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Pitfalls on the Road to Fiscal Decentralization

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About the Author

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IN PAST YEARS, the subject of fiscal decentralization interested mainly specialists—even though several countries, including the United States, came into existence through the political and economic integration of already existing political entities, such as states or principalities. Recently, however, fiscal decentralization has been attracting more general attention, largely because of pressures for greater fiscal decentralization in many countries around the world. The purpose of this paper is to discuss a range of issues related to fiscal decentralization, focusing in particular on possible alternatives to decentralization and various pitfalls that may be associated with it. Unlike much of the previous literature on the subject, therefore, this paper will pay less attention to the actual processes of decentralization and more on whether decentralization is the right direction for a country to choose.

I. THE TREND TOWARD FISCAL DECENTRALIZATION

The term "fiscal decentralization" refers to an increase in taxing and/or spending responsibilities given to subnational jurisdictions. In many cases of fiscal decentralization, additional layers such as states, provinces, and regions are created. A related term, "fiscal federalism," is an advanced form of fiscal decentralization.

Until recent years, countries seemed to be divided into two relatively distinct groups: the "federal" and the "unitary."[1] In federal countries such as Argentina, Australia, Brazil, Canada, Germany, India, Nigeria, Russia, and the United States, subnational governments have important and independent responsibilities for public spending and taxation. These responsibilities are often outlined in each country's constitution, which explicitly recognizes the existence and the powers of the subnational jurisdictions. In unitary countries such as France, Japan, and Chile, on the other hand, spending and taxing decisions are made mostly at the level of the national government, although some spending may be carried out by decentralized agencies or institutions acting on its behalf.[2] This form of *administrative* decentralization should be distinguished from *fiscal* decentralization that generally includes some decentralization of political decisions.

Until perhaps the early 1980s, there were few countries planning to shift fiscal responsibilities from the national toward subnational governments. More recently, however, pressures for fiscal decentralization—or at least for greater fiscal decentralization—have increased in various parts of the world. Canada, China, Colombia, Indonesia, Italy, Spain, and many other countries have been experiencing such pressures, and some have put or are putting into motion policies aimed at increasing the role and independence of subnational governments. In some cases—in

Indonesia, for example—the policies to decentralize are being made in a period of time too short to allow full consideration of alternative policies or to assess carefully potential consequences.

The pressures for more fiscal decentralization have originated from at least four different sources. First, deepening democratization has given more voice and weight to the preferences of specific groups or regions. The view that fiscal decisions made at the local level better reflect citizens' preferences—than, say, decisions made by politicians or officials in often-distant capital cities—has been a common assumption on the part of those pushing for more fiscal decentralization. It has been argued that decentralization decreases the power of those with less knowledge of local preferences and increases the power of those with more knowledge. When a country's population is culturally, ethnically, or linguistically diverse, the rationale for giving different regions more control over their political and economic decisions seems to acquire more legitimacy.

Second, globalization is creating market areas that are no longer identical with national territories. In the past, when countries' economies were mostly closed, the market area relevant to the majority of individuals or enterprises was the national market. With globalization, certain geographical areas within a country have become more closely linked economically to the markets of other countries than to the national market. In a way, globalization has both relaxed economic links among regions of the same country and increased links between those regions and other countries. This process by itself may have increased the desire on the part of some regions to become economically less dependent on the national government. At times, for example, the elected officials of Lombardy in Italy have been acting as if Lombardy was an almost independent country. The same has happened with Quebec in Canada and with the Basque Province in Spain.

Third, in the jargon of economists, decentralization may be similar to a "superior good," which becomes more desirable when incomes increase. As countries become richer, they may demand more of it. If this assumption is correct, decentralization will become even more popular in future years.

Fourth, as incomes and the flow of information increase and as differences in income levels across regions within countries rise, the richer regions become more aware that, through the tax system and spending programs, some—or at times a lot of—income redistribution is taking place from the richer to the poorer regions. This realization leads to demands on the part of the richer regions to reduce the role of the national government and to increase that of the subnational governments. In the Northern Italian regions, this phenomenon has been the driving force for greater fiscal decentralization.

As a result of these trends around the world, the literature dealing with fiscal federalism and fiscal decentralization has grown enormously in recent years. For the most part, that literature either analyzes specific aspects of fiscal decentralization or describes the experiences of particular countries that have federal characteristics or have been experimenting with alternative forms of fiscal decentralization.[3] In these cases, various governmental functions or responsibilities have been transferred to subnational governments or to decentralized agencies.

This paper, by contrast, does not deal with specific countries or specific aspects of decentralization. Rather, it discusses—in a broad and somewhat nontechnical fashion—some issues that have not received the attention they deserve or issues still being debated. Some of these issues relate to the question of whether fiscal decentralization would generate the positive results its advocates claim it will. An implicit message of this paper is that decentralization is more likely to lead to positive outcomes when some conditions are met *before* the process of decentralization starts. This position contrasts with that held by some experts associated with the World Bank. They have argued that, once decisions are made to let the process of greater decentralization go forward, the subnational governments will be stimulated to create needed institutions and modify existing incentives to guide public action that will make the process a likely success.[4]

Part II of this paper argues that, in some cases, alternatives to decentralization should be considered and might be preferable to it. A country faced with pressures to decentralize, or contemplating a decision to decentralize, should first carefully consider these alternatives before making any final decisions. Part III discusses pitfalls associated with decentralization, and Part IV contains some concluding remarks.

II. ALTERNATIVES TO DECENTRALIZATION

Before a decision to proceed with fiscal decentralization is made, some alternatives should be considered. Three alternatives covering a broad range of possibilities are discussed here. The first, and least intrusive, is to carefully assess whether some of the objectives being sought could not be achieved more efficiently and less drastically through changes in current policies and institutions. The second alternative, a more significant move, is to change the role of the state in the economy. The third alternative goes all the way toward extreme decentralization, essentially contemplating the splitting of the country into two or more independent countries.

A. Improving Current Policies

Often demands for decentralization arise because citizens come to see policies followed by the national government as being inadequate, inefficient, or unfair. Policies that concentrate public spending in the capital city, for example, may be resented by other regions. Resource-rich regions may resent policies that transfer excess amounts of income or wealth from their areas to less rich regions. Any number of regions may feel that national policies do not devote enough attention and resources to their region or area and may resent those policies as a result. Highly corrupt or inefficient governments may also encourage demands for more decentralized policy decisions.

In all of these cases and similar circumstances, a first-best option might be to change national policies to make the government function more efficiently and equitably. In the situations described above, the pressure for decentralization must be recognized as essentially a proxy for pressures for a more equitable and efficient government. If the government can improve its effectiveness, pressures for decentralization are likely to abate. If it cannot, these pressures are likely to intensify.

B. Reducing the Role of the State

When decisions are being made about policies aimed at fiscal decentralization, it is customary to start with the current functions of the national government and to identify those that could be transferred to subnational governments. This approach to expenditure assignment generally ignores the fact that many governmental activities can be transferred either to the subnational governments (through fiscal decentralization) or, alternatively, to the private sector. Thus, privatization should also be considered a possible alternative to decentralization for at least some governmental activities.

It can be hypothesized that the smaller the government's role in the economy, the less need for decentralization. This is the other side of the argument that the growth of government in recent decades has brought with it more demands for decentralization. A "minimalist" government, or one that carries out only "core" activities, would probably be best if it were largely a national government. When Adam Smith described his view of what the government should do, it is not likely that he considered a decentralized setup. The growth of government in recent decades—which has been accompanied by a huge expansion of public sector activities in many countries—must have been partly responsible for the increased demands for decentralization witnessed in recent years.[5] In fact, the growth of national (i.e., federal) government in the United States over the years has led one scholar to ask whether federalism has a future there (see Nivola 2001).

To evaluate this alternative, we must ask what kind of activities lend themselves to privatization and what kind lend themselves to decentralization. This is an important question that, to my knowledge, has not been explicitly addressed in the relevant literature. With the benefit of recent years' experience, it appears that many government functions could be accomplished equally well, or in some cases even better and more inexpensively, by the private sector. Technological developments are helping in this direction by creating private alternatives and by often destroying natural monopolies, which in the past created a presumption for public sector involvement.

Recent experiences from many countries, in fact, show that the privatization of various public activities is not only feasible but desirable.[6] Examples range from garbage collection to providing electricity, transportation to communication services, water to health services, higher education to pensions. Even jails and cemeteries can be privatized. Some of these activities are exactly those that are often at the center of discussions for decentralization, so for many public activities, privatization should be considered an alternative to decentralization. Of course, one should not go to the other extreme by assuming that privatization is always the best option for most public sector activities and social services. There are undoubtedly cases where decentralization is the better or at least the preferred option.

In many situations, however, the more extensive the privatization, the less justification for fiscal decentralization. It would be useful to take an inventory of activities that could be either privatized or decentralized, then to assess potential costs and benefits of these alternatives. It bears repeating that, in many instances, if an activity can be decentralized, it can also be privatized. But privatization removes the element of subsidy for the activity because users must bear the full costs of their privatized activities. Thus, part of the decision whether to decentralize or privatize rests on whether the government should subsidize particular activities.[7] This argument must recognize that citizens of some countries might wish to keep some activities public, even when private alternatives are available, and especially when they wish to subsidize them. Examples include some cultural activities and primary and secondary education.

C. Breaking Up Countries

One of the strong theoretical arguments in favor of fiscal decentralization is that the preferences and needs of citizens and taxpayers for public sector activities are better known by local government officials than by those who represent the central government. The reason given is that vicinity or contiguity provides useful information and creates a more direct link between citizens and those making spending and taxing decisions on their behalf. Distance, on the other hand, is assumed to reduce the amount and quality of information available to policy makers as well as their interest in making policy decisions that citizens want. Some experts assume this argument is strong enough to neutralize the advantages that economies of scale in the production of some public goods and services and in the generation of tax revenue may give to arrangements that keep more power in the hands of the national government.

If accepted, this argument implies that, ceteris paribus, small countries should be more successful than large countries in satisfying the social needs of their populations. In other words, if the arguments for decentralization are assumed to be valid, they offer strong reasons for breaking up large countries into smaller ones.[8] Some countries have, in fact, chosen this option rather than the alternative of fiscal decentralization. And there is some evidence that small states may have smaller problems (see Easterly and Fraay 1999). In some cases, the breaking up of countries came after or led to civil wars (Yugoslavia and Indonesia with East Timor). In other cases (Czechoslovakia and, to some extent, the Soviet Union), the break-up was peaceful.

It must be recognized, furthermore, that when size is no longer important for defense against foreign aggression—that is, when annexing other countries by force is no longer fashionable—and when, because of openness and globalization, size becomes less important for economic reasons, cultural affinity and common history remain the main glue that keeps countries together. When these links become weak, the alternative of breaking them into smaller countries should be considered. The number of countries in the world has been increasing; some predict that this trend will continue (see Alesina and Spolaore 1997).

III. POTENTIAL PROBLEMS WITH DECENTRALIZATION

What problems are likely to arise when a process of fiscal decentralization is set in motion? While the appearance of these problems is not inevitable, they have appeared frequently enough in countries with a decentralized fiscal structure to warn that special attention must be directed at reducing the probability that they become major problems. While of relevance to countries at all levels of economic development, these problems are likely to become particularly significant in developing countries.

A. Decentralization and Regulations

Over the past two decades, a growing literature has been considering governments' use of regulations and their effects on society and, especially, the economy. The OECD in particular has paid a lot of attention to regulations in industrial countries, and the World Bank has produced numerous studies on the effect of regulations in developing countries. In the early 1980s, the U.S. Congress also held a series of hearings on regulations affecting American industries. Some economists have attributed at least part of the rapid growth of the U.S. economy in the 1990s to the removal in the late 1970s and '80s of many regulations that had been imposed on the financial, transportation, communications, and other sectors. The communication revolution that created the New Economy might not have occurred so soon without the deregulation of the communication sector.

It is now understood that, while some regulations are useful and necessary—those regarding traffic and airline safety, for instance—some can be damaging to the economy. Some countries' economies have indeed been choked by excessive regulations. Among the damaging regulations are those that take the form of "quasi-fiscal activities": regulations that governments use largely as substitutes for taxes or public spending (see especially Tanzi 1998). Ambitious governments short of public funds and/or without a deep understanding of how market economies operate (transition economies, for example, or many developing countries) may tend to abuse this policy instrument, often causing distortions to the economy and a fall in its growth rate.

Federations or fiscally decentralized countries by definition give more power to subnational governments or jurisdictions. They also have more layers of government than unitary countries—granting states, provinces, regions, etc., some power to tax and spend, for example, and all the power to regulate. Furthermore, introducing new regulations is often easier to obtain politically and administratively than the imposition of taxes.

Except for a handful of successful federations like Australia and the United States, countries with decentralized fiscal structures have not been able to assign sufficient and efficient revenue resources to the subnational jurisdictions.[9] Consequently, subnational governments or jurisdictions are often starved for funds to meet their expenditure objectives. It is natural then that—especially when faced with what they may see as unfunded mandates—they tend to rely more on a tool they can easily control, namely regulations. Examples of these quasi-fiscal regulations are zoning laws, rules on the opening and closing of shops, rent controls, controls over opening of enterprises and shops, and controls on special sales by shops. Although not all of these regulations are damaging, many are. I have always been astonished by the maze of locally imposed regulations that characterize Italian municipalities, for example.[10]

From this discussion, a hypothesis can be advanced: the more decentralized a country becomes (especially when additional layers are created), the greater the probability that an excessive number of damaging regulations will be created. Although there are no data to prove this hypothesis, informal observations convince me that it is correct. This is a potential problem that decentralization enthusiasts will need to recognize.

B. Decentralization and the Internal Market

It is generally taken for granted that a country represents a single market area within which labor, capital, and goods move freely without having to face government-imposed obstacles like those imposed when frontiers between countries have to be crossed. This is not always the case, however. In many decentralized countries and especially in those that lack a strong tradition of respect for free markets—China, Russia, and to some extent, India—subnational jurisdictions often impose obstacles to these movements. Such obstacles can lead to a de facto fragmentation of the national market.

Obstacles may take several forms. In some countries, residency requirements must be satisfied before a person can work or start an activity in another area, or one must have a job before being allowed to stay. Various hidden obstacles may restrict the movement of individuals or goods from one province or state to another. In some places, obtaining access to public schools, kindergarten, or other government services is difficult for individuals who have moved in from another region. Waiting lists become a tool for discriminating against those who migrate from other regions. In some countries, de facto "customs" have been set up between provinces to prevent the export of some goods or to collect taxes on their movements (see octroi taxes in India). Other taxes may restrict the movement of capital, while tax competition in the form of different incentives or tax rates may also lead to the misallocation of resources. Such tax issues have been a major problem in Argentina, for example, and a minor problem in the United States. All these impediments increase the cost of economic activity and reduce the potential benefits of operating in a larger market.[11]

Although some literature considers the misallocation of resources due to tax competition, no study has systematically estimated the costs of market fragmentation due to the obstacles mentioned above. In countries such as Argentina, Brazil, China, India, and Russia, these costs might be significant in terms of misallocation of resources and lower growth rates. Such costs do not arise in truly "unitary" countries. It is rare that fiscal decentralization has the effect of augmenting markets.

C. Decentralization and Corruption

Another issue of potential importance relates to the possible connection between decentralization and corruption. A few years ago, papers by Prud'homme (1995) and Tanzi (1995) advanced the hypothesis that decentralization could lead to more corruption. This hypothesis has led to a growing literature debating the issue or attempting to test it. So far, no broad consensus has emerged. Inter alias, Brueckner (1999) and Triesman (1999) have supported the hypothesis; Fisman and Gatti (2000) and Gurgur and Shah (2000) have rejected it; and de Mello and Barenstein (2001) have reached more nuanced results.

The reason for hypothesizing a positive relationship between fiscal decentralization and corruption is that in many countries, as one would expect, local institutions are less developed than national ones. As a consequence, their ability to control abuses of power by public employees and officials is more limited than at the national level. Many factors can account for this difference in the quality of institutions at the national and subnational levels. For one thing, the brightest and best-trained people tend to join the national government where their career prospects and salaries tend to be higher; national governments are therefore more likely to be able to create more transparent and accountable public administrations. (See, on this, Tanzi 1995.) Furthermore, foreign technical assistance from international institutions and industrial countries is generally provided to the national governments of developing countries and not to the local governments.

These conclusions have to be qualified, of course. In countries such as Australia, Canada, Germany, and the United States, the educational level of the population is so high that highly trained people are available for all levels of government and good institutions can be created by all jurisdictions. In many poor, developing countries, however, the best and most talented people, if they go into public service at all, join the national government. The quality of the subnational institutions and of their staffs thus tends to be lower. Lower salaries, fewer prospects for advancement, regulations, and greater contiguity of employees and citizens create conditions that increase the probability that poorer governance will be more common at the subnational level.

Casual observation suggests that corruption is also more widespread at the subnational level. Even in the United States, cases of explicit corruption have been reported over the years in local governments, but rarely at the national level. Several unpublished and confidential technical assistance reports prepared within the IMF on the public expenditure management systems of developing countries support the conclusion that these systems in developing countries are much better at the national than at the subnational level.

D. Decentralization and the Assignment of Taxes and Expenditures

The relationship between decentralization and the assignment of taxes and expenditures is a central feature of fiscal decentralization. Assigning expenditures means deciding what the spending responsibilities of national and subnational governments are to be. Assigning taxes means giving the subnational governments the option of covering total or additional expenses with their own resources. These assignments tend to be fixed over time, even though changing technologies and economic conditions require that they be reviewed from time to time (see Tanzi 1995).

Like contracts, legal decisions related to expenditures and taxation assignments are never, and can never be, precise and final. In the United States, for example, education is supposed to be a responsibility of the subnational governments. However, the federal government intervenes on a large scale to define curricula and standards, to grant research money, to regulate, to allocate scholarships, and so forth.[12] This kind of intervention is not limited to the United States, but is common to all decentralized countries. It often brings friction between local representatives and the national government, obfuscating their distinct responsibilities. The problem is that it is difficult to assign precise expenditure responsibilities, leading to an overlap of responsibilities. Confusion arises when two or three different jurisdictional levels step in to promote similar objectives.

Assigning taxes to match the expenditure responsibilities of subnational governments is difficult because of administrative consideration, economies of scale in tax administration, access to and sharing of information, tax competition, and other factors that must be taken into account. Experts generally agree that property taxes are the easiest to assign to subnational and especially to local jurisdictions, so these taxes should play an important role in countries where subnational governments work well. Such taxes generate about 3 percent of GDP to the local governments of the United States, but somewhat lower shares in other federal countries. Unfortunately, the taxation of real property is not easy because it requires reliable and updated cadastral values or current market values for the taxed properties. In the United States, cadastral values are not needed because the sale of properties is more frequent and transparent than elsewhere, enabling local tax administrations to use sales prices to determine tax liabilities for not only the sold properties but similar ones. Market valuations are much more difficult in countries where sales of properties take place less frequently or are less transparent. In Italy, for example, those who sell and buy property often underreport the sales price to reduce their tax liabilities vis-a-vis transfer and capital gains taxes. As a consequence, sale prices are not useful in determining properties' taxable values.

Over the years, countries have tried various solutions to deal with this problem. An interesting suggestion was made more than three decades ago by Maurice Allais, the Nobel Prize winner in economics from France, in his book first published in 1977. Allais (1988) proposed that people should self-assess the value of their properties; then, their self-assessments would be made public. Anyone who wanted to buy these properties at a price that exceeded the declared price by, say 40 percent, could step forward and propose to buy them. If the owner refused to sell, the bid plus a penalty would become the new base for determining the tax on that property. In theory, this idea offers a relatively simple, self-enforcing mechanism. In some countries, in fact, the government has the right to buy the properties at the values self-assessed by their owners, but this right has seldom been exercised.

Aside from property and income taxes, a few other taxes like those on car ownership have been assigned to subnational jurisdictions, though with less success. Examples of these taxes range from retail sales taxes in many U.S. states and municipalities, value-added taxes in Brazil and Germany, turnover or cascading sales taxes in Argentina, cash-flow taxes (IRAP) in Italy, and various excise taxes in India. In some countries, such as Argentina and Russia, the national governments have shared the revenue from some taxes they collect with the subnational governments.[13] In China, until a few years ago, it was the subnational jurisdictions that shared their taxes with the national governments. This system led to a precipitous fall in revenue (see Ahmad et al., eds. 1997). The experience of many countries shows how difficult it has been to assign taxes that matched the spending needs or policies of subnational governments.

In general, the greater the regional differences in per capita income, and the more uniform the standards of public services the national government wants subnational governments to provide, the greater must be the resource transfers from the national to the subnational governments, and implicitly from the richer to the poorer regions.[14] The reason is simply that poor regions have lower taxable capacity than richer ones. Transfers, however—especially when not determined by a precise formula—create moral hazards and situations, at times, where "soft budgets" become the norm. Poorer states or regions may become so politically powerful that they expect to be bailed out by the national government if they overspend. It is difficult, however, to establish the optimal level of transfers or the ideal formula to allocate financial resources among the subnational governments.[15]

E. Decentralization and Tax Reform

The existence of a decentralized fiscal structure often becomes a major impediment to fundamental or needed tax reform because of the difficulty in coordinating actions among independent jurisdictions. A few examples will illustrate this problem.

Brazil has been trying to reform its value-added tax for many years, but has faced great political difficulty because the current value-added tax is levied by the states (see Varsano 1999). So far, it has been impossible to reach a consensus among state authorities for changes that would make the tax system more efficient. The current value-added tax has encouraged tax competition and even tax wars among the states, and it has created a substantial de facto fragmentation of the domestic market.

Argentine provinces, on the other hand, continue to use an outdated turnover sales tax—similar to those in European countries in the 1950s before being replaced by value-added taxes. The Argentine tax is a cascading one, which means that it distorts relative prices. The central government hopes to eliminate this tax as it creates distortions in the economy (including discouraging exports) and to replace it with more efficient revenue sources. But for decades, this issue has been the subject of continuous discussion between the national government and the provincial governments. Experts on both sides agree that the present system is inefficient and needs to be changed, but the tax generates substantial revenue to the provinces—about 2 percent of GDP. And because any change would affect each province differently, it has been impossible so far to reach a consensus for reform.

India, in another example, would be much better served with a national value-added tax, rather than its current awkward imposition of different excise taxes at the state level. The national government, however, has encountered difficulties in making the change because of the decentralized character of the country and because of opposition by some states.

These three are not isolated examples, but tell a common story. In countries with revenue-sharing arrangements of major taxes with different levels of government, varying shares of the revenue from particular taxes go to the national and subnational governments. These arrangements affect both tax administration and tax policy. In Argentina, for example, when the national government desperately needed to increase revenue to reduce large fiscal deficits in the 1980s, it tended to pay more attention to taxes for which only a small share of the revenue collected was legally assigned to subnational governments. Some of these were bad taxes, such as those on exports and imports. However, because the national government retained all or most of the revenue from these taxes at a time when it was urgently needed, the national authorities preferred these taxes. This process contributed inevitably to distortions in the tax structure and the retention of an inferior tax system. In other cases—Russia, for example—the tax administration paid more attention to some taxes than to others because of political pressures coming from a particular level of government (see Tanzi 2001).

F. Decentralization and Macroeconomic Coordination

The potential conflict between decentralization and macroeconomic policy has been a frequent subject in the literature, since being recognized by Richard Musgrave (1959) more than forty years ago. With a decentralized fiscal structure, it becomes more difficult to coordinate the fiscal actions of national and subnational jurisdictions to achieve the macroeconomic objectives of a counter-cyclical policy. At times, subnational governments may pursue expansionary fiscal policy, while the national government is pursuing a contractionary fiscal policy. This is especially true when the subnational governments face soft budgets or when they can easily borrow.

These problems have loomed large in Argentina, Brazil, and other countries, and are currently a point of discussion between Indonesia and the IMF. The problems become much less important—even within a decentralized structure—when responsibilities of various governments are well defined and the subnational governments face hard budgetary constraints (see Ter-Minassian and Craig 1997).

G. Decentralization and Fiscal Transparency

Transparency is an area of increasing interest in the economic literature and economic policy. The so-called architecture of the international financial system has given much attention to this subject because of the belief that markets and governments operate much better and more efficiently when they have sufficient, good, and clear information. Transparency must be seen as a public good that only the government can provide.[16] It is obviously more difficult to provide clear and sufficient information when the subnational jurisdictions are fiscally important and operate independently from the national government. Quite apart from the difficulties in understanding the nature of their operations—a problem that also exists often at the national level—subnational governments rarely generate and publish good data on a timely basis. As anyone who has attempted to perform a comparative analysis of the fiscal policies of various countries well knows, the lack of complete or timely statistical information complicates the conduct of fiscal policy and the analysis of public sector operations. For many federal countries, it is almost impossible to have clear, comprehensive data for the general government on a timely basis.

H. Decentralization and Regional Disparities

In decentralized settings, especially where ethnic, linguistic, religious, or cultural differences characterize the populations of different regions within a country, the various subnational jurisdictions may begin to view themselves as separate from the rest of the country, thus putting centrifugal forces into motion.

This problem tends to have more serious implications in those countries where important natural resources are located in particular regions. In a centralized country such as France, for instance, if large oil deposits were found, it would not matter where they were located. The national government would be expected to exploit or tax them, using the money to finance its national activities, and all French citizens would benefit.

In contrast, highly decentralized countries encounter problems with discovery of resources in particular regions because those regions will attempt to claim for their own use the revenue from such a discovery. This operating out of self- rather than national interest leads to political problems, and occasionally even conflicts between regions, as the current situation in Indonesia and past experience in Nigeria indicate. It can also create problems for the income-redistribution role of the government. Again, one of the major functions of national government in recent decades has been the redistribution of income from more affluent to poorer regions, and to individuals through the broadly uniform provision of public goods and services financed by tax systems that are at least proportional or partly progressive.

When the income levels of regions within a country are relatively equal, and when important natural resources are not concentrated in one region, it is easier to have a well-functioning decentralized system. However, when the income levels of regions are vastly different and broadly uniform standards to provide public services can only be maintained by the more affluent regions' subsidizing the poorer ones on a significant scale, it becomes politically more difficult to pursue an effective policy of income redistribution in a decentralized fiscal setting. When differences in income are due to the concentration of natural resources in one region, the difficulty of pursuing such a policy in a decentralized environment can become particularly great, especially if the region sees itself as culturally or ethnically distinct from the rest of the country.

I. Decentralization and Public Sector Employment

One last point is that decentralization may require a rise in public employment due to demands for more levels of public administration than would be the case in a centralized structure where there is limited ability to exploit economies of scale on the part of the various administrations. This conjecture could be tested with actual data; however, I am not aware of any study that has attempted to do so. This issue differs from the more traditional one of whether federal states spend more or less than centralized states.

IV. GENERAL CONCLUSIONS

The issues briefly reviewed in this paper must be seen as challenges to the optimists who believe that fiscal decentralization is the solution to many problems. Rather, the conclusion must be that, if decentralization is an important political objective for a country and if that country can establish institutions that will make decentralization work with a reasonable degree of efficiency (institutions related to tax administration, expenditure management systems, budgets, and so forth, but especially institutions that allow the central government to transfer resources to subnational governments with some assurance that these resources will be used effectively for the purposes for which they are passed on, and without creating expectations for the local governments that if they spend more, they will be bailed out by the national government), then fiscal decentralization can be a good policy. However, under different circumstances—which are unfortunately more common than many experts recognize or wish to acknowledge—it may not be wise to recommend that a country not already decentralized undertake a lunge toward fiscal decentralization. This, for example, is what Indonesia is now attempting to do, and it is not difficult to predict that experiment will produce poor results.

If a country is already decentralized—especially if its constitution requires that it be so—then there is not much one can do except try to make the process as efficient as possible. In such a case, the effort should go into improving the institutions necessary for making fiscal decentralization work.

In the first-best world, there is one key decision to make: whether the government should be unified—as in the French model—or decentralized—as in the American model. If the national territory is too large to be optimally administered by one government (assuming that there are no military or security threats or no strong cultural and ethnic glue to hold the whole territory together), the option of having several smaller countries replace one large decentralized country should be considered. This is particularly true when the population is not homogenous and the country does not have a long history as a single entity. It is easier to have an efficient government in a small, open economy than in a large territory—as the contrast between Singapore and, say, India or Indonesia shows.

In many real world cases, however, countries are to some extent already decentralized at the municipal level. Decisions must be made at the margin, and the main issues are whether to decentralize more by creating additional tiers or by transferring more fiscal responsibilities to existing subnational jurisdictions. The theoretical validity of the argument that the conditions for the success of decentralization could be created by the process of devolution itself, and that there are examples of local governments that are able to respond to the challenge of increased responsibilities, must be recognized. The experience gained in a large number of countries, however, suggests caution because conditions for successful decentralization are often absent. When this is the case, more decentralization means the country will pay a price in terms of lower efficiency and/or less economic stability.

As a recent World Bank study states: "decentralization is neither good nor bad for efficiency, equity, or macroeconomic stability; but rather . . . its effects depend on institution specific design."[17] Unfortunately, the design is often defective, especially in developing countries.

NOTES

1. In all countries, municipalities have had some responsibilities in spending and taxing. However, in the unitary countries, often their spending has been largely financed by transfers from the national government.
2. In both of these groups, municipalities had some independent power. However, federal or fiscally decentralized states have additional tiers or layers beside the municipalities, and the subnational jurisdictions have more independence in making spending and taxing decisions.
3. For country experiences, see Ter-Minassian, ed. (1997). For a discussion of issues, see Breton (1996).
4. Of course, not all World Bank experts share this position. For a balanced assessment, see the paper by Litvack et al. (1998).
5. See Tanzi and Schuknecht (2000) for evidence on the growth of government spending during the last century.
6. Ibid., chapter IX.
7. In theory at least, the government could subsidize the users through cash transfers rather than the activity itself. This, for example, is the case with vouchers or food stamps.
8. It could be argued, however, that a decentralized setting combined with labor mobility offers citizens options vis-a-vis alternative baskets of public goods and taxes that would not be available in small countries as long as people can not freely migrate from one country to another.
9. Even in the United States, total federal outlays for grants to state and local governments have risen from less than 1 percent of GDP in the 1950s to more than 3 percent at present. See United States (2000), pp. 203–6.
10. In Italy, some municipalities even determine the time of the day when a taxi can operate. They also determine when a shop can have special sales on its goods.
11. For a discussion on fiscal competition between Brazilian states and of impediments to trade between states, see Varsano (1999).
12. It is interesting that while the U.S. Constitution does not mention any role for the federal government in the area of education, the first major bill that the Bush administration is sending to Congress deals with education.
13. This sharing has often become a contentious issue.
14. These transfers are often called equalization grants and can be based on fixed formulas or on annual or periodic political agreements. See Ahmad, ed. (1997).
15. An added problem is that local governments may show different levels of efficiency in the use of money. Thus, similar spending may generate different outcomes. See Reviglio (2000) for the example of health spending in Italy.
16. By fiscal transparency, it is assumed that the fiscal activities of the whole public sector are visible and measurable. The public must have a full understanding of, and be able to measure, what the governments at all levels are doing and intend to do. Also, the relevant statistics must be available without undue delay.
17. See Litvack et al. (1998).

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