovernmental forums between the treasuries and the related central and provincial departments involved, assisted in rationalizing expenditures in the key areas, and improving the quality of welfare provision (through the social pension program). It also assisted in addressing the imbalances in education and health care, improving non-personnel inputs and ensuring improved expenditure outcomes.

Momoniat stresses the requirement that the devolution of expenditure and revenue powers be phased in gradually, commensurate with the development of expenditure management capabilities. He feels that donors have not given sufficient attention to this aspect in the rush to decentralization in many countries. Thus, decentralization will work only if there are basic budget and financial reforms together with good governance for transparency and accountability. South Africa has benefited from a realistic multi-year budget framework, supported by effective monitoring and auditing systems.

In short, the South African experience illustrates the recommendations by Ahmad and Mansoor for sequencing decentralization in Indonesia – that function should follow capacity, and that financing should follow the effective devolution of functions.

Notes

1 For a discussion of mechanisms for the design and implementation of transfer systems see Ahmad (1997).
2 Burki and Edwards (1996), World Bank (1999), chapter 6.
3 See Nicholas Stern (2001), p. 78. See also Dethier (2000).
4 See Qian and Weingast (1997).
5 The distinction between unitary and federal states has gradually been eroded with the decentralization process – with a significant transfer of responsibilities to the regional and local tiers of government, including elected governors and mayors, in countries from Colombia to Indonesia whose constitutions remain "unitary."

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