

Globalization and Localization: Decentralization Trends and Outcomes*

**Robert D. Ebel, Lead Economist
Serdar Yilmaz, Public Sector Specialist**

World Bank Institute

I. INTRODUCTION

The practice of governance has long been associated with what central governments do and how they operate. Recent years have seen worldwide interest in decentralization of policymaking power. The pursuit of decentralization is widespread, as both developed and developing countries attempt to challenge central governments' monopoly of policymaking power (World Bank, 1999).

In the western world, decentralization has been carried out to reorganize the organizational structure of government. The main goal has been the provision of public goods and services cost effectively in the "post-welfare state" era (Bennett, 1990; Wildasin, 1997). Developing countries are turning to fiscal decentralization to escape from the traps of ineffective and inefficient governance, macroeconomic instability, and inadequate economic growth (Bird and Vaillancourt, 1999). Throughout post-communist Central and Eastern Europe, decentralization of the state is the direct result of the transition from a socialist system to market economy and democracy (Bird, Ebel, and Wallich, 1995).

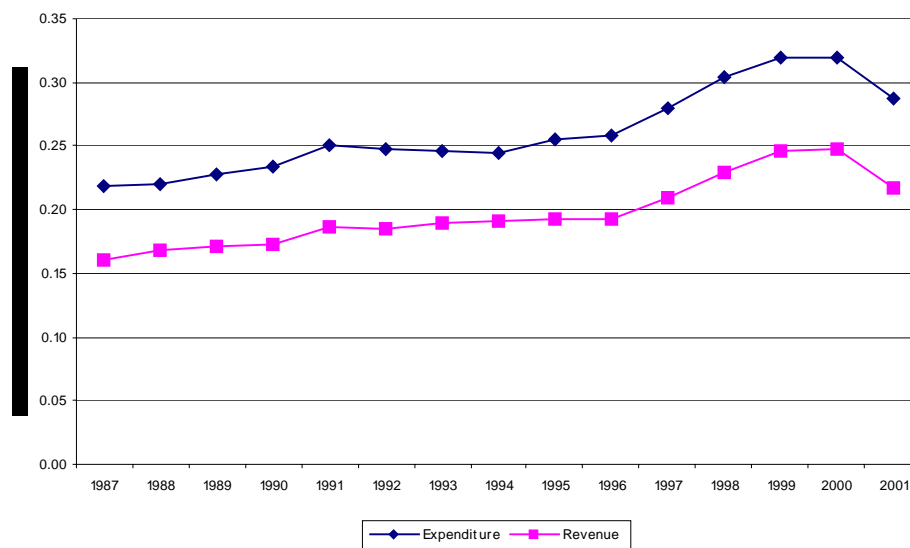
Fiscal decentralization can be an effective means of improving economic and financial management. But it is not a panacea for all economic problems; rather it provides a greater potential for an improved public administration system. The goal of fiscal decentralization is efficiency gains in public services. Stigler (1957) argued that a representative government works best the closer it is to the people. The allocative efficiency argument underpins the economists' rationale for fiscal decentralization. In his seminal work on the theory of public finance, Musgrave (1959) similarly argues that policies of subnational branches of governments should be permitted to differ in order to reflect the preferences of their residents. Carrying Stigler's and Musgrave's arguments further, Oates (1972) formulated the decentralization theorem as "each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision."

** Prepared for the Developing and Strengthening System of Intergovernmental Fiscal Relations and Fiscal Decentralization A Joint Conference of World Bank Institute and Korea Development Institute, Seoul, Korea, July 21~23, 2003.*

The decentralization theorem provides the theoretical basis for fiscal decentralization practices with generality. However, the definition and implementation of decentralization differ greatly across nations due to differences in economic and political structures. This diversity creates challenges to measure and compare the degree of decentralization across countries and to make generalizations about it.

Available Indicators of Decentralization

Figure 1: Decentralization Trends



While most of the governments in the world are still highly centralized, subnational governments are claiming an increasingly larger share of the public sector in terms of both expenditure and revenue (see Figure 1). Figure 1 shows the unweighted average of expenditures and revenues of subnational governments for those countries reported in the Government Finance Statistics of the International Monetary Fund (IMF). Both expenditure and revenue shares of subnational governments are increasing in total public sector.¹

The share of subnational governments in total government spending or revenue gives us an idea of the relative aggregate importance of the different levels of government, and its change over time. However, neither of them is a perfect measure of fiscal decentralization. Comparing the degree of fiscal decentralization across countries is a complex and multifaceted task that requires identification of subnational autonomy and discretion on expenditure and revenue affairs. Although there has been a great effort by both multinational (OECD, 1999, 2001, 2002) and bilateral (USAID, 1999) organizations to develop a methodology for comparable statistics on fiscal decentralization across countries, there is as yet no standardized data set.

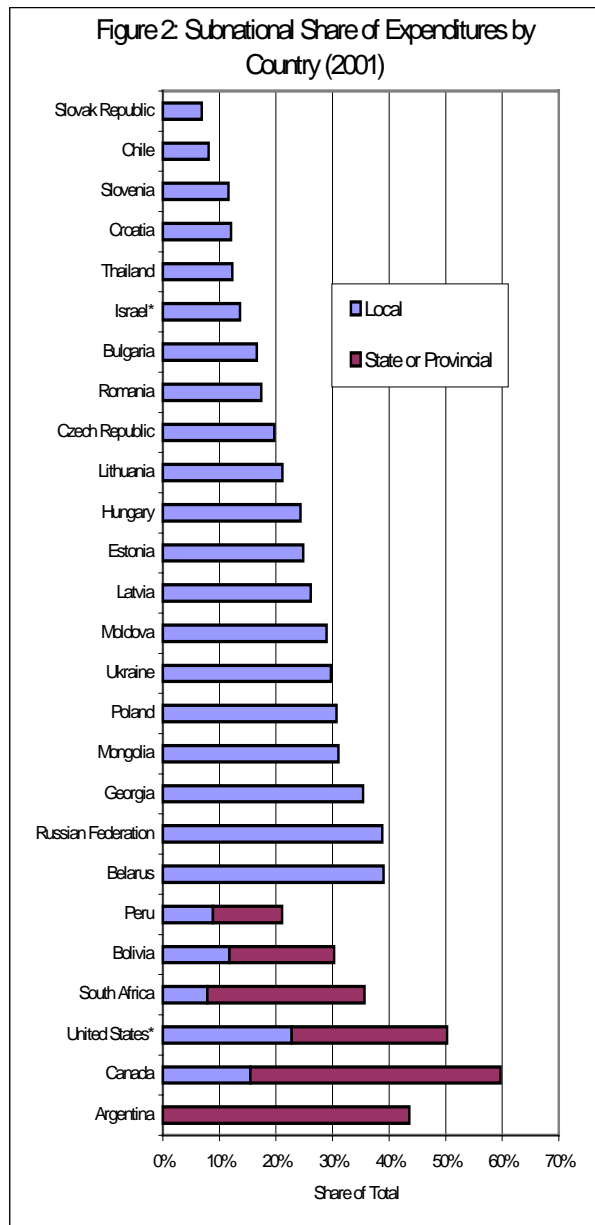
The broadest source of data for cross-country analysis of public finance is the IMF's Government Finance Statistics (GFS), which has consistent definitions across countries over time. Although, GFS is the most widely available internationally

¹ Revenue figures are for all revenues other than intergovernmental grants.

comparable data source on subnational finances, the need to standardize the fiscal variables inevitably leads to a loss of detail and data richness. For example, although GFS provides a breakdown of expenditures by function and economic type, it is silent about expenditure autonomy. Thus, expenditures that are mandated by the central government appear as subnational expenditure in the GFS. Similarly, on the revenue side, the GFS contains information about tax and non-tax revenues, intergovernmental transfers, and other grants, but it does not distinguish whether taxes are collected through shared taxes,

piggybacked taxes, and locally determined "own-source" taxes, or what proportion of intergovernmental transfers is conditional as opposed to general purpose transfers.

Although the expenditure share of subnational governments in total government spending is an imperfect measure of decentralization, it is a common practice in the literature to use the percentage share of subnational governments expenditure to assess the degree of decentralization in a country. Figure 2 shows the degree of fiscal decentralization, measured as the percentage share of subnational governments expenditure in total government spending, in the world. As seen in the figure, in general, subnational governments (intermediate plus local) in federal countries have executed a higher portion of total government spending than their counterparts in unitary countries. In 2001, the average subnational share of expenditures was 40.1% for federal countries and 21.67% for unitary countries.



government structure is different models of intergovernmental fiscal systems and different applications of decentralization practices across countries. Despite these differences, there are certain broad patterns recurring in many countries. Bird (1995) lists them as existence of inadequate "own resources" of subnational governments to finance

* For Israel and the United States, figures are from the year 2000.

the expenditure functions, heterogeneity of subnational governments, and the lack of subnational autonomy to levy taxes that are capable of yielding enough revenue to meet local needs.

Subnational governments have inadequate level of "own resources." The revenues under direct control of local governments invariably less than their expenditures in most of the countries. Table 1 reports local governments revenues as a percentage of their expenditures. The figures in the table are from GFS of the IMF, therefore they are subject to constraints discussed above. For example, the revenue figures include taxes which their rate and base are determined by central government as well as shared taxes. However, regardless of local governments' control over revenue resources, as seen in the table their revenues are less than the expenditure levels in both unitary and federal countries.

Table-1: Local Government Revenues as Percent of Expenditures

Unitary Countries	1997	1998	1999	2000	2001
Albania	3.69%	4.05%	N/A	N/A	N/A
Azerbaijan	66.78%	58.30%	49.64%	N/A	N/A
Belarus	77.73%	81.69%	83.60%	88.49%	85.96%
Bulgaria	65.35%	61.08%	58.50%	55.52%	66.98%
Croatia	93.83%	89.18%	89.75%	94.99%	92.02%
Czech Republic	72.74%	75.80%	71.77%	71.31%	61.22%
Denmark	58.55%	59.25%	60.33%	63.10%	N/A
Estonia	73.10%	72.04%	68.09%	71.47%	58.98%
Iceland	84.29%	85.31%	N/A	N/A	N/A
Kazakhstan	78.76%	71.68%	89.80%	89.54%	N/A
Latvia	73.82%	72.08%	71.37%	71.05%	65.54%
Lithuania	71.71%	80.65%	89.25%	89.16%	85.30%
Mauritius	40.68%	42.52%	39.39%	N/A	N/A
Moldova	58.66%	62.49%	73.73%	68.11%	79.42%
Mongolia	60.10%	57.32%	57.01%	49.39%	55.06%
Norway	61.30%	59.71%	57.90%	N/A	N/A
Poland	66.21%	64.76%	60.47%	59.85%	58.68%
Slovak Republic	79.75%	73.69%	74.90%	76.88%	80.21%
Slovenia	81.88%	80.60%	77.88%	76.54%	78.47%
United Kingdom	27.91%	29.33%	N/A	N/A	N/A
<i>Federal Countries*</i>					
Australia	81.80%	86.69%	N/A	N/A	N/A
Austria	83.89%	82.51%	N/A	N/A	N/A
Bolivia	100.02%	96.97%	102.84%	80.03%	N/A
Mexico	93.32%	83.06%	75.13%	N/A	N/A
Switzerland	82.02%	84.37%	86.04%	N/A	N/A
United States	64.92%	62.78%	62.48%	N/A	N/A

* In federal countries local government is the lowest tier of government.

Source: International Monetary Fund. 2001. Government Finance Statistics Year Book 2002, Country Tables

There are striking variations in the size and capacity of subnational governments. There is a big differences in terms of population, expenditure capacity and revenue sources across subnational units in almost every country. Direct comparison of subnational governments size and capacity across countries is difficult to make but intra-country variations exist in all the countries. In India, for example, the average per capita expenditures of states was 2354.97 rupee in 1998 and it varied from 69.18 to 167.77 % of the national average across states (see Table 2). It is these variations that make the design of intergovernmental transfer system an important component of fiscal decentralization process.

Table-2: Current Per Capita Expenditure Levels of Indian States

	1995	1996	1997	1998
All States	1564.23	1791.62	1946.13	2354.97
ANDHRA PRADESH	93.43%	109.39%	100.63%	94.57%
BIHAR	57.51%	48.16%	47.25%	57.46%
GUJARAT	122.02%	122.91%	132.01%	133.28%
HARYANA	182.70%	197.69%	175.09%	163.82%
KARNATAKA	108.96%	112.82%	109.40%	111.16%
KERALA	119.44%	120.13%	132.93%	129.18%
MADHYA PRADESH	77.86%	83.79%	77.49%	76.45%
MAHARASHTRA	125.66%	131.38%	131.20%	116.45%
ORISSA	86.64%	81.52%	80.38%	86.99%
PUNJAB	159.66%	168.93%	173.78%	167.77%
RAJASTHAN	105.88%	91.70%	88.38%	94.00%
TAMILNADU	116.59%	120.64%	125.90%	118.54%
UTTAR PRADESH	70.86%	66.38%	69.16%	69.18%
WEST BENGAL	73.26%	75.68%	75.05%	85.81%

Source: Indian Subnational Database, The Statistical Information Management and Analysis System, World Bank.

Subnational governments lack the legal authority to levy some taxes. The size and pattern of subnational government taxation varies greatly from country to country (see Table 3). Income and property taxes are the most important sources of subnational revenue. However, as seen in the table, corporate tax on revenues is exclusively the central government's source of revenue.

Table-3: Tax Revenue Attributable to Each Level Government

	Income Tax				Property Tax				Corporate Tax			
	1999		2000		1999		2000		1999		2000	
	C	L	C	L	C	L	C	L	C	L	C	L
Belarus	0.00%	100.00%	0.00%	100.00%	0.00%	100.00%	0.00%	100.00%	100%	0%	100%	0%
Bulgaria	51.96%	48.04%	52.26%	47.74%	0.04%	99.96%	0.09%	99.91%	100%	0%	100%	0%
Croatia	60.64%	39.36%	54.69%	45.31%	32.50%	67.50%	32.21%	67.79%	100%	0%	100%	0%
Czech Republic	36.96%	63.04%	35.38%	64.62%	61.63%	38.37%	57.30%	42.70%	100%	0%	100%	0%
Denmark	42.00%	58.00%	40.98%	59.02%	41.53%	58.47%	35.46%	64.54%	100%	0%	100%	0%
Estonia	43.95%	56.05%	44.33%	55.67%	0.00%	100.00%	0.00%	100.00%	100%	0%	100%	0%
Kazakhstan	2.26%	97.74%	2.35%	97.65%	4.00%	96.00%	2.62%	97.38%	100%	0%	100%	0%
Latvia	28.63%	71.37%	28.42%	71.58%	1.48%	98.52%	0.52%	99.48%	100%	0%	100%	0%
Lithuania	28.72%	71.28%	29.00%	71.00%	0.00%	100.00%	0.00%	100.00%	100%	0%	100%	0%
Mauritius	100.00%	0.00%	N/A	N/A	86.98%	13.02%	N/A	N/A	100%	0%	100%	0%
Moldova	0.00%	100.00%	0.00%	100.00%	1.26%	98.74%	0.11%	99.89%	100%	0%	100%	0%
Mongolia	0.00%	100.00%	0.00%	100.00%	0.00%	100.00%	0.00%	100.00%	100%	0%	100%	0%
Norway	42.22%	57.78%	N/A	N/A	42.99%	57.01%	N/A	N/A	100%	1%	100%	1%
Poland	71.52%	28.48%	72.08%	27.92%	0.13%	99.87%	0.13%	99.87%	100%	0%	100%	0%
Slovak Republic	83.80%	16.20%	79.77%	20.23%	31.42%	68.58%	31.03%	68.97%	100%	0%	100%	0%
Slovenia	100.00%	0.00%	100.00%	0.00%	7.89%	92.11%	3.77%	96.23%	100%	0%	100%	0%

Source: International Monetary Fund. 2002. Government Finance Statistics Year Book 2002, Country Tables

II. WHY DECENTRALIZATION?

The key elements underlying the interest in decentralization are increasing efficiency, transparency and accountability in the public sector. During the last two decades, the economic reforms in developing countries largely focused on the role of markets and understated the importance of the organization of the public sector in achieving broader macro objectives such as economic stability, sustainable growth, and provision of basic public services equitably across people and jurisdictions.

The poor performance of the central governments in achieving those macro objectives has fueled the interest in fiscal decentralization. In recent years, there has been a widespread movement toward assigning certain functions of public sector to subnational governments in order to offload the burden from central government's shoulder and rely more on lower level governments, which are often underutilized and have untapped revenue potential (Smoke, 1994).

In many developing countries, like India (Rao, 1999), Philippines (Rood, 2000), Columbia (Bird and Fiszbein, 1999), and Brazil (Dillinger and Webb, 1999), the failure of the central government in avoiding large fiscal deficits and macroeconomic instability, and in providing adequate level of services has generated a growing interest in decentralization of government functions. However, in some of the developing countries, subnational governments fall short of meeting the expectations due to a variety of reasons, and in several cases, decentralization has been blamed for the underperformance of the public sector. Some macro economists argue that in a decentralized system, since policymaking becomes a responsibility shared by different levels of government, circumvention of central control over monetary and fiscal policies may have aggravated macroeconomic problems in these countries (Prud'homme, 1995; Tanzi, 1996). According to them, central governments are better equipped in dealing with spillover effects of local spending, inflationary pressures of monetization of local debt and cyclical

shocks. To the extent that this line of argument highlights the potential problems arising from decentralization when checks and balances of intergovernmental relations systems are not in place, decentralization can make matters worse. A good decentralization policy is not easy to design; clearly, it can be done well or badly (Bird and Vaillancourt, 1999).

However, empirical research on decentralization and macroeconomic governance gives little support to the macroeconomic concern in general. A recent study on the relationship between fiscal federalism and macroeconomic governance finds that “decentralized fiscal system offers a greater potential for improved macroeconomic governance than centralized fiscal systems.”² In fact, highly decentralized federal countries, such as Switzerland, Germany, Austria, and USA, have very stable macroeconomic performance and low rates of inflation (Shah, 1997).

The concern over macroeconomic performance in a decentralized system stems from the traditional Keynesian demand management argument. In traditional Keynesian theory, fiscal policy is an important tool for the manipulation of short-run demand which affects prices and employment levels. When Musgrave (1959) identified macroeconomic stability as one of the three functions of government, policy makers and economists alike viewed fiscal policies as important factors for the aggregate demand fluctuations and argued that it should be left to the central government. According to Spahn (1998), Keynesian demand management argument has overemphasized the need for centralized macroeconomic policies, because:

- (1) it assumes regionally symmetrical shocks. There may well be regionally asymmetrical shocks.
- (2) it assumes a closed economy. Fiscal shocks would be offset by an exchange-rate change in an open economy.
- (3) it assumes segmented capital markets. As long as capital markets are informed and rational, it might be less costly for subnational governments to borrow from capital markets. Borrowing from central government for the sake of stabilization policy might exceed the cost of region specific risk factors.
- (4) it neglects supply-side effects of effects of fiscal policy. Fiscal policy is not simply "demand management," it has supply-side effects also through the way public resources are used. Local governments can use fiscal policy power to deal with macroeconomic problems, such as unemployment and economic growth.
- (5) it neglects built-in stabilizers. Built-in stabilizers are not confined to the central government alone, they can work at all levels of government. Fiscal stabilization is guaranteed through built-in stabilizers.

Spahn (1998) makes the point that countries like Argentina and Brazil have had macroeconomic problems due to subnational borrowing reflects the fact that the old institutional arrangements do no longer function under the decentralized regime and in order to have an effective mechanism of intergovernmental cooperation, institutional reform is required in countries undergoing decentralization process.

² Huther and Shah (1998) examine statutory aspects of central bank operations, such as the terms of office for chief executive officer, the formal policymaking power, limitations on lending to the government and other 13 criteria and show that there is a positive correlation between central bank independence and decentralization.

The institutional context of intergovernmental fiscal relations entails the overall economic development, the nature of the legal system, ongoing process of economic and political reform, the organization of monetary and financial institutions, and tensions arising from ethnic, religious, or economic differences (Wildasin, 1997). This institutional background has a crucial effect on the nature of the intergovernmental financial system. In countries that do not have institutional structures that support mature and stable federations, subnational governments may use their fiscal power irresponsibly causing macroeconomic problems.

Wildasin (1997) argues that "effective fiscal decentralization requires an institutional structure that minimize these adverse incentives." According to him, three important characteristics of an intergovernmental system that would have significant impact on decentralization process are transparency, accountability, and predictability. In the case of lack of these three characteristics, subnational governments would settle their intergovernmental fiscal transactions on ad hoc basis, responding to the fiscal distress of lower-level units with a variety of special loans, grants, negotiated tax-sharing agreements, directed-credit programs, and other emergency bailouts, rather than establishing firm transparent rules which would govern the form and extent of fiscal flows between central and subnational fiscal and financial institutions.³ Consequently, in order for the decentralization to be effective and successful, the transfer of fiscal power from the center to the localities must be supplemented by institutional arrangements that monitor the system. Such proper arrangements that enforce hard-budget constraints motivate responsible behavior by the subnational governments and reduce the possibility of macroeconomic instability.

It is important to recognize that fiscal decentralization does not necessarily lead to macroeconomic instability. In fact, most countries choose to decentralize *because of* macroeconomic distress. The poor macroeconomic performance in these centralized countries typically resulted in large budget deficits, which were financed primarily by external borrowings. Over time, interest payments claimed an increasing share of their budget and the vicious cycle of borrowing and debt service left central governments without a choice but to rely more and more on local governments for service provision.

However, in the absence of appropriate rules that regulate intergovernmental relations, forcing local governments to provide adequate level of services and maintaining a sustainable decentralized system has proven to be difficult in many countries. Today, we are faced with the fact that many central government fail to deliver macroeconomic stability and adequate level of public services. The question is whether fiscal decentralization aggravates macroeconomic problems when appropriate rules are in place, the institutions of political control and accountability are mature, and administrative professionalism and control mechanisms are developed.

The question of the impact of fiscal decentralization on macroeconomic indicators has been analyzed from different perspectives in the academic literature. Empirical studies have tested the impact of fiscal decentralization on public sector size and economic growth and found contradictory results (see Box 1 and 2). A simple analysis of the relationship between subnational government spending and GDP provides some preliminary findings about the impact of fiscal decentralization on a basic

³ *Op. cit.* Wildasin (1998).

macroeconomic indicator. Table 4 reports correlation coefficients between GDP per capita and local government spending. As seen in the table, in developed countries, where people are more educated and institutions of a civil society have been better developed, there is a high and significant positive correlation between the two variables. On the other hand, in developing countries, where the institutions of political control and accountability are yet to cultivate, the correlation coefficients are low, even negative.

Table-4: Correlation coefficients for GDP Per Capita and Local Government Spending*

Australia	0.985	Italy	0.951
Austria	0.996	Kenya	-0.774
Belgium	0.955	Luxembourg	0.981
Bolivia	-0.850	Mexico	0.544
Canada	0.992	Netherlands	0.910
Chile	-0.362	Norway	0.984
Colombia	-0.726	Philippines	0.147
Denmark	0.971	Portugal	0.982
Finland	0.981	Spain	0.996
France	0.956	Sweden	0.234
Germany	0.978	Switzerland	0.974
Iceland	0.875	Thailand	0.818
Ireland	0.936	UK	0.982
Isreal	0.345	USA	0.991

* In federal countries local governments are defined as below state governments, therefore it does not refer to state plus local governments total.

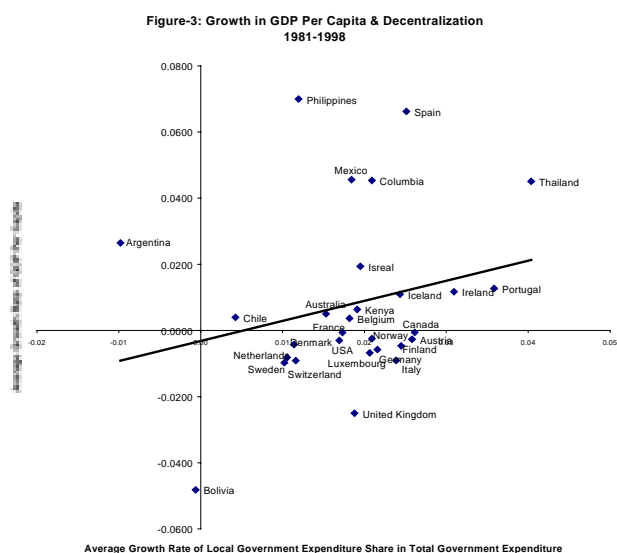


Figure 3 presents the same relationship on a scatter diagram. It appears that there is a linear relationship between the growth rates of local government expenditure share and GDP per capita in the same group of countries. As seen in the chart, higher decentralization is positively associated with the average growth rate of per capita GDP; as countries become more decentralized (the average growth rate of local governments expenditure increases) the growth in GDP per capita increases.

Box -1: Empirical Studies on the Impact of Fiscal Decentralization on Public Sector Size

If greater decentralization increases number of alternative fiscal jurisdictions, any attempt to increase tax rates in one jurisdiction would result in migration of its residents to another jurisdiction (Tiebout, 1956). In Tiebout's analysis, taxpayers migrate alternative jurisdictions in order to avoid higher taxes and interjurisdictional competition limit excessive taxing power of the governments. Along with the lines of Tiebout, Brennan and Buchanan (1980) developed the “Leviathan” hypothesis, in which they argue that fiscal decentralization serves as a constraint on the behavior of the revenue-maximizing government. The "Leviathan" hypothesis predicts that the overall size of the public sector should vary inversely with fiscal decentralization; fiscal decentralization increases competition among local governments, which ultimately limits the size of the public sector. Empirical studies have tested the relationship between subnational government expenditures in total government expenditure and reduction in the total public sector size and reported conflicting results.

Studies Testing “Leviathan” Hypothesis

Study	Unit of Analysis	Findings
Oates (1985)	Cross-country comparison	No significant relationship
Nelson (1986)	United States	No significant relationship
Marlow (1988)	United States	Strong negative correlation
Grossman (1989)	United States	Strong negative correlation
Joulfaian and Marlow (1990)	United States	Strong negative correlation
Grossman and West (1994)	Canada	Strong negative correlation
Ehdaie (1994)	Cross-country comparison	Strong negative correlation

Box -2: Empirical Studies on the Impact of Fiscal Decentralization on Economic Growth

There has been little research done on the impact of fiscal decentralization on economic growth. Until recently the debate over the merits of fiscal decentralization had been on theoretical grounds of efficiency gains and the empirical studies that have analyzed the impact of fiscal decentralization on economic growth have only appeared recently. The general finding of these studies is that fiscal decentralization is associated with slower economic growth.

Studies on The Impact of Fiscal Decentralization on Economic Growth

Study	Unit of Analysis	Findings
Davoodi and Zou (1998)	Cross-country comparison	Significant negative relationship
Xie, Zou and Davoodi (1999)	United States	Significant negative relationship
Zhang and Zou (1998)	China	Significant negative relationship

Serious methodological issues confront efforts to carry out studies about the impact of fiscal decentralization on economic growth. First, there is the issue of specification of empirical model. The literature on economic growth suggests that growth is a complex phenomenon with multi-dimensions (Levine and Renelt, 1992). These studies are criticized on the grounds of a possible model misspecification (Martinez-Vazquez and McNab, 1997). Second, the fiscal decentralization variable used in these studies does not represent the multidimensionality of the issue. Without controlling for subnational governments' autonomy

over expenditure and revenue decisions and whether subnational officials are democratically elected, the expenditure share of subnational governments as a fiscal decentralization variable means very little in representing the level of decentralization. Third, regression coefficients may very well be the product of spurious correlation. In regression analysis models, the cause-and-effect relationship runs directly from explanatory variables to the dependent variable. However, if both dependent and independent variables are determined simultaneously, the distinction between dependent and explanatory variables becomes dubious. If there is no unidirectional cause-and-effect relationship, the dependent variable is determined by explanatory variables, and some of the explanatory variables are, in turn, determined by output. Given that there has been extensive research on the role of economics on growth on fiscal decentralization (Oates, 1985; Pommerehne, 1977; Kee, 1977; Bahl and Nath, 1986) and very little research on the causation line from fiscal decentralization to economic growth, it is highly suspected that the regression coefficients reported on these studies is a mere reflection of spurious correlation. Therefore, the theoretical underpinnings of the relationship between fiscal decentralization and economic growth still need to be further developed.

The strong positive correlation between decentralization and GDP per capita in developed countries support the argument that as people become more educated, better informed about their governments, and more aware of problems that affect their lives, their desire to bring the control of government functions closer to themselves grows (Smoke, 1994). In fact, much of the decentralization that has taken place in the past decade has been motivated by political dynamics that promote democracy and transparency. In most countries, decentralization has been an essential part of the democratization process as discredited autocratic central regimes are replaced by elected governments and the spread of multiparty democratic systems give a chance to local voice to be heard.

The rationale for democratic participation and transparency is to make it possible for people to participate in and influence the decisions made within their own geographical area. In a decentralized system, where locally elected governments have the power to pursue the agenda mandated by voters, citizen participation in decision making process cultivates a culture of democracy and transparency in public management system. Therefore, an important component of decentralization process is to design mechanisms that would encourage participation of citizens in decision-making process.

Participation is concerned with increasing the role of citizens in choosing their leaders and in telling what to do. Regular elections, local referendums, permanent councils and other institutional structures are some of the easily identifiable and effective tools that may improve the ability of local governments to identify and act on citizen preferences in a decentralized setting. Studies have shown that citizens' participation and control over government's actions can increase the quality of public management system and that participation of citizens in decision-making process can lead to some identifiable improvements in the allocation of resources (Putnam, 1993; Fiszbein, 1997, Narayan and Pritchett, 1997).

In a seminal study Putnam (1993) compares regional governance practices in Italy and concludes that regional governments that are more open to constituent pressure were more successful at managing resources and delivering services. In a similar study,

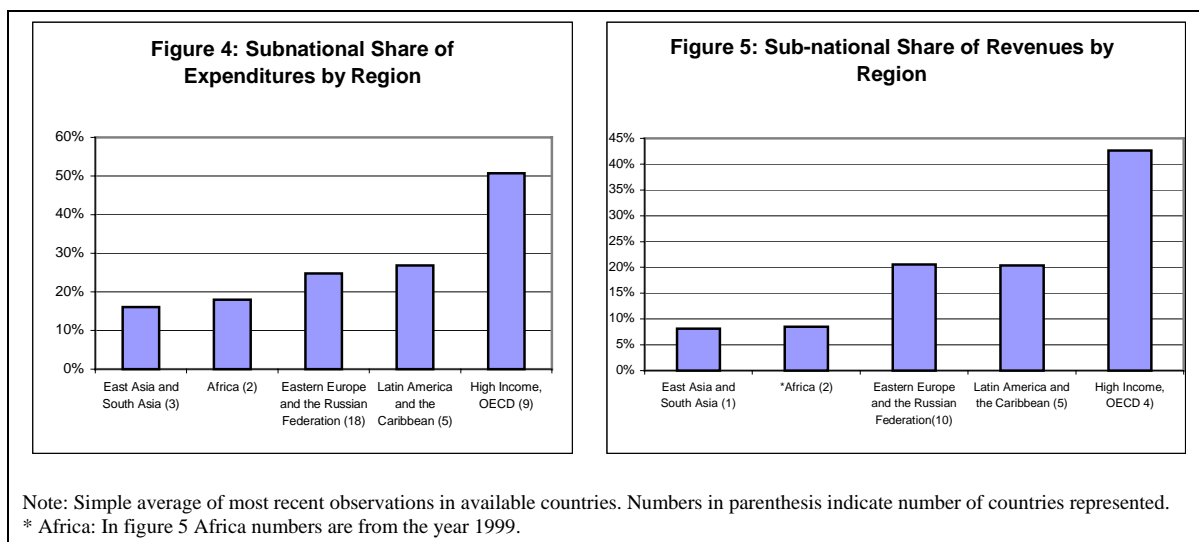
Fiszbein (1997) shows that in Columbia, elected officials whose jobs are under public scrutiny are more likely to pick better staff to work for them. Finally, in a recent study Narayan and Pritchett (1997) analyze the relationship between the quality of local schooling and the level of social capital in rural Tanzania. They conclude that there is a positive association between schooling and social capital which in return increase the economic well-being of rural communities.

Two other studies found similar results in the analysis of the relationship between fiscal decentralization and political participation and governance quality recently. Huther and Shah (1998) have developed governance quality index, to analyze the relationship between fiscal decentralization and governance quality, for a sample of 80 countries. The index is composed of four indices: citizen participation index, government orientation index, social development index, and economic management index. Their findings suggest that decentralized systems are more responsive to citizens' preferences than centralized systems. In another study, the Inter-American Bank analyzed different aspects of fiscal decentralization in Latin American and the Caribbean countries and conclude that there is a positive association between political autonomy and participation at lower levels of government, and the extent to which government expenditures are decentralized (The Economic and Social Progress Report, 1997).

III. DIFFERENCES IN THE DEGREE OF DECENTRALIZATION

In the past, due to political ideology or the autocratic character of the regime, some countries felt the need to keep their distant provinces together under one power. As discussed in the previous section, there are several factors contributed to the growing interest in fiscal decentralization. Although, these are common factors for most of the countries, there exist differences in the degree of decentralization across nations (see figure 4 and 5)⁴. These differences are in part explained by different size variables, such as population (Oates, 1972; Pommerehne, 1977; Bahl and Nath, 1986), land area (Oates, 1972), and GDP (Pommerehne, 1977).

⁴ Figures 4 and 5 present the variation in expenditure and revenue shares of subnational governments across regions. As presented in figures 4 and 5, high-income countries are relatively more decentralized than others. Subnational governments in East Asian and South Asian countries appear to have the lowest level of subnational expenditure and revenue shares compared to other regions of the world. However, this may not be the case. South Asia pillar in figure 4 includes only Thailand, Macao, and Mongolia. In figure 5, it only includes Thailand, which is not a reflection of the characteristics of the region. Otherwise, sub-Saharan Africa would have the lowest levels of subnational revenue and expenditure shares.



Figures 6, 7, and 8 present the association between country size and decentralization for federal and unitary countries separately.⁵ The reason for separating them is the differences in governance systems. In general, the public administration system in large countries is based on principles of federalism and the division of power between central government and its component units is provided by the constitution. However, the centralization-decentralization distinction is not synonymous with the distinction between federal and unitary systems. Just like unitary countries can be decentralized federal countries can be centralized.

Figure 6 shows the association between GDP per capita and decentralization in federal and unitary countries. The regression line suggests that GDP per capita is positively associated with higher decentralization in both groups. The positive association is stronger and the regression analysis has a stronger explanatory power for unitary countries. The positive association of decentralization and GDP per capita suggests that an increase in income increases expenditure levels for subnational governments. The steeper regression line for unitary states implies that the increase in income levels has a stronger effect on subnational governments' expenditure levels than it has in federal states.

Figure 7 presents the association between population and fiscal decentralization for the same group of countries. It appears that population is positively associated with higher levels of subnational governments spending in both groups also. However, as seen in the figure, unlike GDP per capita, the positive association is stronger for federal countries. The stronger association of population with fiscal decentralization in federal countries is consistent with the argument that as the country size gets bigger, subnational governments are expected to play an important role in delivering public services.

The third size variable that explains the degree of differences among countries is land area. Figure 8 shows the relationship between land area and decentralization. As seen in the figure, the regression line has a positive slope for both groups of countries, which suggest that land area is positively associated with higher decentralization. The

⁵ The figures for subnational governments' expenditure share are from GFS used in Figure 1 and the size variables are from World Development Indicators of the World Bank.

magnitude of the impact of land area on fiscal decentralization is stronger for unitary states than federal ones.

Figure-6: Decentralization and GDP

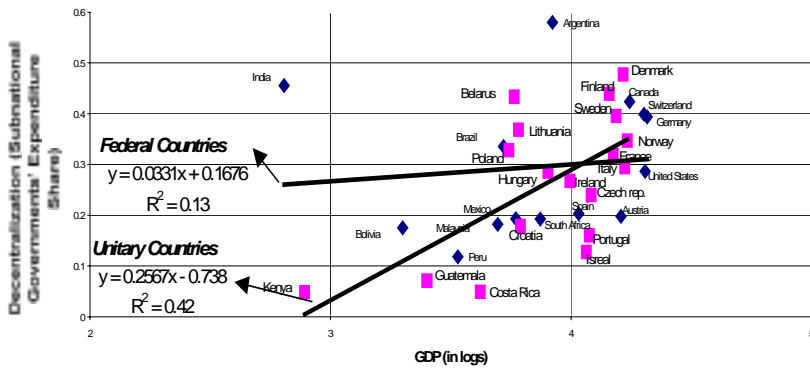


Figure-7: Decentralization and Population

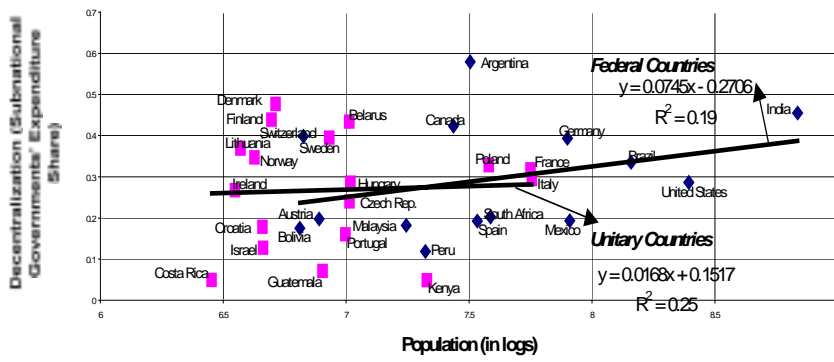
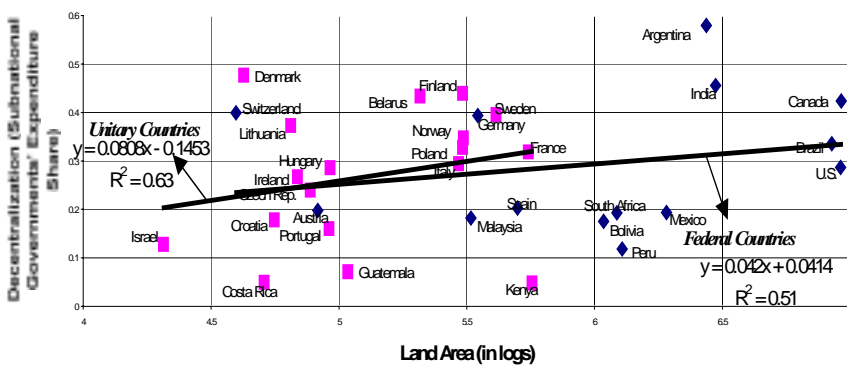


Figure-8: Decentralization and Land Area



IV. HOW TO DECENTRALIZE?

The transfer of authority and responsibility for public functions from the central government to subordinate or quasi-independent government organizations covers a broad range of topics (World Bank, 1999). There is no prescribed set of rules governing the decentralization process that apply to all countries. Decentralization takes different forms in different countries, depending on the objectives driving the change in structure of government.

In general, decentralization of public policy making power is the transfer of legal and political authority to plan projects, make decisions and manage public functions from the central government and its agencies to institutions within smaller geographical boundaries - subnational governments. Power can be transferred on three fronts: political, administrative, and fiscal. Although, each type of decentralization has different characteristics, system outcomes, and policy implications, the expected impact on people's life is an increase in the quality (see Figure 9). While distinguishing among different types of decentralization is useful for highlighting its many dimensions, it is impossible to disentangle the inter-linkages between these three concepts.

Decentralization on political fronts aims to give citizens and their elected representatives more power in public decision-making. The concept implies the transfer of policy and legislative power to citizens and their democratically elected representatives. Political decentralization is often associated with pluralistic politics and representative governments. If necessary, it requires constitutional or statutory reforms, development of pluralistic political parties, the strengthening of legislatures, and the creation of local political units and the encouragement of effective public interest groups.⁶

On the administrative front, decentralization of policymaking power means the redistribution of authority, responsibility, and financial resources among different levels of government. Administrative decentralization can be done in two different ways: functional and areal distribution of power (Rondinelli, 1981). Functional distribution is to transfer authority to specialized organizations that operate across jurisdictions. An example of functional distribution is the creation of field offices within national ministries dealing with health care, education, and transportation issues. Areal distribution of power aims to transfer responsibility for public functions to institutions within specified geographical and political boundaries. Usually, areal distribution of power is to a subnational government - a province, district or municipality.

In the case of administrative distribution of power, an important distinction that has important implications on intergovernmental relations systems is the forms of decentralization: deconcentration, delegation, and devolution.

1. *Deconcentration* involves the shifting of responsibilities from central government agencies located in the capital city to regional offices. Rondinelli (1981) defines deconcentration as local administration in which all subordinate levels of government within a country are agents of the central authority either appointed by or are responsible directly to the central government. This is the least extensive type of administrative decentralization.

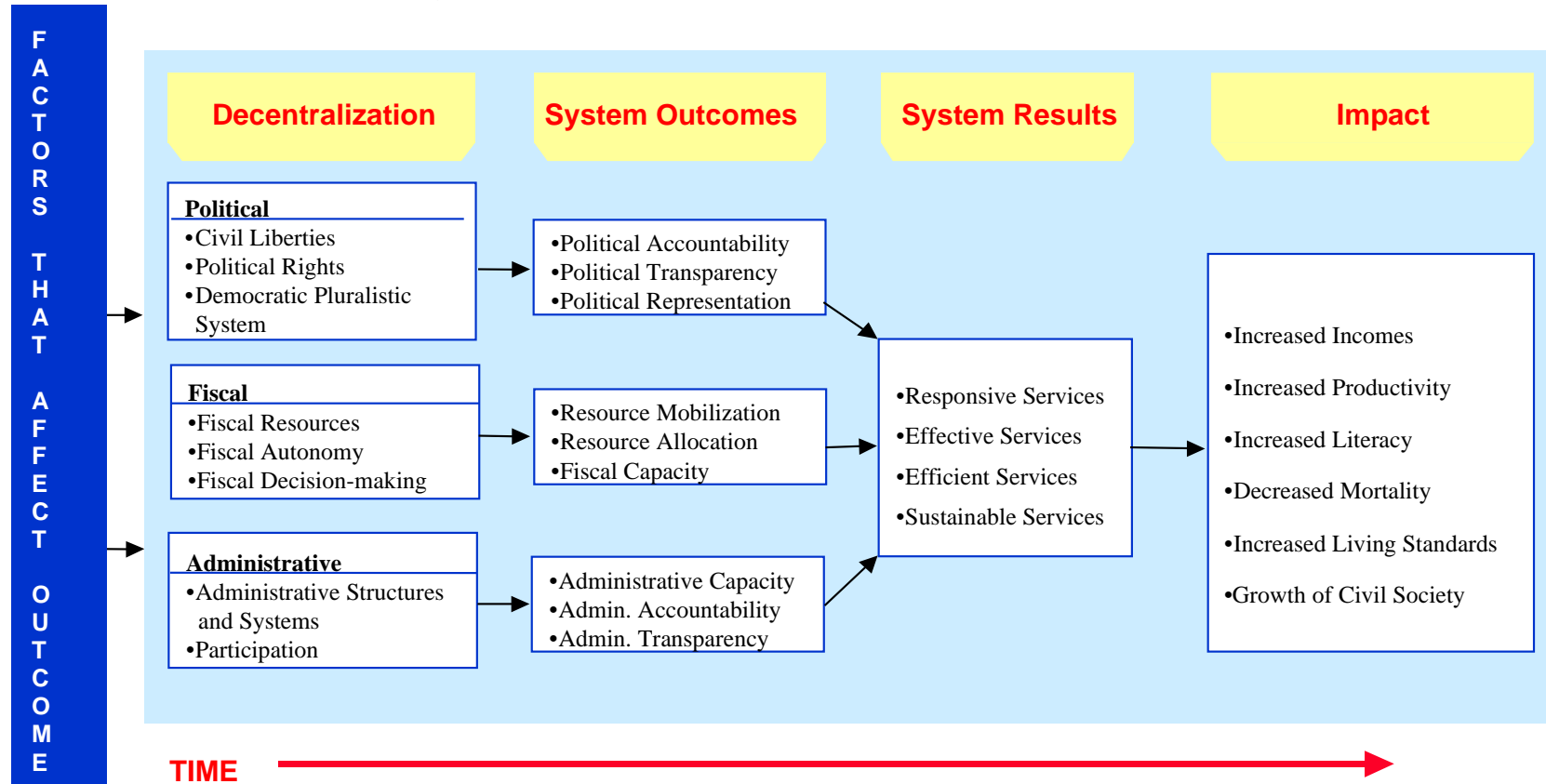
⁶ *Op. cit.* Rondinelli (1999).

2. *Delegation* refers to the transfer of public policy making and administrative authority and/or responsibility for carefully spelled out tasks to institutions and organizations that are either independent or under the central government's indirect control. Typically, delegation of functions is by the central ministries to semi-autonomous organizations not wholly controlled by the central government but legally accountable to it, such as state owned enterprises, public utilities, and regional planning and economic development authorities.
3. *Devolution* is the most extreme form of decentralization where independently established subnational governments are given the responsibility for the delivery of a set of public services along with the authority to impose taxes and fees to finance services. In a devolved system, subnational governments have independent authority to raise their own revenues and to make investment decisions. It is devolution of administrative power that underlies decentralization of power on political fronts.

Devolution is usually synonymous to fiscal decentralization where subnational governments have clear expenditure assignments, substantial budget autonomy, and legally recognized geographical boundaries within which they perform public functions. Although the varieties of fiscal decentralization may exist, corresponding to the degree of independent decision making exercised at the subnational level, the general description of the term fiscal decentralization encompasses the political, economic, and institutional underpinnings of intergovernmental fiscal relations, and ranges from examining the efficiency of public institutions and developing sustainable infrastructure finance, to rationalizing fiscal transfer mechanisms and supporting the social safety net (Ebel and Hotra, 1997).

Therefore, a carefully designed fiscal decentralization policy should not only enhance local autonomy where subnational governments are allowed to act independently within their own sphere of competence in designing revenue and expenditure policies but also promote political accountability, economic efficiency and transparency.

Figure- 9: Decentralization on Three Fronts



Source : Adapted from Parker, Andrew N. 1995, "Decentralization: The Way Forward for Rural Development?" Policy Research Working Paper 1475. The World Bank, Washington, D.C.

There is no easy answer to the question of how to design a decentralization strategy to promote transparency, accountability, and efficiency in intergovernmental financial systems. Ideally the intergovernmental fiscal system should function leaving little room for ambiguity and negotiations among different levels of government. Therefore, an important component of a decentralization strategy is designing a legal and regulatory framework that would provide guidance to different levels of government in sorting out the roles and responsibilities.

In the process of decentralization, the constitution should enshrine the broad principles on which decentralization is to operate, including rights and responsibilities of all levels of government, the description, and role of key institutions at central and local levels, and the basis on which detailed rules may be established or changed (Ford, 1999). The specific parameters of the intergovernmental fiscal system and the institutional details of the local government structure must be defined in the laws governing relations across governments. Ford (1999) lists the issues that the legal framework of reform efforts should address as:

- Classification of local governments within tiers established under the constitution;
- Broad organization structures and their roles and responsibilities;
- Terms of office, operating powers, procedures, and limitations of the political leadership, as distinct from the civil service;
- The degree of autonomy of personnel policies and administration of local governments;
- The taxing and fiscal administration authority of local governments;
- The borrowing authority and capacities of local governments;
- The distribution of budgeting, expenditure management, accounting, auditing, and reporting requirements;
- Service provision and delivery authority;
- The mechanisms for citizen participation and voice.

V. FOUR PILLARS OF THE INTERGOVERNMENTAL FISCAL SYSTEM

The design of a decentralized system requires the "sorting-out" of public sector responsibilities among different types of governments and the process of sorting out entails the transfer of some decision-making powers from central to subnational governments (Ebel, Varfalavi and Varga, 2000). However, designing a decentralized system is not limited to the question of assigning responsibilities among different levels of government. The question is designing an intergovernmental finance system that can best achieve the national policy objectives. Such objectives may include not only efficiency, transparency, and accountability but also achieving equity among people and places, maintaining national integrity and political stability. The challenge is to design an intergovernmental system that links decentralization reforms to the economic, social, and institutional development of the society. According to Bird (2000), such a design is based on four pillars: expenditure assignment, revenue assignment, intergovernmental transfers/grants, and subnational debt/borrowing.

Expenditures

Expenditure assignment is the first step in designing an intergovernmental fiscal system. Designing revenue and transfer components of a decentralized intergovernmental fiscal system in the absence of concrete expenditure responsibilities would weaken the decentralization process (Martinez-Vazquez, 1994). In Latin America and Eastern Europe, many countries have focused only on the revenue side of decentralization and neglected a clear assignment of expenditure responsibilities. This led to weak decentralized systems and fiscally overburdened central governments.

The lack of clarity in the definition of subnational responsibilities has a negative impact in three important respects. First, if the responsibilities are imprecise, the necessary corresponding revenues will remain poorly defined. Second, without clear responsibilities, subnational government officials might prefer to invest in populist projects which benefit them in the short run rather than in projects with long term impact on the region's economy (such as infrastructure, education, etc.). Third, there will be a confusion whether subnational expenditures represent local priorities or centrally determined programs.

The key to the success of a decentralized system is matching expenditure responsibilities with the objectives of service assignment. A report prepared by the US Advisory Commission on Intergovernmental Relations (ACIR) on Governmental Functions and Processes (1974) lists four criteria in assigning services: economic efficiency, fiscal equity, political accountability, and administrative effectiveness. As presented in Figure 10, these characteristics suggest that expenditure assignments should be made to governmental units that can

...(1) supply a service at the lowest possible cost; (2) finance a function with the greatest possible fiscal equalization; (3) provide a service with adequate popular political control; and (4) administer a function in an authoritative, technically proficient, and cooperative fashion.⁷

These four factors provide a framework to determine whether each function could be best performed by central government or any other level of governmental unit. In more specific terms they relate economic, political, and administrative considerations to the size variable:⁸

1. *Economic Efficiency*: Functions should be assigned to jurisdictions
 - (a) that are large enough to realize economies of scale and small enough not to incur diseconomies of scale; [economies of scale]
 - (b) that are willing to provide alternative service offerings to their citizens and specific services within a price range and level of effectiveness acceptable to local citizenry; [public sector competition]
 - (c) that adopt pricing policies for their functions whenever possible. [public sector pricing]
2. *Fiscal Equity*: Appropriate functions should be assigned to jurisdictions

⁷ ACIR (1974), p. 7.

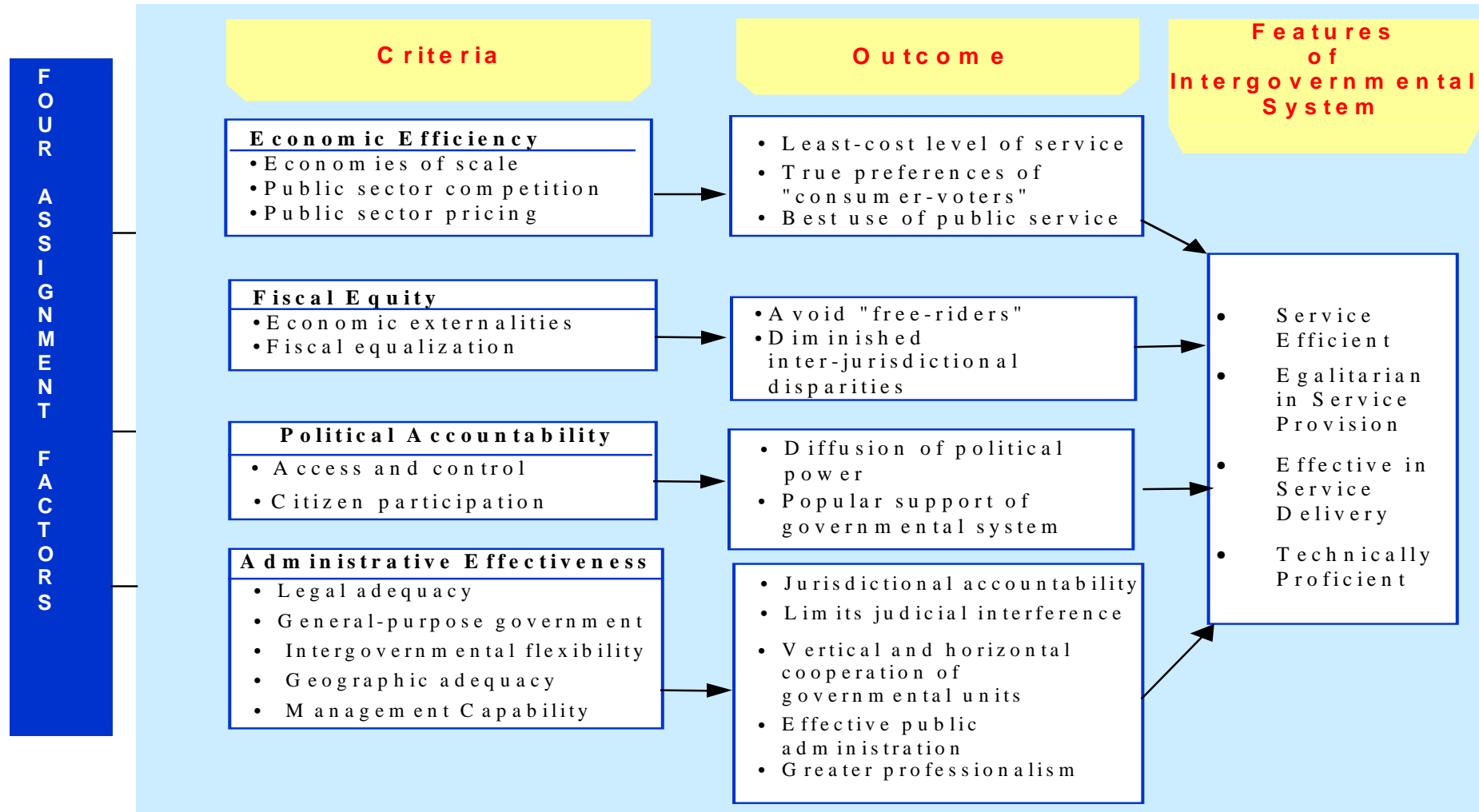
⁸ ACIR (1974), p. 7.

- (a) that are large enough to encompass the cost and benefits of a function or that are willing to compensate other jurisdictions for the service costs imposed or for benefits received by them ; [economic externalities]
 - (b) that have adequate fiscal capacity to finance their public service responsibilities and that are willing to implement measures that insure inter-personal inter-jurisdictional fiscal equity in the performance of a function. [fiscal equalization]
3. *Political Accountability*: Functions should be assigned to jurisdictions
- (a) that are controllable by, accessible to, and accountable to their residents in the performance of their public service responsibilities; [access and control]
 - (b) that maximize the conditions and opportunities for active and productive citizen participation in the performance of a function. [citizen participation]
4. *Administrative Effectiveness*: Functions should be assigned to jurisdictions
- (a) that are responsible for a wide variety of functions and that can balance competing functional interests; [general-purpose character]
 - (b) that encompass a geographic area adequate for effective performance of a function; [geographic adequacy];
 - (c) that explicitly determine the goals of and means of discharging public service responsibilities and that periodically reassess program goals in light of performance standards; [management capability]
 - (d) that are willing to pursue intergovernmental policies for promoting inter-local functional cooperation and reducing inter-local functional conflict; [intergovernmental flexibility] and
 - (e) that have adequate legal authority to perform a function and rely on it in administering the function. [legal adequacy]

The ACIR report stresses that these characteristics might yield conflicting recommendations for expenditure assignment therefore based on the objectives of decentralization they must be weighted against each other in assigning functional responsibilities. For example, if education services are assigned to subnational governments, wealthier jurisdictions will have more financial resources than poor jurisdictions to allocate for this function. Therefore, assigning this function to subnational governments will contradict to fiscal equalization criteria. However, assigning it to the central government means loss of political control for local residents.

Table 5 provides an overview of expenditure patterns across countries reported in the Government Finance Statistics Yearbook 1998. As seen in the table, functions with high degree of spillover externalities (such as defense and welfare) are exclusively performed by central governments and functions which require a high degree of political accountability (such as education) are performed by subnational governments in both federal and unitary countries.

Figure-10: Expenditure Assignment Process



Source : Adapted from ACIR. (1974). Governmental Functions and Process: Local and Area-wide. Advisory Commission on Intergovernmental Relations, A-45. Washington, D.C.

Tables-5 A & B: Expenditure Shares of Central and Subnational Governments in Unitary and Federal Countries

Table- 5A	Defense		Education		Health		Housing		Police		Recreation		Welfare		Subsidies		Other	
	C	L	C	L	C	L	C	L	C	L	C	L	C	L	C	L	C	L
Albania	100%	0%	20%	80%	70%	30%	68%	32%	100%	0%	65%	35%	81%	19%	63%	37%	75%	25%
Azerbaijan	100%	0%	17%	83%	16%	84%	2%	98%	100%	0%	55%	45%	99%	1%	100%	0%	84%	16%
Belarus	98%	2%	18%	82%	21%	79%	0%	100%	81%	19%	42%	58%	97%	3%	92%	8%	74%	26%
Bulgaria	100%	0%	39%	61%	44%	56%	32%	68%	98%	2%	65%	35%	94%	6%	90%	10%	82%	18%
Croatia	100%	0%	81%	19%	99%	1%	63%	37%	99%	1%	31%	69%	99%	1%	54%	46%	64%	36%
Czech Republic	98%	2%	82%	18%	95%	5%	23%	77%	83%	17%	35%	65%	93%	7%	98%	2%	41%	59%
Denmark	100%	0%	53%	47%	5%	95%	69%	31%	88%	12%	43%	57%	46%	54%	65%	35%	73%	27%
Estonia	100%	0%	45%	55%	97%	3%	1%	99%	99%	1%	61%	39%	91%	9%	56%	44%	62%	38%
Iceland	100%	0%	47%	53%	99%	1%	31%	69%	92%	8%	45%	55%	78%	22%	82%	18%	78%	22%
Kazakhstan	86%	14%	22%	78%	57%	43%	0%	100%	75%	25%	55%	45%	73%	27%	66%	34%	79%	21%
Latvia	99%	1%	28%	72%	95%	5%	20%	80%	93%	7%	53%	47%	94%	6%	91%	9%	66%	34%
Lithuania	100%	0%	30%	70%	98%	2%	0%	100%	97%	3%	61%	39%	91%	9%	99%	1%	78%	22%
Mauritius	100%	0%	100%	0%	100%	0%	77%	23%	99%	1%	79%	21%	99%	1%	100%	0%	91%	9%
Moldova	100%	0%	32%	68%	40%	60%	23%	77%	85%	15%	64%	36%	95%	5%	93%	7%	57%	43%
Mongolia	100%	0%	28%	72%	13%	87%	38%	62%	51%	49%	61%	39%	99%	1%	31%	69%	56%	44%
Norway	100%	0%	37%	63%	23%	77%	13%	87%	83%	17%	35%	65%	81%	19%	85%	15%	66%	34%
Poland	100%	0%	43%	57%	88%	12%	18%	82%	96%	4%	45%	55%	95%	5%	88%	12%	62%	38%
Slovak Republic	100%	0%	100%	0%	100%	0%	40%	60%	95%	5%	72%	28%	99%	1%	96%	4%	73%	27%
Slovenia	99%	1%	76%	24%	99%	1%	22%	78%	94%	6%	55%	45%	99%	1%	77%	23%	81%	19%
United Kingdom	100%	0%	33%	67%	100%	0%	59%	41%	48%	52%	35%	65%	80%	20%	91%	9%	78%	22%

Table- 5B	Defense			Education			Health			Housing			Police			Recreation			Welfare			Subsidies			Other		
	C	S	L	C	S	L	C	S	L	C	S	L	C	S	L	C	S	L	C	S	L	C	S	L	C	S	L
Australia	100%	0%	0%	28%	72%	0%	52%	47%	1%	23%	44%	33%	13%	83%	3%	20%	46%	34%	90%	8%	1%	58%	33%	9%	46%	46%	8%
Bolivia	100%	0%	0%	57%	37%	6%	38%	47%	15%	23%	31%	46%	100%	0%	0%	24%	14%	62%	93%	6%	2%	30%	39%	30%	78%	5%	17%
Switzerland	90%	5%	5%	10%	55%	36%	57%	25%	19%	14%	23%	63%	7%	67%	26%	13%	31%	56%	78%	14%	8%	33%	44%	23%	39%	28%	33%
United States	100%	0%	0%	5%	43%	52%	57%	32%	11%	72%	9%	20%	18%	28%	55%	24%	11%	65%	69%	22%	8%	64%	26%	9%	69%	13%	19%
Russian Fed.	100%	0%	0%	14%	NA	86%	15%	NA	85%	7%	NA	93%	73%	NA	27%	15%	NA	85%	90%	NA	10%	89%	NA	11%	64%	NA	36%
Indonesia	100%	0%	0%	93%	NA	7%	91%	NA	9%	98%	NA	2%	99%	NA	1%	100%	NA	0%	100%	NA	0%	14%	NA	86%	100%	NA	0%

C= Central Government, S= State or Provincial Government, L= Local Government

Source: International Monetary Fund, 1998. Government Finance Statistics Yearbook 1998.

Revenues

The essence of decentralization is that subnational governments have the authority and responsibility to own-finance local services at the margin. Complete fiscal autonomy over revenues requires that in principle local governments can change tax rates and set tax bases. Box 3 illustrates varying levels of local revenue autonomy in different tax designs. The general principles of revenue assignment to different levels of governments are listed in fiscal federalism and local government finance literature (Oates, 1972; Bird, 2000):

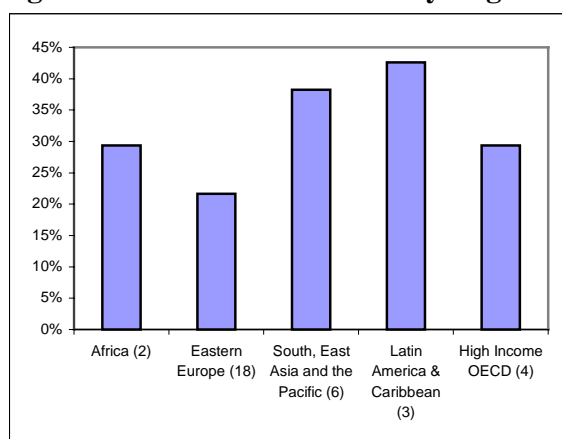
1. The tax base assigned to subnational governments should be immobile in order to allow local authorities some freedom to vary rates without the base vanishing. Inter-jurisdictional mobility of tax base makes taxation of mobile factors difficult to subnational governments.
2. Redistributive taxes should be assigned to the central government. Taxes imposed on mobile factors for redistribution purposes might result in inefficient jurisdictional allocation of the factors of production. Uniform redistributive taxes minimize locational distortions of economic activities.
3. Services provided by subnational governments should be financed through user charges and other local fees and taxes that are related to benefits. Efficient allocation of resources requires subnational governments to recover their expenses from the beneficiaries of their services. Examples of benefit related revenues include taxes levied on motor vehicles and fuels and construction fees.
4. It should not be possible to export the tax to nonresidents.
5. Taxes that are subject to important economies of scale in collection efforts should be centralized.
6. Taxes subject to cyclical fluctuations needs to be protected by a system of counter-cyclical rate adjustments in order to avoid subnational governments exploitation of fiscal power.
7. Taxes levied on tax bases that are unevenly distributed should be centralized. Uneven distribution of tax bases among subnational governments forces the residents of one subnational area to bear the economic burden of taxes imposed by another jurisdiction. Taxation of natural resource is the best example of this type of taxation practice.
8. Local revenue yield should be adequate to meet local needs and sufficiently buoyant, that is expanding at least as fast as expenditures over time.
9. The revenue yield should be stable and predictable over time.
10. The revenue system should be easy to administer efficiently and effectively.
11. Subnational taxes should be visible to encourage subnational government liability.

Box- 3: Fiscal Autonomy in Subcentral Governments

Own taxes	Base and rate under local control.
Overlapping taxes	Nationwide tax base, but rates under local control
Nontax revenues	Fees and charges. Generally, the central government specifies where such charges can be levied and the provisions that govern their calculation.
Shared taxes	Nationwide base and rates, but within a fixed proportion of the tax revenue (on a tax-by-tax basis or on the basis of a “pool” of different tax sources) being allocated to the subcentral government in question, based on (1) the revenue accruing within each jurisdiction (also called the derivation principle) or (2) other criteria, typically population, expenditure needs, and/or tax capacity.
General purpose grant	Subcentral government share is fixed by central government (usually with a redistributive element), but the former is free to determine how the grant should be spent; the amounts received by individual authorities may depend on their efforts.
Specific grants	The absolute amount of the grant may be determined by central government or it may be “open-ended” (that is, dependant on the expenditure levels decided by lower levels of government), but in either case central government specifies the expenditure programs for which the funds should be spent.

Source: Anwar Shah, *The Reform of Intergovernmental Fiscal Relations In Developing & Emerging Countries*, Policy and Research Series #23, World Bank 1994.

Figure 11: Vertical Imbalance by Region



Note: Measured as transfers to sub-national governments as a share of sub-national expenditures. Simple average of most recent observations in available countries. Numbers in parenthesis indicate number of countries represented.

Intergovernmental Transfers

The revenue and expenditure assignments give rise to vertical and horizontal imbalances within a nation's intergovernmental finances. In fact, every intergovernmental transfer system has two dimensions: (i) *the vertical dimension*, concerned with the distribution of revenues between central and local governments; and (ii) *the horizontal dimension*, concerned with the allocation of financial resources among the recipient units.

A vertical imbalance occurs when the expenditure responsibilities of subnational governments do not match with their revenue raising power.

As seen in Figure 11, the issue of vertical imbalance is widespread in all regions. At least 30 percent of the subnational governments' revenues come from intergovernmental transfers in all regions. A horizontal imbalance occurs when own fiscal capacities to carry out the same functions differ across subnational governments. In all countries, these imbalances are handled through a variety of transfer mechanism in order to allow subnational governments to perform their assigned functions. Figures 12 through 16 present the importance of intergovernmental transfers in the composition of subnational governments' revenue structure across regions.

There are different forms of transfer mechanisms: sharing revenues and tax bases, establishing conditional or unconditional grant systems. Central government and subnational governments can share revenues based on a formula or share a tax base by one of them applying a surcharge on other's tax. In the case of establishing grant systems, conditional grants require matching elements by the recipient government but unconditional grants are given to the recipient government with full discretion to spend. The choice of transfer mechanism depends on the objectives of the intergovernmental policies. If the only concern of the intergovernmental system is to address vertical fiscal gaps, this could be achieved either by revenue sharing or by "gap-filling" unconditional grants. The horizontal imbalances can be alleviated with equalization transfers from the central government to subnational government. However, in practice, measuring the horizontal imbalance and relative fiscal capacities of subnational governments is a very difficult task and only very few countries review them. The countries that undertake a comprehensive review of horizontal balances are Australia, Canada, and Germany (Ahmad and Craig, 1997).

The intergovernmental transfer system of a country usually has diverse objectives to meet and in most cases, these objectives may need to be met through a combination of policy tools. According to Ahmad and Craig (1997), there are three different policy responses to establishing the link between vertical and horizontal balances:

1. Correct each imbalance by separate policy measures: The vertical imbalance at each level is resolved by tax-sharing or grant arrangements. Horizontal imbalances are then resolved by payments from regions with higher fiscal capacity to poorer regions. This is the approach used in Germany.
2. Implement an integrated system of equalization grants: The vertical and horizontal imbalances are dealt with simultaneously through a system of grants, including equalization payments and special purpose grants. This is the Australian and Canadian approach.
3. Correct only the vertical imbalance and ignore horizontal imbalance: As under the first option, vertical imbalances are resolved by tax sharing and grants, but no action is taken to correct horizontal imbalances. Capital and labor migration then responds, not only to earned income differentials, but also to the regional net fiscal benefits (net benefit received from government expenditure and of taxes paid). There may be, however, special purpose grants servicing central government objectives, which may also reduce horizontal imbalances at least in some functional areas. This is broadly the approach in the United States.

Figure- 12: Composition of Subnational Revenues and Grants in Europe and Central Asia

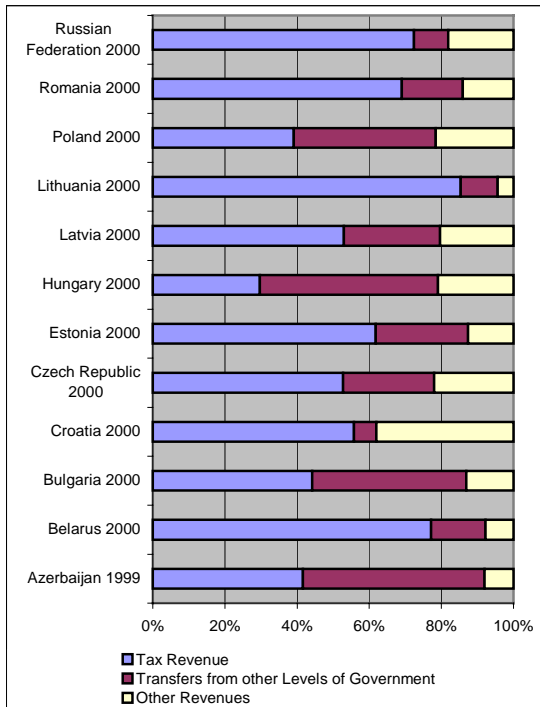


Figure- 14: Composition of Subnational Revenues and Grants in High-Income OECD Countries

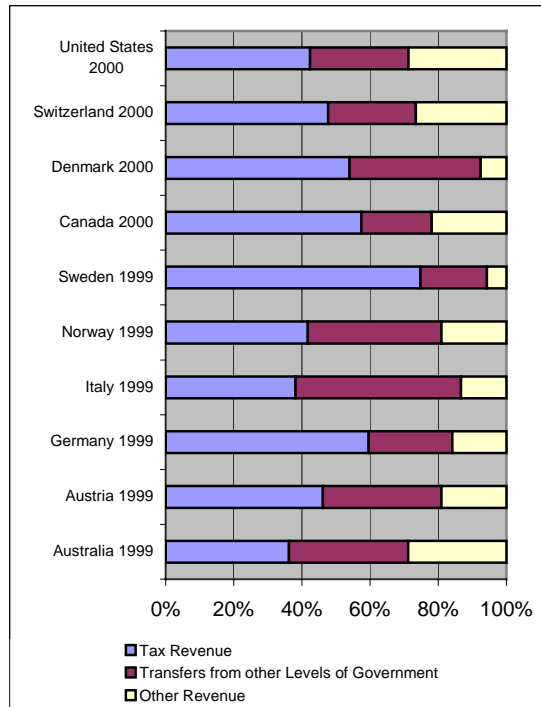


Figure- 13: Composition of Subnational Revenues and Grants in East Asia and the Pacific

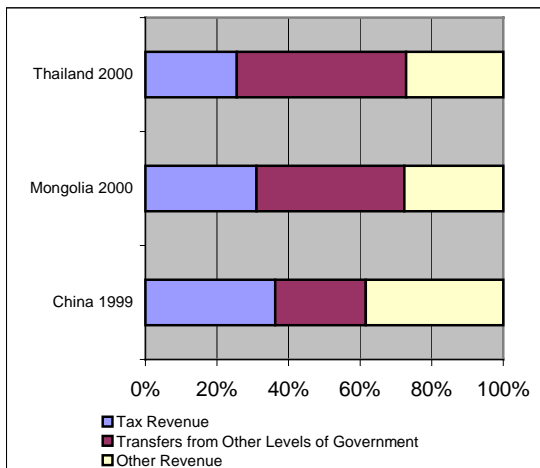
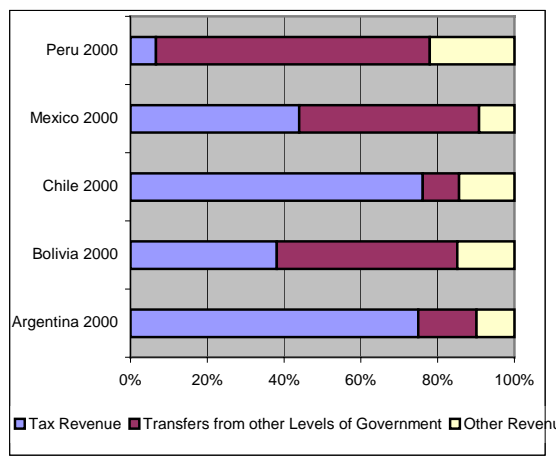
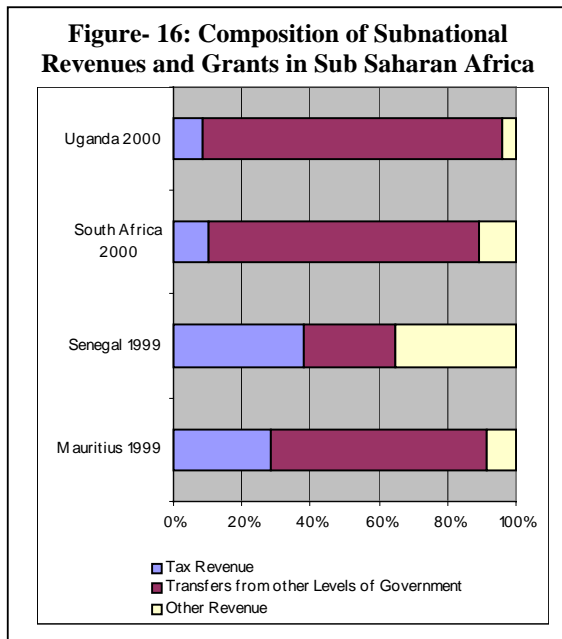


Figure- 15: Composition of Subnational Revenues and Grants in Latin America and the Caribbean



There are three key factors in the design of intergovernmental fiscal transfers: the size of distributable pool, the basis for distributing transfers, and conditionality (Bird, 2000). Determining the distributable pool has an important impact on the stability of the intergovernmental fiscal relations system. Sharing a fixed percentage of all central taxes is a better way of establishing transfer system rather than sharing on an ad hoc basis. Sharing must be based on the basis of a formula. Discretionary or negotiated transfers are

Figure- 16: Composition of Subnational Revenues and Grants in Sub Saharan Africa



unstable and unpredictable in nature. The formula for revenue sharing should take needs and capacity into consideration. Once the first two factors have been sorted out, the last question is whether the transfer should be made conditional on a measure. Expenditure conditionality ensures that the transfer amount is spent on a specified service. On the other hand, performance conditionality links transfers to a performance criteria.

Subnational Borrowing/Debt

There are three primary reasons why subnational borrowing can be considered as an appropriate tool for subnational public finance:

1. *Intergenerational equity*: The benefits of certain investment projects, such as infrastructure and education, are spread over time, which means that not only present residents of a locality, but also future residents will consume the services provided by the projects. Therefore, the benefit principle of taxation suggests that future residents should also contribute the cost of investment. For this purpose borrowing is an appropriate tool that offers a means through which payments for capital projects can be spread over the life of the project so as to coincide more closely with the stream of future benefits (Oates, 1972).
2. *Economic Development*: Delaying infrastructure investments might have a negative impact on subnational economic performance. Such a negative impact will have a direct effect on residents' life in terms of less employment opportunities and decline of earning levels. Therefore, borrowing is an appropriate tool for subnational governments in investing infrastructure projects to stimulate regional economy.
3. *Synchronization of Expenditure and Revenue Flows*: Access to financial tools offers an opportunity to subnational governments to synchronize expenditures incurred and revenue collection. For a variety of reasons expenditure incurred and tax intake may not be fully synchronized for a particular year. In such a situation, borrowing provides subnational governments with the chance to smooth out the mismatch and provide services without disruption.

There are at least two different channels through which subnational governments can borrow: through a public intermediary such as infrastructure bank or direct borrowing from private capital markets. The international experience suggests that lending through a public entity, either central government lending or public financial intermediary, suffers from political favoritism (World Bank, 1990). Direct access to private markets entails development of market-based relationship between lenders and subnational governments, which requires the use of private credit rating and bond insurance agencies to monitor subnational borrowing. Establishing these institutions offers a potential for improving transparency and political accountability in local government management. As capital

markets emerge, residents of local governments would learn more about the financial health of their governments.

Subnational borrowing is an important component of the devolution of fiscal powers to local authorities. However, a well-designed regulatory framework for subnational borrowing is necessary to ensure that subnational borrowing does not provide perverse incentives to lending institutions and subnational governments for excessive lending and borrowing. Such a framework includes standardized accounting procedures for subnational governments, disclosure of subnational governments' liabilities and repayment capacity. However, these measures by themselves will not be sufficient to curb moral hazard problem. The macro concern of moral hazard occurs when subnational governments are backed by the central government by providing guarantees to their borrowing. In these circumstances, the incentive structure is set for excessive borrowing of subnational governments, which would ultimately lead subnational governments to default on loans.

A common proposal to deal with subnational governments' default on loans is to institute limits on the borrowing ability of subnational governments (Ter-Minassian and Craig, 1997). There are two reasons limiting subnational governments' borrowing ability (Bird, 2000). First, if there is no constraint on subnational governments borrowing, the propensity to behave fiscally irresponsible is very high. In the absence of the checks and balances of the subnational debt issuance mechanism, subnational governments may increase their current expenditures well above their capacity to finance them and close the gap through borrowing, especially in countries where general inability of central governments to impose hard-budget constraints exist. The second reason for imposing restrictions on subnational borrowing is macroeconomic stabilization. Since the central government has the responsibility for stabilization policies, it is important that it has full control over public debt.

VI. CONCLUDING REMARKS

This module has stressed that fiscal decentralization is a multifaceted complex issue. One of the principal arguments in this module is that specific aspects of the fiscal decentralization process can be worked out in the context of each individual country. Legal and constitutional framework, as well as institutional structure of the public administration system in each country has a bearing on the outcome fiscal decentralization application. However, the common components of designing a decentralized system of intergovernmental fiscal relations in all countries are assignment of responsibilities for governmental functions, assignment of the power among levels of government to tax people and collect revenues, the nature of intergovernmental transfers system and ability of subnational governments to borrow.

The failure to design these interrelated components in a consistent way may lead to undesirable results. However, the issue of designing an effective intergovernmental structure is not limited to these components. It involves electing local government officials, having approved budget locally, absence of mandates on local governments as regards to employment and salaries, keeping adequate books of account and monitoring, and monitoring progress towards an effective fiscal decentralization. Annex 1 provides a comparative assessment of the decentralized system in selected countries in East Asia.

References:

- ACIR. 1974. *Governmental Functions and Processes: Local and Areawide*. Advisory Commission on Intergovernmental Relations, A-45, Washington DC.
- Ahmad, Ehtisham and Jon Craig. (1997). "Intergovernmental Transfers" in Teresa Ter-Minassian (ed.) *Fiscal Federalism in Theory and Practice* (Washington DC: IMF).
- Bahl, Roy W. and Shyam Nath. 1986. "Public Expenditure Decentralization in Developing Economies" *Government and Policy* 4: 405-18.
- Bennett, Robert J., ed. (1990). *Decentralization, Local Governments and Markets* (Oxford: Clarendon Press).
- Bird, Richard M. (2000). *Intergovernmental Fiscal Relations: Universal Principals, Local Applications*" International Studies Program Working Paper 00-2, Andrew Young School of Policy Studies, Georgia State University, Atlanta.
- Bird, Richard M. (1995). *Financing Local Services: Patterns, Problems and Possibilities*, Centre for Urban and Community Studies, University of Toronto.
- Bird, Richard M. and Vaillancourt, François, eds. (1999) *Fiscal Decentralization in Developing Countries* (Cambridge: Cambridge University Press).
- Bird, Richard M. and Fiszbein, Ariel, (1999) "Columbia: The Central Role of the Central Government in Fiscal Decentralization" in Richard M. Bird and François Vaillancourt (eds.) *Fiscal Decentralization in Developing Countries* (Cambridge: Cambridge University Press).
- Brennan, G. and J. Buchanan. 1980. *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (Cambridge: Cambridge University Press).
- Davoodi, Hamid and Heng-fu Zou, 1998. "Fiscal Decentralization and Economic Growth A Cross-Country Study" *Journal of Urban Economics* 43: 244-257.
- Dillinger, William and Webb, Steven B. (1999). "Fiscal Management in Federal Democracies: Argentina and Brazil" World Bank Policy Research Working Paper No. 2121.
- Ebel, R. and K. Hotra. (1997). "World Bank Supports Fiscal Decentralization" *Transition* 8 (5): 11-12.
- Ebel, R., Istvan Varfalavi, and Sandor Varga. 2000. "Sorting Out Government Roles and Responsibilities in the Hungarian Transition" World Bank Institute Working Paper No. 37156.
- Ehdaie, J. (1994). "Fiscal Decentralization and the Size of Government An Extension with Evidence from Cross-Country Data" World Bank Policy Research Working Paper No. 1387.
- Fiszbein, A. 1997. "Emergence of Local Capacity: Lessons from Columbia" *World Development* 25(7): 1029-43.
- Ford, J. 1999. "Constitutional, Legal, and Regulatory Framework for Decentralization" in J. Litvack and J. Seddon (eds.) *Decentralization Briefing Notes* (Washington, DC: World Bank Institute).
- Fukuyama, F. 1995. *Trust: The Social Virtues and the Creation of Prosperity* (Washington, DC: Free Press).

- Gandhi, V. P. 1995. "Intergovernmental Fiscal Relations and Economic Performance" in Jayanta Roy (ed.) *Macroeconomic Management and Fiscal Decentralization*, EDI Seminar Series, The World Bank.
- Grossman, P. J. 1989. "Fiscal Decentralization and Government Size: An Extension." *Public Choice* 62: 63-69.
- Grossman, P. J. and E. G. West, 1994. "Federalism and the Growth of Government Revisited." *Public Choice* 79: 19-32.
- Joulfaian, D. and M. Marlow, 1990. "Government Size and Decentralization: Evidence from Disaggregated Data." *Southern Economic Journal* 56: 1094- 1102.
- Levine, Ross and David Renelt. 1992. "A Sensitivity Analysis of Cross-Country Growth Regressions" *American Economic Review* 82 (4): 942-63.
- Marlow, M. L. 1988. "Fiscal Decentralization and Government Size." *Public Choice* 56: 259-269.
- Martinez-Vazquez, Jorge and Robert McNab. 1997. "Fiscal Decentralization, Economic Growth, and Democratic Governance" Georgia State University Andrew Young School of Policy Studies Working Paper Series No. 97-6.
- Musgrave, R. A. 1959. *The Theory of Public Finance* (New York: McGraw-Hill).
- Narayan, Deepa and Lant Pritchett. 1997. "Cents and Sociability: Household Income and Social Capital in Rural Tanzania" World Bank Policy Research Working Paper No. 1796.
- Nelson, M. A. 1986. "An Empirical Analysis of State and Local Tax Structure in the Context of the Leviathan Model of Government." *Public Choice* 49: 283-294.
- Oates, Wallace. 1972. *Fiscal Federalism* (New York: Harcourt, Brace, Jovanovich).
- Oates, Wallace. 1985. "Searching for Leviathan: An Empirical Study." *American Economic Review* 75: 748-757.
- OECD. 1999. "The OECD 1999 Survey on Fiscal Design Across Levels of Government" Directorate for Financial, Fiscal and Enterprise Affairs, OECD, Paris.
- OECD. 2002. "fiscal Design Surveys Across Levels of Government". Tax Policy Studies No. 7, OECD, Paris.
- Parker, A. N. (1995). "Decentralization: The Way Forward for Rural Development?" World Bank Policy Research Working Paper No. 1475.
- Pommerehne, Werner W. 1977. "Quantitative Aspects of Federalism: A Study of Six Countries" in W. Oates (ed.) *The Political Economy of Fiscal Federalism* (Lexington, Mass.: D.C. Heath).
- Putnam, R., R. Leonardi, and R. Nanetti. 1993. *Making Democracy Work: Civic Traditions in Modern Italy* (Princeton: Princeton University Press).
- Rao, Govinda M. (1999). "India: Intergovernmental Fiscal relations in a Planned Economy" in Richard M. Bird and François Vaillancourt (eds.) *Fiscal Decentralization in Developing Countries* (Cambridge: Cambridge University Press).
- Rondinelli, D. (1999). "What is Decentralization?" in J. Litvack and J. Seddon (eds.) *Decentralization Briefing Notes* (Washington, DC: World Bank Institute).
- Rondinelli, D. (1981). "Government Decentralization in Comparative Perspective: Theory and Practice in Developing Countries" *International Review of Administrative Sciences* 47: 133-145.

- Rood, Steven. (2000). "Decentralization, Democracy, and Development," in David G. Timberman (ed.) *The Philippines: New Directions in Domestic Policy and Foreign Relations* (New York: Asia Society).
- Smoke, Paul. 1994. *Local Government Finance in Developing Countries: The Case of Kenya* (University of Oxford: Oxford).
- Spahn, Paul B. 1998. "Intergovernmental Relations, Macroeconomic Stability, and Economic Growth" Paper presented at the Intergovernmental Fiscal Relations and Local Financial Management Course of the World Bank Institute, Vienna.
- Stigler, G. 1957. "The Tenable Range of Functions of Local Government" in US Congress Joint Economic Committee. (ed.) *Federal Expenditure Policy for Economic Growth and Stability* (Government Printing Office: Washington, DC).
- Ter-Minassian, T. and J. Craig. (1997). "Control of Subnational Government Borrowing" in Teresa Ter-Minassian (ed.) *Fiscal Federalism in Theory and Practice* (Washington DC: IMF).
- Tiebout, Charles M. 1956. "A Pure Theory of Public Expenditures" *Journal of Political Economy* 64: 416-424.
- USAID. 1999. "transition Economies and Fiscal Reforms". Proceedings of the Conference on Central and Eastern Europe and the New Independent States, Istanbul. USAID, Washington, DC.
- Wildasin, David. Ed. (1997). *Fiscal Aspects of Evolving Federations* (Cambridge: Cambridge University Press).
- Wildasin, David E. (1998). "Fiscal Aspects of Evolving Federations: Issues for Policy and Research" World Bank Policy Research Working Paper No. 1884.
- World Bank. 1999. *World Development Report 1999/2000: Entering the 21st Century*. New York: Oxford University Press.
- World Bank. 1995. "Azerbaijan: Baku Water Supply Rehabilitation Project" Environment Department Paper Series, Assessment Series Paper 17, Washington, DC.
- World Bank. 1990. "Financial Systems and Development" Policy Research Series No. 15, Washington DC.
- Xie, Danyang, Heng-fu Zou and Hamid Davoodi. 1999. "Fiscal Decentralization and Economic Growth in the United States" *Journal of Urban Economics* 45: 228-39.
- Zhang, Tao and Heng-fu Zou. 1998. "Fiscal Decentralization, Public Spending, and Economic Growth on China" *Journal of Public Economics* 67:221-40.