Sequencing Fiscal Decentralization

Roy Bahl and Jorge Martinez-Vazquez

Andrew Young School of Policy Studies
Georgia State University
Atlanta, Georgia 30303
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Introduction: The Issue

Decentralization is a global phenomenon. If designed well, it can move decision making closer to people, thereby enhancing the efficiency and responsiveness of public service delivery. It might also improve economic growth and offer a potentially powerful tool for alleviating poverty. However, design is complicated, since it spans political, fiscal, and administrative policies and institutions. A review of the experience in various countries suggests that the success or failure of decentralization often depends on whether a coherent decentralization strategy has been developed, and whether adequate mechanisms exist for managing the implementation process, which often includes multiple reform components, divergent interests (among central vs. local governments, sectoral ministries vs. central agencies, bureaucrats vs. politicians vs. citizens, etc.) and insufficient information.

While there is extensive knowledge about how to design decentralization policies, considerably less is understood about how a decentralization program should be sequenced and implemented. The latter questions, we think, are very important. Countries embarking on decentralization often struggle with the decisions about the essential components of decentralization, the order of introduction of decentralization policies, the number of years necessary to bring a full program online, and the components of the transition strategy. We argue in this paper that the sequencing of decentralization policies is an important determinant of its success. The consequences of a poorly sequenced decentralization program can range from ineffectiveness and subsequent failing support of decentralization efforts, to macroeconomic instability and even chaotic situations and fundamental failure in public sector delivery, to minor delays and complications.

Logically, and as experience shows, some decentralization measures (e.g., devolution of expenditure responsibilities) may not yield the desired decentralization outcome without a previous complementary reform (e.g., providing for budget autonomy by eliminating mandates), or the effects may even be pernicious (putting revenue decentralization ahead of any other decentralization reforms). As we elaborate in this paper, there is ample country evidence, accumulated over several decades, that the order of decentralization policy does matter. At best, the argument that sequencing does not matter may be correct only if one is willing to ignore the adjustment, friction and time costs that may be involved in getting to the “right” decentralization outcome. The more likely outcome is that “making it up as we go” will not lead to the same structure of decentralization as will a planned strategy. But we hasten to say that this is hypothesis.

There also would seem to be a relationship between sequencing choices and the time period needed to implement a full decentralization program. Some countries (e.g. India) are content with a long planning horizon for decentralization. In these countries if anything has gone wrong because of poor sequencing, they are willing to take the time to work out some solution (at whatever cost). However, in countries where decentralization is a long, piecemeal process, the

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* The authors are Professors of Economics, The Andrew Young School of Policy Studies, Georgia State University.
interest groups involved gain property rights, and positions become very hard to move. The time period needed for full implementation becomes even longer.

Sequencing is a much more important matter for countries that have recently embarked upon a decentralization strategy and for those who are planning a major overhaul of their existing system. In such cases, investing the time to plan the proper sequencing can significantly reduce the costs and risks of the transition to decentralized governance. Getting it right the first time is also important because it minimizes the risk of losing political support for decentralization objectives as might occur when the early experience with the new regime is a negative one due to faulty sequencing or design.

There are two ways in which one might develop normative guidelines for sequencing decentralization. One is to offer a textbook approach, i.e. in a world without political and administrative constraints, what is the best way to bring a decentralization strategy on line? We propose such an approach in the next section of this paper. The other is to draw out real world lessons about sequencing decentralization by studying the practice, which reflects the political economy issues that intervene in the process of designing and implementing a fiscal decentralization. In this paper, we consider the practice in some detail in five countries—Indonesia, India, Mexico, Russia, and Tanzania—and comment on the experience in several other countries. These five countries were chosen for special attention because they are representative of ongoing decentralization processes around the world and because they exhibit a good cross section of experiences on the issue of sequencing. We emphasize again that our concern in this paper is with the sequencing of fiscal decentralization rather than with the principles of a good fiscal decentralization, though there is significant overlap in these two topics.

It will disappoint some that we do not conclude that there is a single best approach to sequencing fiscal decentralization. Countries differ widely in their readiness to absorb such a comprehensive transformation in their governance systems, in their political and cultural divides, in their constitutions and legal systems, and in the strength of their resolve about introducing decentralization. While there are some important principles that all countries should adhere to, it seems clear that one formula will not produce the same results in every country.

Moreover, there is the question of what constitutes a successful or failed decentralization. After all, one cannot easily point to instances where countries have completely abandoned a fiscal decentralization strategy because it “did not achieve its goals.” Like the cases of privatization of SOEs and the introduction of VAT, once the train is out of the station, it is rarely derailed. But we must also acknowledge that there is no generally accepted benchmark for a successful decentralization. What we try to concentrate on in this paper is the sequencing of decentralization policies that would give a country the best chance for achieving its goals for the program.

The plan of this paper is as follows. We begin by laying out a normative approach to sequencing. We turn then to a dissecting of each component of the sequence, and make the arguments, pro and con, for this ordering of decentralization policy and implementation decisions. At each step, we make an attempt to describe the experience, with a special focus on the case study countries chosen. We conclude with a view about what theory and practice seem to have taught us about the sequencing of decentralization.

A Normative Textbook Approach

The definitive text on how to phase in a fiscal decentralization program has not been written. And given the contentious issues that surround this policy decision, and the differences among country settings, a definitive text may never be written. What we might do, however, is offer a stylized approach to sequencing decentralization that could be argued is a best route to
implementing a sustainable system. This might serve as a reasonable baseline against which to compare the real world practice, where politics and administrative constraints will certainly rule the day.

Our version of the textbook approach to sequencing fiscal decentralization has six steps, as outlined in Figure 1. As a precursor to fiscal decentralization to subnational governments, the higher level government should deconcentrate its service delivery to the regions. This makes decentralization more feasible when the time comes, because there is already a local experience with managing local service delivery. In particular, a deconcentrated system, as opposed to a centralized system, can significantly facilitate the transfer of personnel and facilities, ultimately of service delivery, from the central government to subnational entities when the time for decentralization comes. Over the past several decades there have been many examples of previously centralized systems facing serious obstacles to genuine decentralization because of the resistance of public servants to move out of the nation’s capital and their line ministries’ offices and into communities throughout the national territory.

The actual fiscal decentralization process begins with a national debate involving the key stakeholders (Step 2). This debate might be in the context of a national election, sometimes responding to bottom-up demands for local autonomy. Alternatively, it might be part of a discussion led by an appointed national commission to consider governance. Either way, a general consensus may be reached about the sentiment for pushing ahead with decentralization and some clear “champions” of decentralization should emerge.
**FIGURE 1**

**A Normative Approach to Sequencing Fiscal Decentralization**

<table>
<thead>
<tr>
<th>Step 1</th>
<th>Step 2</th>
<th>Step 3</th>
<th>Step 4</th>
<th>Step 5</th>
<th>Step 6</th>
<th>Step 7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Implement a policy of deconcentration of central government service delivery to the regions.</td>
<td>Carry Out a National Debate on the Issues related to decentralization policy.</td>
<td>Do the Policy Design and Develop a White</td>
<td>Pass the Decentralization Law</td>
<td>Develop the Implementing Regulations</td>
<td>Implement the Decentralization Program</td>
<td>Monitor, Evaluate, and Retrofit</td>
</tr>
</tbody>
</table>
The reason for beginning the process with a national debate is to get some degree of consensus or buy-in to the idea. Such a mandate is necessary if the decentralization program is to stay on track and be sustainable.

The third step is the design of the fiscal decentralization program, culminating in a policy paper or a framework for the fiscal decentralization. While the national consensus might lead to the broad idea of moving government closer to the people, the White Paper would lay out the Government’s plan for accomplishing this. It would outline the main components of the fiscal decentralization program with a timetable for implementation and would serve as the basis for writing the law. The policy paper would also lay out the relationship between fiscal decentralization policy and other, related government initiatives, e.g., civil service reform, financial reporting system reforms, and election law reforms. A crucial question in this regard is, “which of these policy initiatives comes first?”

Step four is to draft and pass the decentralization law(s). This naturally follows on from the national mandate and from the policy paper, and it gives legal standing to the implementation of the fiscal decentralization measures. The law must be clear and it must be true to the policy design. The decentralization law might stand alone, or some elements of the decentralization program might become part of the constitution.

The next step is to adopt a set of implementing regulations that spell out the detail of how the fiscal decentralization will be put in place. For example, the White Paper and the law might call for the transfer of civil servants from central to subnational governments. The implementing regulations on the other hand, would spell out the detail of this transfer, provide clarity on exceptions, note how pensions will be handled, lay out seniority provisions, etc. The implementing regulations also would provide detail on the transition elements of the decentralization strategy, i.e., what would need to happen in year 1, in year 2, and so on. Essentially, the implementing regulations are written for those government officials—central and local—who would put the new system in place.

Step six is implementation, which involves a multitude of tasks. Following a very clear set of rules and regulations, the central and subnational governments begin operating with their decentralized political and administrative institutions and begin assuming their new fiscal responsibilities. Probably coincident with a fiscal year, the subnational governments would begin delivering the set of functions they have been assigned and arranging to cover costs with the new package of resources they have been given. The central government would begin transferring revenues to subnational governments by a new formula, and would have offloaded the designated expenditure management and delivery responsibilities. Depending on the structure of the fiscal decentralization, civil servants will have been transferred from the center to the subnational governments.

From the first day of implementation, there should be a well-designed and operational system of monitoring and evaluation by the central (state) government and a well laid out accountability system at the subnational level (step seven). The higher level government must carefully track the progress of the fiscal decentralization, measure this against the goals of the decentralization, and have a process in place for making necessary policy adjustments. Step seven is continuing. In the first years, it is primarily concerned with dealing with unforeseen implementation problems. In later years, its primary role can be monitoring the impacts of the system, identifying those times when policy or administrative adjustments are necessary, and reporting on the performance of the intergovernmental fiscal system. The monitoring and evaluation unit should be a permanent body.
The seven steps outlined above might be thought of as constituting a normative approach to introducing a sustainable fiscal decentralization strategy. This sequencing allows each step to build on the necessary prerequisites, and therefore could minimize the chances for failure of the system to accomplish its objectives. In the real world, however, there are important constraints that steer countries away from such an optimal sequencing. And sometimes, these departures are in the best interests of getting the job done. But clearly, while some departures may be admissible in terms of the costs and disruption involved in the decentralization process (for example, getting the implementation started without clear implementing regulations), some other departures may be too costly (for example, decentralizing revenues before there are clear expenditure assignments to different levels of government.)

Before we move on, we need to ask whether the seven steps outlined above provide the right scope for sequencing fiscal decentralization. For example, should the sequence include some previous steps to allow for the development of enabling institutions, such as the rule of law for the adjudication of intergovernmental disputes or democratic electoral rules? Without denying that some good cases can be built for these and other preconditions as possible steps in the sequence, a theoretical normative approach has to start somewhere and be built on some necessary assumptions. Our basic assumption here is that all preconditions outside the seven steps outlined above exist or otherwise are not binding for the decentralization process.

In the next part of this paper, we reconsider each of these seven steps in an optimal sequencing, provide more detail on what is entailed in each, examine the potential costs of ignoring or mishandling each step, and consider how sequencing has have been addressed in a number of countries that either have already decentralized or are in the process of doing so. Our goal is to develop amendments to the normative approach outlined in Figure 1, based on the international practice, and to identify some of the reasons for deviation and the risks that can come from making different sequencing decisions.

**Deconcentration Before Decentralization**

Before a decentralization policy is put in place, higher level governments might consider a deconcentration of its activities. This might include delivering certain services at the subnational level with a cadre of central officers involved in the service delivery in the local region. When decentralization policy is crafted, the local civil service is ready to take on the responsibilities assigned to the subnational level, and the possibilities for extreme disruption of service delivery are minimized. This was a major reason why Indonesia’s “big bang” decentralization was accomplished without a breakdown in public service delivery. On the other hand, the slow pace and reversals of decentralization policies in many Latin American countries over the past several decades may be linked to initial conditions characterized by the absence of genuine deconcentration of public services.

**The National Debate About Fiscal Decentralization**

The momentum for decentralization may originate from the bottom up, as in Russia, Spain or Estonia, from the top down, as in Tanzania, Thailand or Bulgaria, or from both directions as in Mexico, India, or Indonesia. Regardless of where the pressure originates, some form of national discussion about the desirability of decentralization is an important first step in the process. The key political and administrative stakeholders and ultimately the voters (if there are voters) must buy into the desirability and general outlines of a fiscal decentralization strategy. Otherwise, fiscal decentralization may not be sustainable. This national discussion should be about the basic goals of the decentralization program and the options that are available, but should not dwell on the detail. The idea is to get some general agreement on what fiscal
decentralization should accomplish and on how it should change the way government does its business. The national debate that took place in Canada during the last part of the past century on federal-provincial fiscal relationships provides a good example of this.

Ideally, this national debate will involve the main political parties, will have some degree of formality (as in the case of a national commission) and will be transparent (as in the case of a national election). This step in the sequencing should not be skipped if decentralization is to steadily move forward according to a plan and if it is to be sustainable. If it is not the first step in the process, it almost certainly will take place later and in that event could prove detrimental or perhaps even fatal to the implementation of the program. A recent example is provided by Moldova where in the past three years an incipient and promising decentralization program got reversed and abandoned once the opposition party took power in the national elections.

Three important things could be accomplished by the national debate. First, the reasons why decentralization has come on to the national agenda of policy options could be aired out. Some general agreement about the primary reasons for fiscal decentralization will set the stage for the proper design of the policy agenda. A second important part of the national debate phase is identification of the interest groups that are essential participants in various parts of the discussion about decentralization policies. Finally, the national discussion, or perhaps better termed “the national compromise,” can help to establish the champions of fiscal decentralization. As we argue below, the champions are essential to a successful implementation of decentralization.

**The Reasons for Decentralization**

It is no easy matter to get an answer to the fundamental question, “why decentralization?” Decentralization is usually introduced as a policy to offset a problem that has caused dissatisfaction with the present system of governance. It is important that the national debate identify this underlying problem. This becomes a crucial step in designing a program that will match up with the demands coming from those who are calling for a change from the present system. Without a clear statement of the problem and the overarching goal to be achieved, there is no hope of ever identifying a “successful” outcome.

It is difficult to identify the underlying problem, however, because it depends very much on whose vantage is taken. When viewed through the eyes of the population in general, fiscal decentralization can become a high priority policy issue for a number of reasons. One general reason for an increased demand for decentralization is that people are dissatisfied with the performance of their governments. In a developing country context, this often means that they are dissatisfied with the quality of public services that they receive, with their lack of voice in determining outcomes, and with the responsiveness and accountability of government officials. Another often-mentioned reason is that significant groupings of voters feel unconnected to the present governance structure because they are ethnically or culturally different. There may also be a general perception of failure and resentment towards highly centralized models of governance, such as has been the case in Russia and other countries in transition from planned socialism and absolutist regimes. In yet other cases, the problem may be the fiscal irresponsibility of subnational governments and the need to find a new set of rules under which they might operate.

From the perspective of the central government political and administrative bureaucracy, however, the underlying rationale, even though a reaction to the same basic issues, may be quite different. Politicians at the central level simply may react opportunistically to a decentralization initiative and support improved citizen participation in governance to gather more political favor. Or, the reasons may be more complex, such as to appease centrifugal or separatist forces and hold the country together. Or, central officials might believe that decentralization in service delivery
has gone as far as it can and devolution is the next logical step. All of this rhetoric needs to be part of the national discussion because it is suggestive of the kind of policy design that is necessary, and because it calls out the relationship between the underlying problems as seen by the population and the policy direction being advocated by government leaders.

Someone or some committee will need to sort through the rhetoric of the debate, identify the underlying reasons for a decentralization movement, and use this as key input in developing the policy framework paper. The arguments that usually are part of this rhetoric are summarized in Annex A.

**Why Make the Case?**

The designers of the decentralization package must sift through the rhetoric and sort out the reasons underlying the demand for decentralization. Why is it so important to identify the reasons for decentralization? Because airing out these justifications for fiscal decentralization and making the priority objectives clear can be invaluable in designing a program that fits the goals. To illustrate this, one might think of six key policy components of a fiscal decentralization program, as shown in the column heads in Table 1. While all are typically on the menu of options for fiscal decentralization, the intensity with which they are pursued as part of the decentralization program depends on the objectives that most drive the decentralization strategy. Possible objectives are presented in the five rows of Table 1. Of course, there will be differences in the intensity levels with which each of these objectives are pursued in the different decentralization scenarios. But the point of Table 1 is that these intensities and the entire decentralization architecture will tend to differ considerably depending on what is driving the decentralization process.

For example, a program driven by the goal of political decentralization (row 2) might focus heavily on the guarantee of local control over fiscal matters, and on budget-making autonomy and control of the local civil service. Such a package may satisfy those whose primary interest is wrestling control over local service delivery away from the higher level governments. This objective for fiscal decentralization might draw much less push for the guarantee of independent revenue powers, which might be seen as a second or even a later round reform. Clearly, the order in which decentralization policies are introduced in a program driven by this objective may be very different from the best sequencing for a program driven by another primary goal.

By contrast, consider a program whose primary objective is to stimulate local economic development (row 1). Here the demand for more subnational government revenue raising powers could be much stronger. Local development leaders, especially in more advanced urban areas, may push for taxing powers, borrowing powers, and more expenditure responsibility, in order to improve infrastructure enough to attract investors and jobs. Those driven by the development objective may be less resistant to sharing some decision-making power with higher level governments, and even may be willing to accept a nationally controlled civil service.

A program focused on improving administrative efficiency, as shown in row 3 of Table 1, might be focused on gaining more local control over budgets. Such a program might be a reaction to inefficient public service delivery, often in key social service areas such as education and health. The emphasis would be on local control to do a better job. These subnational governments would be looking for more freedom to spend budgetary funds as they see fit, and for more control (hire and fire and compensation decisions) over local public employees, their major input for delivering local services.
<table>
<thead>
<tr>
<th>Reasons Offered</th>
<th>Policy Design</th>
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<tbody>
<tr>
<td></td>
<td>Broad Expenditure Assignment</td>
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<tr>
<td>Economic Development</td>
<td>VS</td>
</tr>
<tr>
<td>Political Decentralization</td>
<td>M</td>
</tr>
<tr>
<td>Administrative Efficiency</td>
<td>M</td>
</tr>
<tr>
<td>Recognizing Diversity in Services; Preventing a Dissolution</td>
<td>M</td>
</tr>
<tr>
<td>Local Government Capacity Building</td>
<td>M</td>
</tr>
<tr>
<td>Fiscal Discipline</td>
<td>M</td>
</tr>
</tbody>
</table>

VS= Very strong demand  
M= Moderate demand  
W= Weak demand

¹ This might include provision for popular election of the local council, local appointment of chief local officers and safeguards against the abolition of local councils by higher level governments.
Sequencing in such a case would involve, first, gaining budgetary autonomy and some measure of control over the local civil service.

The main point in this discussion is that the design of the decentralization program, and the sequencing of decentralization policies, must follow identification of the primary objectives of the decentralization. A national discussion of the reasons for decentralization would seem absolutely essential. Moreover, only by knowing the primary objectives of the program can one know whether the decentralization strategy has been successful.

However, identifying the primary objectives of the decentralization may not be an easy task. The objectives that most drive the decentralization strategy can be wrapped in a heavy load of many other contemporary issues. This is well illustrated in the five countries of our focus.

**Indonesia.** The celebrated Indonesian “big-bang” decentralization in 2001 was a long-in-the-making policy reform that was driven by a perceived over-centralization of government decision-making and a perceived exploitation of some regions by a very strong and allegedly corrupt Suharto regime. The center ruled with a combination of a military threat that would discourage all but the most strident opposition, a puppet Parliament, and a well-developed system of local patronage.

The Asian financial crisis of 1997 was the catalyst for the new decentralization policy. The inability of the Suharto regime to handle this “economic earthquake” caused widespread social unrest and seemed to empower many whose alienation to government had been longstanding: those who saw themselves as ethnic outcasts by the Java-controlled government, and the natural resource rich regions who saw themselves as having been too long exploited by Jakarta.

By the classification in Table 1, Indonesia’s was very much a political decentralization, but it had elements that were meant to diffuse secession tendencies. Decentralization was the natural follow-on to the democracy initiative that followed the fall of Suharto. President Habibie endorsed a program of local autonomy and very limited authority to the provinces soon after he came to office. The program provided broad expenditure assignments to local governments, local political control and control over the civil service but did not emphasize revenue raising and borrowing power. Eventually, the decentralization included special revenue sharing focused on the regions that are rich in natural resources and, not coincidentaly, the greates threat for a breakaway.

**Russia.** The decentralization process in the Russian Federation got started in the very moment the country got its independence from the disintegrating Soviet Union in the last months of 1991. Independence movements and centrifugal forces in many of the regions in the Russian periphery, especially those with heavy ethnic populations, in combination with a weak center in the midst of a power struggle between President Yeltsin and a communist dominated parliament, seemed to call for a decentralization program with heavy emphasis on local political control, expenditure autonomy, and control over the civil service. Not satisfied, many regions tried to claim revenue raising powers and negotiated bilateral treaties in fiscal matters and other issues with the federal authorities.

After the passing of a new Constitution and Yeltsin’s re-election, the federal government made a concerted effort to regain control and initiative in the decentralization process. This

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2 Two very good discussions of the origins of the Indonesian decentralization program are Rasyid (2004) and Hofman and Kaiser (2004).

3 See Martinez-Vazquez and Boex (2001) for a discussion of the evolving decentralization process in Russia over the last decade.
objective would not be met until after the election of President Putin with a very significant electoral mandate and the approval of new budget and tax codes. The decentralization program today is more oriented toward the objective of administrative efficiency with emphasis on expenditure autonomy and local control of civil service, but with low degrees of revenue-raising powers and even local political control. In this latter respect, the new plan is to have the regional governments appointed from the Kremlin as opposed to being elected as had been the case since the mid-1990s. In general, the policy measures that are featured in the present decentralization program would seem consistent with the overall objectives that have been laid down by the present leadership in government.

**India.** The fiscal federalism system was conceived as a fairly centralized federation out of the fears of fragmentation, following the separation of the Muslim areas into the separate country of Pakistan. In many ways the system was inspired by a planned economic model with heavy intervention by the central government. Although the system has been reformed many times, there has never been fundamental reform to adapt intergovernmental fiscal relations to a decentralized market-oriented economic model with an autonomous role for local governments in the delivery of public services. The large fiscal deficits of the states have renewed interest in reforming the system of state and local government financing.

The current intergovernmental reform focus in India is on the lack of fiscal discipline and the debt accumulation at the state level and the destabilization threat this implies. The aggregate budget deficit of the state governments is roughly equivalent to that of the central government. The primary goal of current reform would seem to put pressure on the states to balance their budgets and to reduce borrowings in cases where repayment capacity is not present.

Second, and equally important reason for reform initiative is the failure of the current system, where decentralization has stopped at the state level, to reach local governments, to deliver basic public services and improve the quality of life of many millions of citizens. The decentralization program today continues to be oriented toward political decentralization at the state level with strong emphasis on political control and control over the civil service and broad expenditure powers guaranteed in the Constitution. This is in spite of a constitutional amendment that mandates the passing of fiscal autonomy to the third tier.

India would seem to be a case where the government’s objectives for the decentralization initiative do not match the policy instruments that have been put in play. Fiscal discipline would appear to require a hard budget constraint and subnational government revenue raising powers that enable a filling of fiscal gaps. The states have not been given sufficient autonomy in revenue raising. Decentralization with a focus on political autonomy to the lowest tier also does not match up well with the policy instruments being put in place in most states. Expenditure functions remain either murky or transparent, and little expenditure autonomy has been given.

**Tanzania.** At independence, Tanzania had a relatively strong system of local government. However, in the early 1970s, both urban and rural local governments were abolished as part of a series of highly centralized, socialist reforms. Although elected local governments were restored in the early 1980s, it was not until the late 1990s that one could say the decentralization was back on the agenda in a significant way. The decentralization under discussion in Tanzania now is one that has grown out of wider economic and governance reforms that feature the introduction of multi-party politics (NCG, 2004).

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Since the period of centralization and planned economy under President Julius Nyerere, Tanzania has pursued a more gradual approach to decentralization. The causes of the current program stem from the political and economic liberalization of the past twenty years, and the reintroduction of local government in 1982. However, these elected local governments had little discretion and service delivery was controlled by the deconcentrated regional administrations. The result, widely perceived, was a declining quality of local public services.

By 1998, the Government had committed to a program of decentralization through devolution (as opposed to deconcentration or delegation), primarily to address the problem of inadequate local public services. The Local Government Reform Program, launched in 1999 was designed by the central government to put into operation a wide reform agenda for local governments, with the intent to provide local authorities with significantly more autonomy to respond to local demands for services and improving the accountability of local officials. The decentralization program today continues to be oriented toward enhancing the local role in the administration (provision) of local services and building local government capacity with strong emphasis on a policy design that provides for expenditure autonomy and local control over civil service.

While it seems clear that local government finance is high on the reform agenda in Tanzania, the Government has been slow to proactively enact specific reforms. Instead, the reform process has largely been reactive, with policy makers responding to specific problems e.g. dissatisfaction with the Development Levy (the major local tax) or concern about the proliferation of conditional grants.

Much has occurred in mainland Tanzania in recent years, particularly in the realm of fiscal decentralization. Political autonomy and increased efficiency in service delivery would seem to be the driving force behind the reform. The main thrust of this reform has been to reduce the arbitrary discretion of central government officials over local government finance issues through the introduction of a formula-based transfer system, with the hope that local governments will be empowered to improve local service delivery.

Mexico. In reaction to a century of wars and revolution, Mexico’s 1917 federal Constitution provided for significantly centralized fiscal and political systems. Centralization was reinforced for much of the twentieth century under the control of the single party regime by the PRI (Institutional Revolutionary Party). During this period, state and local budget affairs were largely controlled from Mexico City. Demands for genuine devolution and decentralization got started with the winning of state governorships by opposition parties in 1989 and came to full fruition in 2000 when the National Action Party (PAN) candidate Vicente Fox won the presidential election. After that, it became fashionable for all political forces to support greater decentralization in the country. There had been considerable devolution of expenditure responsibilities, going back to the last decade of the PRI rule.

Revenue raising powers remain centralized in large part due to voluntary agreements between the state and federal governments, under the “fiscal coordination” program. States depend on different forms of central revenue transfers for 80 to 90 percent of their budgets. Local governments still represent a small proportion of the public sector (about 5 percent of expenditures). Although there have been demands for the devolution of more revenue raising authority, especially by the richer states in the North that have benefited most from NAFTA, poorer states in the center and the southern part of the country have been much less enthusiastic.

6 Zanzibar, which has its own, separate internal governance structure, has been much slower to reform.
7 See Courchene, Diaz-Cayeros, and Webb (2000), and other papers in Giugale and Webb (2000) for a complete discussion of the evolution and problems of fiscal federalism in Mexico.
out of fears that they may lose in a more decentralized system of revenue assignments and a leaner federal budget.

In 2004 a National Finance Convention was convened with the objective of developing a national consensus on the direction of future decentralization reforms in Mexico.\(^8\) The impetus for the new drive for decentralization in Mexico has been enhanced political competition and demands for greater political decentralization and administrative efficiency. The current policy design of fiscal federalism, as predicted in Table 1, emphasizes expenditure autonomy and local political control and control over the civil service.

**Who Should Be the Participants in the National Discussion?**

A national debate about the merits of fiscal decentralization ideally would involve all relevant interest groups, i.e., all of those who see potential benefits or costs from a move toward fiscal decentralization. The discussion will be led by the central government, who ultimately will make the rules of any new decentralization. But the discussion must be much more inclusive. A basic idea behind decentralization is to empower those at the state and local level by making them part of the decision-making process. It would be self-defeating to leave them out of the debate. The flip side of this is that much of the central bureaucracy will lose power with decentralization. It would be equally foolish to leave them out of the debate. The goal is to develop as much of a consensus as is possible and to forestall later criticism that the process was not transparent.

But there are some important tradeoffs involved. The broader the audience in the national debate, the harder it will be to gain consensus for a program. The result may be a prolonged discussion that finally dies of inertia, or a watered-down program that may not address the underlying problems.

The national debate may be spontaneous, as it was in Indonesia, and all parties can have voice. In other cases, the national discussion is more formal and orchestrated from the top, as in the cases of such diverse places as Tanzania, China, Bulgaria or Vietnam. It is not unusual for the national discussion about decentralization to be the responsibility of a commission or even a Ministry. In such cases, the discussion is led by the higher level government (central or state), as was the case in South Africa. It is a mistake, however, to leave the national discussion fully in the hands of the central (or state) government.\(^9\) The result can be a struggle between central ministries that would gain or lose influence, with potentially little input from the subnational governments, who are key to making fiscal decentralization succeed.

The Parliament or Legislature should be part of the national discussion. After the decentralization program is underway, Parliament will be the body that passes (or repeals) the legislation that supports or defeats the intent of the decentralization program. In fact, if the general framework for decentralization is not in place at the time of implementation, Parliament may well become a principal influence on the shape of the program. This is all the more reason to have Parliament or Congress heavily involved in the initial national debate. However, Parliament alone cannot lead the national discussion because its members may be too politically driven and power is often too unequally divided. Parliament was not a key player in the national debate over decentralization in Indonesia. However, shortly after the program was conceived, Parliament became a principal influence on policy making and in fact played a very important role in shaping the decentralization program in its first years.

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\(^8\) See the discussion in Webb and Gonzalez (2003) on the difficulties and opportunities Mexico faces in reaching a national consensus for future reforms.

\(^9\) A more conspicuous example of this kind of mistake is to put the line ministries at the central level in charge of defining decentralization in their respective sectors, such as has been the case in El Salvador, Nicaragua and other Central America countries (see Arze and Martinez-Vazquez, 2004).
Parliament in Tanzania played only a minor role. In fact, one of the reasons for the formula-based transfer system was because MOF was tired of being unable to explain to MPs the criteria for distribution of revenues among local governments.

There must be room in the national debate for the subnational government sector. This is not easily accomplished because often this sector is not represented in an organized way. There usually are associations of local governments, or of mayors, or governors, and these should be given voice in the national discussion. For example, in Mexico, the National Conference of Governors (Conago) has emerged as a powerful counterpart to the federal government. However, because their interests diverge (e.g., richer vs. poorer regions, or urban vs. rural local governments), their formal representation may be splintered. In Russia in the mid 1990s, an association representing a small number of the richer regions lobbied the federal government, sometimes quite effectively, on a variety of divisive issues, such as the overall level of interregional redistribution and the sharing of revenues from natural resources. The Association of Local Authorities in Tanzania is very weak, and has little impact on the reform process, although the urban areas do appear to have some political power.

It is important that a central ministry not be taken to stand for the interests of local governments. The Ministry of Local Government or Ministry of Home Affairs may be “closest” to the subnational governments on a day-to-day basis, but in many cases are not strong proponents of significantly enhanced local fiscal autonomy. Their interests may well be in the direction of not giving up control over the fiscal operations of the local governments. Arguably, this has been the experience with the Ministry of Home Affairs in Indonesia.

Depending on the country, other interest groups may be able to play a valuable role. Civil society, unions, and representatives of the civil service may be important contributors to the development of a decentralization program. Typically these groups do not find a place at the table in the national discussion, and when they do, their knowledge about the subject of decentralization may be limited to a single issue of self-interest. For example, national teacher and health professional unions have been a serious impediment to the decentralization of education and health services in Mexico. However, informal organizations and NGOs have become increasingly important in fiscal decentralization strategies and it would be a mistake to ignore them in the national debate.

The Format for Discussion

In what format can the national discussion about decentralization take place? Sometimes the process itself can play a major role in shaping the kind of decentralization that will be adopted.

The discussion may be prompted by external events and the national debate is organized as a result of these events. One possibility is that it can be part of a political or economic upheaval, such as the end of apartheid in South Africa or the breakup of the Soviet Union and regime change in Central and Eastern Europe. In such cases, the national discussion about decentralization can be especially reactionary to the unfairness of the present (past) system, and more prone to develop an entirely new framework than to adjust the present system. Indonesia and Bosnia-Herzegovina are other cases in point.

In Tanzania, the latest wave of decentralization reforms got started with a National Conference in 1996 under the banner of “Towards a Shared Vision for Local Government in Tanzania.” The results of the conference were incorporated in a strategy document, The Local Government Reform Agenda (LGRA), which in 1998 was endorsed by the Government.

In Indonesia, the process was simply commissioned. The Ministry of Regional Autonomy (later the Ministry of Home Affairs) was commissioned to draw up the law describing the new assignment of expenditure responsibly, the new civil services rules, and the nature of local government autonomy in matters of fiscal management. The Ministry of Finance was commissioned to draft the law on the financing of these local governments including revisions to the system of intergovernmental fiscal transfers.

A second way in which the decentralization discussion might be joined is through the deliberations of an appointed commission. In this case, the reform program might be less comprehensive, especially if there is no national imperative to make a sweeping change in the system of governance. This has been the situation for over five decades with India’s Finance Commissions.\(^\text{11}\) This has also been the case in Russia in the late 1990s when several government commissions were created to suggest alternative paths to reforming equalization transfers and other aspects of the intergovernmental finance system. More recently, President Putin appointed the Kozak commission for the same purpose and the commission recommendations have been highly influential in the reform agenda of the Russian government.\(^\text{12}\)

In Pakistan, the military government appointed the National Reconstruction Bureau (NRB) in 1999 and charged it with developing a decentralization plan. Though inputs from all sectors were encouraged, the NRB had a relatively free hand in developing the program. The appointed head of the NRB was a retired general.

In other cases, the national discussion about decentralization may be more conventional and may take place in the context of a regular national or state election, as was the case in Mexico’s presidential election of 2000.

Finally, the national discussion may be led by Congress or it may even be part of a constitutional mandate.

**The Champions**

An important ingredient for the success of fiscal decentralization is a coalition of strong advocates. These advocates, or champions, will keep decentralization in the center of the national debate and will work to develop the coalitions necessary to enact a decentralization policy. Particularly for international agencies and bi-lateral donors who would encourage fiscal decentralization initiatives, it is important to identify the champions and continue to support them.

But what if there are no decentralization champions? In theory, the policy design may go on but in practice what is likely to happen is that the entire process will drag on for years with otherwise minor obstacles becoming insurmountable. The recent experiences of countries like Thailand and Georgia show how the process of decentralization has failed to advance because of a lack of strong champions.

One might use ad hoc reasoning to try and identify the centers of strong support for decentralization policy. We have sorted the various centers of power in the making of policy decisions, according to how fiscal decentralization would impact on their political and bureaucratic power. We consider only self-interest and not statesmanship. Such a categorization, presented in Table 2, suggests why fiscal decentralization in many countries has to date been

\(^{11}\) India has had twelve successive Finance Commissions with the main role of recommending to Government on center-state revenue sharing and other finance issues. An independent Finance Commission is mandated in the Constitution. See Singh (2004).

\(^{12}\) See the discussion in Martinez-Vazquez, Timofeev and Boex (2005).
more rhetoric than action. To many, it will seem a paradox that fiscal decentralization can be such a popular policy rhetoric in developing and transition countries, but that, at the same time, it has few natural political champions.

The strongest supporters are listed in the top panels of the table. One would imagine that decentralization is a grass roots movement, which means that voters and elected politicians, including the President, (head of state) will be the natural champions. Voters should be unambiguous supporters because they are further empowered to make fiscal choices. The enthusiasm might be a little more tempered for the elected head of state. On the one hand, decentralization can be a popular vote-getting strategy. But, if decentralization conflicts with the government’s preferred macroeconomic stabilization policy, the President’s support will be less firm. Hyperinflation or recession is likely to offer far more of a threat to re-election chances than the absence of a good decentralization program. The possibility of spinning off too much power to the regions, especially to those who are to some degree mutinous, can also cause the President to be less supportive of decentralization initiatives.

13 Of course, groups of voters may be opponents if they perceive that their group interests (economic and others) are better protected through a centralized government arrangement.
Indonesia’s President Suharto managed to hold off decentralization for such reasons, in part because the prospect of being voted out of office was not a real threat. His administration

<table>
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<tr>
<th>Potentially Strong Supporters</th>
<th>Comments</th>
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<tbody>
<tr>
<td>The People and their elected representatives</td>
<td>Demand for more participation in governance at the local level.</td>
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<tr>
<td>The President</td>
<td>Decentralization is a popular policy with the electorate. However, the President must also be very mindful of stabilization concerns with decentralization, since inflation and unemployment are usually the greatest danger to his/her political standing.</td>
</tr>
<tr>
<td>The Parliament or Congress</td>
<td>Decentralization is a popular policy with the electorate. Parliament would like to identify with specific local projects they could “bring home,” therefore, they will favor a less transparent and less structured system. Parliament is also the most likely vehicle for regional minorities and other groups to make their aspirations for autonomic government heard.</td>
</tr>
<tr>
<td>Urban Local Governments</td>
<td>“Give us the autonomy to tax and spend.” Urban local governments are often most concerned with how their autonomy is circumscribed, and how their access to their tax base is limited.</td>
</tr>
<tr>
<td>External Donors</td>
<td>They provide encouragement and some technical assistance to get the process underway, but are no substitute for an in-country champion.</td>
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<th>Potentially Weak Supporters</th>
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<tbody>
<tr>
<td>Ministry of Finance</td>
<td>Would propose strict limits to decentralization in order to hold the main fiscal tools for stabilization policy purposes.</td>
</tr>
<tr>
<td>Ministry of Economy</td>
<td>Would like to control the type of investment made, as well as the regional distribution of investment. Typically interested in programs with big externalities vs. local benefit programs.</td>
</tr>
<tr>
<td>Line Ministries</td>
<td>Would like to control the standards of public service delivery, and often would like to hold an approval or sign off power.</td>
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<tr>
<th>Ambivalent Supporters</th>
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<tr>
<td>Ministry of Local Government</td>
<td>Would favor a greater guaranteed share for local governments, but would like to control the distribution of those resources.</td>
</tr>
<tr>
<td>Weaker local/regional governments</td>
<td>Would like a guaranteed transfer of resources from the urban and wealthier local/regional governments to the rest. More interested in a transfer system than in a local taxing system.</td>
</tr>
</tbody>
</table>
fell because of an economic crisis. His successor, President Habibe, would have to survive a re-election and embraced decentralization as a vote-getting strategy. The winner of the election, President Megawati Sukarnoputri in whose term the decentralization program was implemented, never embraced this policy. President Yeltsin of Russia whole-heartily embraced decentralization in 1992 as an instrument in his power struggle with an opposition-controlled parliament. He had to retract very soon thereafter from his statement of “let the regions have as much power as they can digest” because of the unruly and destabilizing behavior of a handful of regions with separatist designs. His successor, President Putin has continued a relentless process of re-centralization of the finances and political power, so that regional governors starting in 2005 will no longer be elected but will be appointed from Moscow. In Mexico, part of the strategy of the winning presidential race strategy of Vicente Fox in 2000 was to embrace decentralization and power devolution to the state and local governments, thus riding on popular discontent with a centralized regime that had run the country for the better part of the last century.

Parliament will embrace programs that voters embrace, and therefore is a potential champion of decentralization. However, members of Congress sometimes are most interested in how programs benefit their own constituency, hence may be less enthusiastic than policy analysts about the need for transparency.

The local governments will favor decentralization, but the rich and poor will have very different views about the best version of decentralization. The more well-off local areas will favor increased fiscal discretion and a laissez faire approach to fiscal decentralization and the poor will opt for a redistributive system based on a guaranteed revenue flow. As noted above, those trends have been quite apparent in Mexico and Russia, and to a large extent the same is true in India. Tanzania’s local government reforms were successful in large part due to an unusual confluence of political support for the reforms from different quarters, including the President’s Office for Local Government; the Ministry of Finance (which sought a more systematic approach to allocating resources to local governments in order to enhance the efficient delivery of local services), and Parliament (which sought greater transparency in the allocation of local government resources).

Finally, some of the external donors and advisors will champion fiscal decentralization. The World Bank, the Asian Development Bank, the Inter-American Development Bank, the UNDP, and many bilateral donor organizations (USAID, DFID, DANIDA, etc.) see decentralization as part of a development strategy that will lead to a more satisfactory and balanced growth. USAID and some other bilateral donors, besides advocating decentralization, are also heavily influenced by their goal of developing democratic institutions and improving governance. The IMF usually takes a more cautious and qualified view because of their concern with any policy that might promote fiscal instability. But the external advisors play an important catalytic role. Sometimes they play the role of principal advisors and can have an important influence on the policy design. When they bring funding as the carrot, they oftentimes catch the attention of government officials and stimulate the government to look harder at the decentralization issue. But unless the government itself is enthusiastic, the harder look will not lead to meaningful policy reform and in fact will be quickly forgotten when the money is gone. The implementation stage may never be reached. The World Bank and IMF played an important role in the Indonesian decentralization. They advised the government on the need for a contingency fund, provided continuing advice and program support, and provided financial assistance to the government. They also played very important roles in Russia’s decentralization but more minor ones in Mexico and Tanzania.

There tend to be three major roadblocks of fiscal decentralization policy. The Ministry of Finance, the keeper of the tools to address macroeconomic instability, often will not want to give up control over these tools. When this Ministry is on record as favoring decentralization, it will
often tend to be a controlled form of decentralization. One might look for the following features in such a program:

- Limited freedom for local governments to set tax rates for any major taxes;
- Strict control of borrowing powers;
- Budget approval by higher level government, or stringent expenditure mandates;
- An *ad hoc* system for determining the vertical share of intergovernmental transfers, that would give the central government some flexibility to withhold full distributions in hard times; and
- Centrally controlled wage and salary rates for local government employees.

Typically, the Ministry of Finance will be more favorable to an *ad hoc* than to a transparent regime. Clearly, an *ad hoc* system provides more flexibility and room for maneuver for pursuing stabilization and even equalization objectives, but it can also yield arbitrary and uncertain results for local governments. It took years for the Russian Ministry of Finance to give up the *ad hoc* system that it had inherited from Soviet times. Indonesia is an interesting exception to this rule. The MOF-designed system of intergovernmental transfers features a vertical share equivalent to 25 percent of central government collections. Otherwise, however, the system of decentralized finance includes little by way of local taxing or borrowing powers, and there remains a central determination of civil servant compensation.

The Ministry of Economy also could be a significant opponent. This Ministry will be interested in a system that allows central rather than local direction of investment through the control of public investment programs (PIPs) or capital budgets. If investment decisions are decentralized to any significant extent, it might be seen as compromising national planning on the distribution of capital expenditures by function and by location.

The line ministries often will oppose decentralization on grounds that seem more paternalistic. Their view is that the local governments do not have the technical capacity to deliver services or to plan resource allocation, hence there must be strong central direction. Line ministries, if they are persuaded on fiscal decentralization, will be more comfortable with conditional grants and mandated expenditure requirements. Part of the problem is that line ministries fail to see a role for themselves in a decentralized system. This tends to happen more often in those countries where central line ministries worked as input controlling and micromanagement centers as opposed to regulating, enabling and evaluating institutions.

**The Policy Design: The White Paper**

Fiscal decentralization is a policy that is designed to achieve certain objectives. Therefore, it is critical that the objectives be clearly specified before the program is designed. The overall framework for the decentralization must be elaborated in a policy paper. Moreover, the policy paper must be specific enough, and comprehensive enough, to guide the development of the law and the implementation.

What if there is no such policy paper? In theory, the results can be very undesirable. Two major problems are almost certain to occur.

First, without a roadmap for the decentralization strategy, government and Parliament are more prone to “make it up as they go.” This is dangerous. It can lead to pieces of the decentralization strategy that do not fit together, e.g., starting the process by decentralizing revenues before any re-assignment of expenditure functions, an expenditure assignment list that does not match revenues assigned, borrowing powers with no provision for repayment capacity,
building expectations of fiscal responsibility but no provision for a hard budget constraint, or assuming that all subnational governments will have the same capacity to implement decentralization programs. Even with a White Paper in place, elected politicians and bureaucrats who are new to the scene might introduce changes that are contradictory and eventually harmful to the objectives of the decentralization. But this will be much less likely to happen if a framework is clearly in place.

Another problem with not having a documented framework is that later year policy changes may not be consistent with the overall goals for the fiscal decentralization program. It is easier, for example, for Parliament to pass a new decentralization measure and label it as “supportive of the strategy,” when the strategy has not been written down. An interesting case in point is Indonesia, where a hold harmless system was put in place by Parliament to protect local government from receiving any reductions in revenues upon the introduction of the new system of equalization grants. This hold harmless provision minimized the equalization effects of the new grant regime and helped perpetuate undesirable aspects of the previous system (directly compensating local governments by the number of their employees.) This was not envisioned in the original program design. Parliament, after year one of the decentralization program, decided to keep this hold harmless system in place. With hindsight, the problem was that there never was a firm plan as to how the new transfer system would be phased in. Of course, Parliament may have overruled any firm plan in favor of their own program in any case, but the existence of a policy paper would have made that much more difficult.

The White Paper that frames the decentralization policy needs to cover all of the elements of the program, but it need not cover them in a detail that would be expected in the implementing regulations, nor should it strive to impose a tight timetable where all reforms should happen at once. However, it should be the result of a careful analysis of the options, it should have benefited from review and input from a broad cross-section of stakeholders, and it should propose a realistic timetable with a clear and connected road map of the steps to be taken over the next several years. The White Paper should be a published document in order to give transparency to the process.

Common sense would seem to dictate the need for an overall framework as an early step in implementing decentralization, yet countries often skip this step. Indonesia never did prepare an overall framework and instead went forward with two laws followed by a set of implementing regulations. The result, as discussed below, has been a good bit of “making it up as we go” which has brought some serious challenges to the decentralization program. Decentralization has been reasonably successful in Indonesia, despite the absence of a guiding framework. The question to raise is how much successful it would have been with a framework. Similarly, Russia jumped into the decentralization process in 1992 without preparing an explicit framework and overall strategy. Successive laws and measures, often disconnected and sometimes contradictory were issued for a number of years. It took Russia almost a decade to issue a comprehensive vision of the decentralization process in what became known as the Kozak Commission Report in 2002.15

14 The problems that arose from no real fiscal decentralization plan were recognized by the government, and in 2002, the Ministry of Finance issued a draft “White Paper” on Fiscal Decentralization (Ministry of Finance, 2002). Though the basic objectives and policies were aired out, this document was not the result of a broad national discussion. It could however, be an input to redrafting the original laws, an exercise that was underway at the time of this writing.

15 After the August 1998 ruble crisis, a wide reform process, such as the Budget Code and Tax Code, gained new momentum and the Government issued a document that can also be considered a White Paper under the title of “Concept of reform of Intergovernmental Fiscal Relations in the Russian Federation for 1999-2001.” However, this document has less buy-in and smaller scope than the Kozak Report. For a discussion see Martinez-Vazquez (2002).
Mexico’s decentralization policy has continued to drift forwards and sideways without a comprehensive reform blueprint.

Tanzania, on the other hand, did produce a White Paper on local government reform at the beginning of the current phase of decentralization reforms in 1998. While this policy paper does not provide a great amount of detail on planned fiscal adjustments, it lays out the government’s general objectives for the program, i.e. “...to improve service delivery by making local authorities more democratic and autonomous within the framework established by central government...” (Local Government Reform Programme, 1998, Section 1, p. 5). By persistently emphasizing the theme of “decentralization by devolution,” Tanzania’s “Government Policy Paper on Local Government Reform” has continued to inform and order the ongoing reform process quite successfully, while its lack of specific policy reforms may have helped to reduce potential opposition against the reform agenda. Since the expenditure responsibilities delegated to local authorities in Tanzania had gradually expanded since the early 1980s to include primary education, basic health services, and most other typical local functions, the basic elements of the current decentralization strategy revolve around providing local governments with greater de facto autonomy over the delivery of local services through an overhaul of the system of intergovernmental transfers and a devolution of components of the development budget. But, it is widely recognized that a more comprehensive plan for fiscal decentralization is necessary, in particular to correct conflicts in the trends of increasing expenditure autonomy and sharp declines in local revenue autonomy. Though a strategic local government finance framework has been promised by the Office of the President to fill the gaps of the original policy paper on local government reform, it has not yet been delivered.

Elsewhere in East Africa, the experience is mixed (NCG, 2004). Uganda has adopted a fiscal decentralization strategy and it was adopted by Government in 2002. However, the strategy is not comprehensive and to date is still focused on reforming the system of intergovernmental transfers. Kenya, on the other hand, has identified some areas of local government finance reform, but has not developed a comprehensive strategy.

India is a case apart in this respect. Although there has not been a fundamental White Paper mapping out the reform of India’s federalism, every five years India’s Finance Commission issues a comprehensive report on intergovernmental finance issues and options for reform. In November 2004, the Twelfth Finance Commission issued its report for the 2005-10 period. The problem in India is that there is no one ministry or organization that is responsible for the whole of intergovernmental fiscal relations. For example, transfers to the states are in the hands of three centers: the Finance commission, the Planning Commission and line agencies. Individual states control the intergovernmental schemes within their jurisdictions. Moreover, recent constitutional amendments have mandated more devolution of fiscal responsibilities to the third tier governments, and leadership for this has been placed in the hands of the states.

Policy Design: The Sequencing

Some would argue that the single most important factor in getting a successful decentralization in place is to include the key elements in the policy design. But, what are the key elements? And, must all be introduced simultaneously, or are there some sequencing rules? The basic objectives of the fiscal decentralization will dictate the key elements, though there are some core components that must be included in any fiscal decentralization package. As we discuss below, the political and administrative constraints to decentralization limit consideration of even some of these core factors. But where these constraints are truly binding, the result may be a flawed policy design that will never bear fruit.
The following are a set of principles that might constitute a normative approach to policy design.

**Fiscal Decentralization Policy Should Be Comprehensive**

Intergovernmental fiscal relations must be thought of as a system, and all the pieces in this system must fit together.\(^{16}\) Ideally, the implementation of a decentralization program should begin with a design of the comprehensive system, and should lay out the plan for each element of the system. A little reflection will lead one quickly to the conclusion that fiscal decentralization involves a lot more than what are traditionally thought of as fiscal issues. In fact, the electoral system and the civil service and other institutional arrangements are arguably as important to assuring the success of fiscal decentralization as are the taxing and spending components. A “one-off” piecemeal reform, encompassing only one element of the system (e.g., central government revenue sharing with local governments), is not likely to fully capture the benefits of decentralization. In fact, it can lead to undesirable outcomes, including larger central deficits and macroeconomic instability.\(^{17}\)

A phased-in strategy is probably the right way to reform fiscal decentralization to avoid the risk of “reform shock.” This issue is discussed further below under the heading of “Implementation.” But regardless of the pace for reform chosen, countries should follow a comprehensive plan covering the main elements of the new system and how they need to be coordinated with each other. When the pace of reform chosen is gradual, the authorities should also prepare to deal with the transition problems during phase-in, and should have a sequencing plan.

The key elements of a system of fiscal decentralization are described in the first column of Table 3. In the remaining three columns of Table 3, we summarize how these components might be structured under more and less successful systems of fiscal decentralization. The point to be made here is that there are several elements that must fit together into a comprehensive plan for fiscal decentralization.

Managerial control is an important component of local autonomy, and has important implications for the local budget. Subnational governments need to allocate staff to areas where needs are greatest, and to hold staff accountable for their performance. Otherwise elected subnational governments cannot be held fully accountable for the quality of services they deliver. Likewise, subnational government financial management requires control over the wage bill of local government employees.

Countries vary widely in the extent to which expenditure autonomy is extended to control over local employees (Evans and Manning, 2004). Indian states have significant autonomy in this respect, but do not extend this autonomy to local governments. Similarly, public employment policy in Pakistan remains lodged at the Provincial level. In Mexico, the central government still determines (or negotiates) the compensation rates for government employees. Central determination of compensation is also the case in Uganda.

**Expenditure autonomy.** Local governments must have significant control over their expenditure package (production efficiency), and responsibility to deliver services that are

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\(^{16}\) *Intergovernmental fiscal relations* is a term that refers generally to division of fiscal powers and responsibilities among levels of government. *Fiscal decentralization* refers to an intergovernmental system where the balance of power moves more toward the subnational government sector than has been the case.

\(^{17}\) See Burki, Dillinger, and Perry (1999) for a discussion on these types of problems in Latin America.
important to the local population (allocative efficiency) If central (direct or indirect) mandates on local budget choices rule the day, it is unlikely that the efficiency gains from decentralization will be captured. In fact, however, local discretion is often limited in several ways including minimum expenditure requirements, unfunded mandates, conditional grants, and higher level government determination of the hiring/firing and compensation of local public employees.

**Revenue Autonomy.** Subnational governments must be given some revenue autonomy if there is to be a hard budget constraint imposed on them, and if they are to have discretion in deciding on the level of their budgets. This means that a decentralization program must allow some provision for local governments to choose the level of their taxes and charges, and where appropriate, to access capital markets for financing of long-lived infrastructure assets.

It is also important that subnational governments receive intergovernmental transfers that give them discretion to choose the mix of their public expenditures. Unconditional grants or block grants can provide such discretion, whereas tightly earmarked transfers do not. Unless local government decision makers do not have such freedom to decide on the use of transfers, they will not be held fully accountable by the local voters for the outcome of the public expenditures.

**Hard Budget Constraint.** Subnational governments should be subjected to a hard budget constraint. This forces subnational governments to live within their means, and forces local subnational government officials to be accountable for the fiscal choices that they make. As noted in row 4 of Table 3, a second best approach to fiscal management and budgeting is local approval of the budget, but with a soft budget constraint. Under this arrangement, subnational governments may be given some latitude in overspending, and may be allowed to cover their deficits by overdrafts, or deferring payment to creditors including bond holders, suppliers or even their employees. This is a not uncommon case in developing countries, often with potentially serious consequences for macroeconomic stability, as the known cases of Argentina and Brazil in the recent past illustrate well. In other cases, such as in India today, the practice of soft budget constraints at the subnational level does not immediately represent a threat to macroeconomic stability but it leads nevertheless to a wasteful use of scarce public resources.

**Local Civil Service.** Some decision must be made about the degree of control that subnational governments will have over the employees who deliver services in the local area. This is an essential ingredient of decentralization policy. If they are to be local government employees, then local councils might be held full accountable for the efficiency with which they work. If they are to remain employees of higher level governments, or if the power to hire, fire and promote is vested in a higher level government, then local councils are relatively powerless to affect changes the quality of local public services.

Perhaps more important is the question of who controls the number of subnational government employees, and who controls the compensation paid. Since subnational governments, particularly local governments, tend to be very labor intensive, their budgetary health is heavily influenced by the total compensation paid to public employees. Since in many countries these compensation decisions are made by higher level governments, a serious challenge is made to the goal of imposing a hard budget constraint on lower level governments.

**Accountability.** Accountability to local voters is perhaps the most crucial element of a decentralized system, and the one that ties together all of the above. Local councils should be locally elected, preferably by vote of the local population. The same is true of provincial/state legislature. If the local leadership is appointed by higher levels of government, its accountability likely will be upwards and not down to the local population. The efficiency gains that are at the heart of fiscal decentralization strategies will not be captured if local voters cannot have a voice in making budget choices. There are other problems with not providing for accountability to
local voters. For one, the governing local council will not be under the gun to provide better services in order to insure its re-election.

Countries like China and Vietnam which have been pursuing substantial decentralization reforms on many fronts, but which still do not have contested, democratic elections, are not benefiting from the full range of efficiency gains associated with decentralization. In particular, the dominance of vertical accountability to upper-level government officials and the desire to please them quite likely leads to distorted spending decisions at the subnational level.\textsuperscript{18}

Awareness of these issues has led both China and Vietnam to experiment with openly contested elections at the lowest level of local government, the rural settlements.\textsuperscript{19} A full solution to this problem requires, in countries like China and Vietnam, a regime change, which is not likely to happen anytime soon. Does it mean in this case that decentralization in these countries is meaningless or ineffective? It would appear that there are still sizable advantages to be obtained from decentralization in production efficiency and competition among local governments,\textsuperscript{20} and some gains in allocative efficiency from limited levels of horizontal accountability.\textsuperscript{21} Full horizontal accountability to voters is limited in other developing and transitional countries by less than full direct elections of executive and legislative branches of government. In a common modality, the legislative branch is democratically elected but the executive branch is appointed by the center, as will now be the case in Russia’s regions. Representatives may be indirectly elected by lower-level governments, as in the case of the district councils in the Czech Republic. The point with any of these variations is that accountability and, therefore the overall performance of decentralization, will be hurt the further away the system moves from full democratic institutions. Even the method followed in democratic elections may have consequences for accountability. For example, proportional representation under closed-party list systems may generate strong alliances and accountability toward the party bosses in the capital of the country in comparison to district-wide winner-take-all open elections.

Tanzania’s political system is a vestige of the British colonial system. Councilors are directly elected from politically nominated candidates, on a ward-by-ward basis. The mayor and standing committees are elected by the council members. Although Tanzania officially operates under a multi-party system, the political process at the local level is still heavily influenced by the internal politics of the ruling party (CCM), which is particularly powerful in rural areas.

\textsuperscript{18} For example, Martinez-Vazquez, Qiao, and Wang (2005) argue that the lack of horizontal accountability in China has led to different expenditure patterns in poorer and richer provinces.


\textsuperscript{20} Montinola, Qian, and Weingast, (1995) and Qian, and Weingast, (1996) argue that the fiscal decentralization process started in China in the mid 1980s with the “contracting system” was “market preserving” in that it stimulated local governments to become entrepreneurial and to seek the growth of their local economies.

\textsuperscript{21} Local councils, although not freely elected, are often open to the complaints and demands of local residents. Furthermore, local governments in richer areas where there is more residential mobility, such as China’s coastal provinces or in the Ho Chi Minh City area in south Vietnam, need to be more responsive to the preferences and demands of residents to retain and attract qualified workers and to compete for investors.
<table>
<thead>
<tr>
<th>Component</th>
<th>Desirable Feature</th>
<th>Second Best</th>
<th>Least Desirable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Representation</td>
<td>Popular Election of executive and legislative branches</td>
<td>Indirect Election. Part elected (legislative) and part appointed (executive)</td>
<td>Appointment by higher level government</td>
</tr>
<tr>
<td>Chief Officers</td>
<td>Locally appointed</td>
<td>Central Secondment</td>
<td>Direct delivery by line ministries.</td>
</tr>
<tr>
<td>Expenditure Discretion</td>
<td>Significant control over how money is spent</td>
<td>Autonomy with significant limits. Expenditure mandates, minimum requirements and norms</td>
<td>Effectively a spending agent of the higher level government</td>
</tr>
<tr>
<td>Budget</td>
<td>Local approval; hard budget constraint</td>
<td>Local approval; soft budget constraint</td>
<td>Central approval; soft budget constraint</td>
</tr>
<tr>
<td>Revenue</td>
<td>Significant local power: discretion to change rates in a closed list of taxes</td>
<td>Some local power: discretion to choose tax bases, introduce new taxes</td>
<td>No revenue raising power and full reliance on revenue sharing</td>
</tr>
<tr>
<td>Intergovernmental equalization transfers</td>
<td>Unconditional and formula driven</td>
<td>Conditional and formula driven</td>
<td>Ad hoc and discretionary</td>
</tr>
<tr>
<td>Conditional, specific purpose</td>
<td>Block grants using formulas or other objective allocations; matching</td>
<td></td>
<td>Ad hoc and discretionary</td>
</tr>
<tr>
<td>Borrowing Powers</td>
<td>Broad borrowing powers and hard budget constraint</td>
<td>Restricted borrowing powers</td>
<td>No borrowing powers</td>
</tr>
<tr>
<td>Civil Service</td>
<td>Locals hire, fire and determine compensation</td>
<td>Locals hire and fire but unable to determine compensation</td>
<td>No power to hire, fire, or determine compensation.</td>
</tr>
</tbody>
</table>
It is also important that the local council appoint the local chief officers (e.g., treasurer, chief education officer, etc.). Otherwise, implementation will not be locally directed, and services may be delivered as directed by the center. However, local appointment of chief local officers presupposes the existence of an adequate pool of local administrative talent. This is more likely to be true for postings in urban areas than in rural areas. In cases where there is a shortage of skilled administrative officers, secondment of central officials is a second-best approach until adequate local capacity is developed. There will be a loss in local control but this might be made up with gains in technical efficiency. The bigger problem with secondment policies is that they may weaken the drive to generate more permanent solutions, such as improving administrative capacity through local training programs.\(^{22}\)

Tanzania’s public employment system is in transition and is confusing. By law, local governments have some control (hiring and firing) over staff but Council Directors and heads of departments continue to be appointed and managed by the central government. In addition, certain line ministries continue to transfer their staff to the local government level, despite the new legislation (NCG, 2004, p. 56).

**Making Policies Consistent.** Getting all the pieces of the fiscal decentralization puzzle on the table gives the best chances for success. Making the pieces fit together is the sufficient condition. In a sense, this is what the sequencing question is all about. For example, Indonesia’s big-bang decentralization of 2000 did consider both expenditure assignment and revenue assignment, but the planning was done by two different ministries with little coordination (Alm, Aten and Bahl, 2001). There did not seem to be a concern about making the two sides of the budget fit together.

Not everyone believes that design should be comprehensive. Some countries (and international agencies) may at times think of a fiscal decentralization program as no more than a revision of the revenue sharing system, or an upgrading of the property tax administration. Some ignore the fiscal issues completely and think of decentralization only in terms of the local election system, and planners very often focus exclusively on getting inputs from local population groups included in the project selection discussion. The “one dimension” approach is not likely to be sustainable or produce successful decentralization because other elements crucial to capturing the benefits may not have changed in a supportive way, or may even work to yield offsetting results. There are many examples of problems with piecemeal reform from which we might draw:

- Russia by the mid 1990s had reformed its intergovernmental fiscal system to replace *ad hoc* grants with a formula-based transfer, but had not removed its extensive system of expenditure mandates nor had it fully hardened the budget constraint because of “mutual settlements” between the federal and regional governments, which were actually used to provide soft budget loans and grants. Clearly there were gains in transparency and stability on the transfer side, but this was not accompanied by increased local discretion as to the expenditure of these monies nor by incentives for revenue mobilization and more responsible use of resources. Fortunately, recent reforms have addressed these problems, but others such as reduced accountability by the elimination of direct elections of regional governors have been introduced.

- South Africa has assigned significant non-property taxing powers to subnational governments, including a payroll and turnover tax, and has granted local governments some borrowing powers. However, the government still has not put in place a hard budget constraint for local governments to promote incentives and force efficient use of

\(^{22}\) However, there can be some benefits also from the practice of secondment, such as bringing social cohesiveness in ethnically diverse countries with otherwise little population mobility.
these instruments. Many other countries, for example India and Spain, are suffering today from the same problem.

- China’s 1994 fiscal reform dramatically changed the national revenue sharing system, gave local governments more control over the administration of locally assigned taxes, and changed the balance of revenue availability between the two levels of government in favor of the Center. However, no commensurate changes in expenditure assignment were made. This led to significant pressures on subnational budgets and to the use by these local governments of “illegal” fees and other extra-budgetary means of financing their expenditure obligations. This in turn meant less fiscal transparency and in general poorer quality fiscal management and budgeting practices.

Certainly one can have great sympathy for a strategy of not introducing more decentralization and changes than can be handled at one time. However, it is important that there be an overall plan and that each decentralization measure introduced fit into that plan now and in the future.

**Finance Follows Function**

It is important to get the correct order of reform as regards to how much should be spent by subnational governments, and how much revenue should be given to subnational governments. There is a conventional wisdom. First should come the assignment of expenditure responsibility to subnational governments, and then the assignment of revenue raising powers and central government revenue shares should be determined. There is a good logic to this finance-follows-function rule.

The first reason is that one cannot establish the required level of subnational government revenues independent of an estimate of expenditure needs. If one begins this process by fixing the subnational government revenue share, the correspondence between expenditure needs and revenue allocations is lost.\(^{23}\) The amount of revenue given to subnational governments (in transfers) should be driven by how much the higher level government thinks ought to be spent on the assigned functions.

The second reason is that it becomes difficult to effectively impose a hard budget constraint at the subnational level if there is an insufficient revenue assignment. Examples abound of local governments being given expenditure responsibilities and mandates that exceed their assigned revenues. They may take this to mean that they are expected to overspend and that the deficit will be covered by the higher level government. If, on the other hand, subnational government revenues are over assigned, then the central government can become fiscally strapped and there will be pressures on the central budget deficit. Such was the case in China in the mid-1990s.

There is a third argument for finance to follow function, and this is discussed less often. The economically efficient assignment of revenues requires a prior knowledge of expenditure assignment. The simple classification presented in Table 4 gives a flavor of the issue. For example, services that may be priced (public utilities, bus transportation) should be largely financed by user charges; general services with a local area benefit zone (roads, parks) should be financed with local taxes; and goods characterized by significant externalities should be financed from region-wide taxes and intergovernmental transfers. A blanket statement that the aggregate of local government services should be financed by user charges, property taxes, and

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\(^{23}\) Note that even if the subnational government revenue share is determined on a basis of expenditure needs, it does not follow that there will be a correspondence for every local government. The finance follows function rule applies only to the aggregate vertical share.
intergovernmental transfers, simply misses the efficiency point. Government must settle on the assignment of expenditure responsibilities to local governments, before it can choose an efficient mix of taxing (Bahl and Linn, 1992).

A fourth reason is that the assignment of revenue powers may cause a waning of the resistance of line ministries to expenditure realignment. Once the funds to support certain functions have been transferred, there is little rationale for line ministries to argue to keep control over direct delivery. Beginning the reform discussion on the expenditure side invites this debate.

Despite all this good a priori reasoning, most countries begin the business of intergovernmental reform on the revenue side. Examples of this sequencing abound in Latin America, and Thailand is in the midst of doing so. And, there are some who would see this as a not-too-serious policy mistake. One justification for this “back-end” approach is that the expenditure needs of subnational governments often are so great that feasible intergovernmental revenue reform programs do not typically make much of a dent in the service level and infrastructure backlog. In such a case, it is sometimes argued that it matters little where one begins. This would seem a flawed argument, though. All that happens in this case is that standards for minimum subnational government services are increased or reduced in an implicit way. It is far better to do this reduction explicitly than implicitly. This argues for starting intergovernmental fiscal reform on the expenditure side.

Another reason why many countries get the revenue and expenditure assignment decision in the wrong order is that the revenue side is easier to work. Politically, at the central level, it is rather easy for a President to propose and a parliament to approve a proposition for a given percentage of central government revenues to be shared with local governments. This is a populist measure that very few outside the government or inside the government, with the possible exception of the Ministry of Finance, will oppose. Matters are much more political and opposition more likely to take place for issues involving the decentralization of expenditure responsibilities. From the perspective of local governments, an entitlement to some level of revenue sharing is also clearly more attractive than being assigned expenditure responsibilities for which there may or may not be adequate funding.24

The assignment of expenditure responsibility is a much more politically charged issue. Giving local governments significant control over the expenditure budget reduces the control that can be exerted by the line ministries and shifts the balance of power away from the center. Moreover, once decentralized to local governments, expenditures are not so easily controlled or “called back.” Revenue assignment, as practiced in most developing countries, is a less permanent proposition: local tax rates can be limited or subject to approval, intergovernmental transfers to local governments might not be delivered as promised, and all borrowing might be subject to central government approval.

24 The exception is those countries where decentralization is driven by political, ethnic, or separatist reasons. In this case regional and local governments are eager to get as much expenditure responsibility as possible even if it is well known that the finances may not follow for some time to come. That is the position taken, for example, by ethnic republics in Russia, such as Tatarstan and Bashkortostan, or by the ethnic Indonesian provinces of Aceh and Papua-New Guinea.
TABLE 4
Efficiency-Based Criteria for Revenue Assignment

<table>
<thead>
<tr>
<th>Expenditure Category</th>
<th>Can be Priced?</th>
<th>Externalities?</th>
<th>Benefit Spillover beyond the local region?</th>
<th>Examples</th>
<th>Proper Financing Instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td>General local services</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
<td>Local roads, parks</td>
<td>General local tax</td>
</tr>
<tr>
<td>Utility-type services</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Buses, water supply</td>
<td>User charge</td>
</tr>
<tr>
<td>Market goods</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>Consumer goods</td>
<td>Private sector</td>
</tr>
<tr>
<td>Social goods</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Education, health</td>
<td>Combination of local and regional taxes and transfers</td>
</tr>
</tbody>
</table>

Source: Bahl and Linn, 1992
On the implementation side, policy analysts know well how to design reforms in tax systems and intergovernmental transfer systems, implementing these reforms is a manageable issue, and such reforms can yield visible, short-term results. The decentralization of expenditure responsibility poses more challenging implementation problems. First, the decentralization of expenditure responsibilities needs to be performed simultaneously in the context of reformed national sectoral laws (e.g. Education Law, Health Law, etc.), which are fully coordinated with the Decentralization Law not only in terms of expenditure assignments, but also clearly redefine the role to be played by lines ministries and other central government agencies within the new decentralized framework. The failure to coordinate central government sectoral policies with decentralization policy generally leads to confrontations between agencies at different levels of government, confusion in expenditure assignment, and inefficient outcomes. Second, subnational governments must have the capacity to deliver the newly assigned services or to develop the new skills to do so. The public policy fear is that service quality will deteriorate while local governments are climbing the learning curve. Expenditure assignment is a more risky proposition.

Most bothersome of all, there are no hard and fast rules about which functions should be assigned to which level of government. Work on expenditure assignment requires a painstaking unbundling of each function into sub functions, and for concurrent functions, the identification of attributes for regulation, financing and implementation, and then analysis of the viability of each as a central, state or local responsibility. Policy analysts, international donors, and central ministries all find reasons to shy away from this difficult analytic task.

Some analysts and even policy makers in countries undergoing recent decentralization take an “evolutionary” view of the expenditure assignment question. In this mind frame, the different levels of government will eventually sort out the functions they should perform. After all, they claim, one can find decentralized developed countries with rather stable and well sorted out expenditure assignments at different levels of government, which never had a comprehensive law explicitly stating expenditure assignments. However, this argument ignores the fact that it may have taken these countries decades, if not centuries, of political friction and inefficient public sector operations to arrive at the de facto expenditure assignments one can observe today.

Is there a correct way to implement the finance-follows-function rule for sequencing? We suggest a three-step process. First, one might begin by clearly assigning a package of expenditure responsibilities to subnational governments on the basis of the subsidiarity principle, benefit areas of services and externalities present, economies of scale and scope, and best international practice. This is a subjective exercise, and there is no unique answer for every country. In fact, many countries apply these exact criteria and come to different answers about what subnational governments should do.

The second step is to establish the cost of providing minimum levels of these services. As is the case for expenditure assignment, there is no one best way to do this. The international practice suggests three basic approaches:

1. One can use a “retrospective” methodology and try to calculate a cost that is equivalent to the moneys spent on those services before they were decentralized (e.g. Spain). This approach simply assigns a vertical share of revenues to the subnational government sector that is adequate to cover the existing level of spending for the functions being reassigned.

The advantage of this approach is that it is relatively easy to implement and minimizes disruption. The disadvantage is that it assumes that existing levels of spending are somehow “proper,” when in fact it is these existing levels that may have prompted the move toward decentralization in the first place. If it’s done on a region-by-region basis, it may perpetuate the
service and funding inequities of the past. This approach is also problematic in a dynamic sense, for example if it is used to evaluate expenditure needs in equalization transfers formulae in future years, because the distribution of population and other conditions may change very fast.

2. A second approach is to establish minimum spending levels by using per capita (or per client) financial norms. An advantage of this method is that the per capita financial norms can be modified by information on existing conditions in the local government areas, such as differences in prices due to climate or geography (e.g., South Africa, Ukraine, and the U.K.).

3. A more complicated approach is to define minimum physical service standards for the provision of each service and try to cost them out separately (e.g., Japan, the Netherlands, and Denmark.) This approach has the advantage of allowing a costing of the inputs required for delivering a minimum level of services. Hence it can provide detailed information on the cost implications of higher or lower vertical shares.

The third step in this process is to bring affordability into the discussion. Ultimately, the choice of an exact minimum service level will be driven by affordability. While the retrospective method ensures affordability, the per capita method and the method that costs out and adds up physical norms and standards does not. What is affordable is also driven by national priorities. Thus, how a country ends up quantifying expenditure needs also depends on the national consensus regarding how important some services are vis-à-vis others, and in particular those assigned to the subnational sector vs. those retained at the central level. Some methods for quantifying expenditure needs, for example financial per capita expenditure norms, are more adaptable to changes in national priorities than others.

There is one last normative issue to be considered. This is whether expenditure assignments should be uniform for all subnational units. The alternative is some asymmetric treatment depending on administrative capacity and readiness of subnational governments to absorb expanded expenditure responsibilities. Asymmetric treatments have the disadvantage of creating complexity but, the ability to adapt to very different conditions and capabilities may more than offset that disadvantage. Furthermore, asymmetric treatments are by nature temporary, because local governments have an incentive to use all the technical assistance provided so that they can graduate and assume the competencies assigned to their peers.

**Indonesia.** Indonesia’s planning for the big bang decentralization of 2001 was led by an expenditure assignment team (Ministry of Home Affairs) and a revenue team (Ministry of Finance). The two working groups were charged with fixing the expenditure assignment and revenue package for the subnational governments, but they worked independently and submitted independent recommendations. The MOHA recommended that five functions be assigned to the national government, and that all else be devolved to local governments. There was no estimate of the amounts of expenditure that this reassignment implied. As it turned out, the Ministry of Finance identified a vertical share in the intergovernmental transfer system (approximately 25 percent of national revenues raised) that was more than adequate to cover the aggregate amount of expenditures devolved, based on the amounts spent in the previous year (Hofman and Kaiser, 2004). De facto, it was a retrospective approach. Two years into the decentralization program, the Ministry of Home Affairs was still involved in an exercise to identify minimum needed

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25 We should note that the problem of quantifying needs is not unique to expenditure assignments. Equalization transfer systems that take into account needs also are presented with the same exact problem.
expenditures based on physical standards. By 2005, it still seemed to be the case that financing was leading function.

**Tanzania.** Tanzania perhaps has come closer to following a finance-follows function rule, though the practice is far from satisfactory. In practice, there is a reasonably clear assignment of expenditure responsibility for local governments, though there is some confusion over responsibility for concurrent functions. The Minister for Local Government in the Office of the President has substantial discretion in the allocation of grants to local governments and makes the allocations according to perceived expenditure needs and local government requests. Until recently, these funding requests were supposed to be based on a set of national minimum standards for public services that had been set by Government. While the central government has not been able to provide adequate funding to achieve these “minimum standards”, at least the standards provide an objective reflection the policy intentions of the central government. Since there are few local government own source revenues, these aggregate allocations which are negotiated by sector more or less account for the total amount of local financing. The system is far from transparent and is driven by a higher level of government rather than by local voters. Still it is a system where in some fashion, the financing of local government follows the functional assignment.

**Russia.** In Russia, explicit and stable expenditure assignments at the three government levels were finally achieved with the approval of the Budget Code in 2001. This was preceded by periods where the federal authorities shifted down quite indiscriminately expenditure responsibilities to subnational governments to either help balance its own budget or discontinue programs that were politically difficult to terminate, such as consumer subsidies. An important part of the expenditure assignment problem in Russia before the Budget Code was the presence of large unfunded expenditure mandates to subnational governments, especially in social welfare. This led to payment arrears and defaults and lack of citizen respect among subnational governments. The Budget Code made this practice illegal and currently all federal expenditure mandates come with their own financing.

**India.** India’s expenditure assignment has been left to the 1950 Constitution and its amendments over the years. The Seventh Schedule of the Constitution contains the exclusive lists of expenditure responsibilities for the Union and State governments as well as the concurrent responsibilities. Any residuary functions not listed in the Schedule are assumed to reside with the Union government. No responsibilities were assigned to the local level until 1992 when an amendment to the Constitution assigned up to 37 expenditure functions to urban and rural local governments, but all are concurrent with State governments.

The Constitution also assigned revenue sources to the Union and State governments, with the majority accruing to the Union government, and created a Finance Commission for advising the Union government every five years how to share its revenues with the States. In theory, the Indian arrangement would seem to obey the “finance follows function” rule.

Nevertheless, there is continuous debate about the adequacy of revenues to cover subnational grant expenditures. How to best solve the vertical imbalance between expenditure responsibilities and revenues at the state level has been now addressed by twelve Finance Commissions but the issue continues to be a hot one in Indian politics. Besides technical issues involving incentives and soft budget constraints, friction on the recommendations of the Finance

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Commission can be expected because of the different perspectives and priorities of the central and state governments.

**Mexico.** In Mexico, the Constitution refers to the division of some responsibilities, but it leaves explicit assignments to sectoral laws. In practice, expenditure responsibilities have been decentralized by unilateral decisions of the federal government on a sector-by-sector basis. This has had the advantage of sometimes enabling subnational governments to participate in the planning and letting them negotiate with the federal governments the different stages of the decentralization. Another advantage of the gradual approach followed in Mexico is that despite the existence of many concurrent responsibilities, the assignments often distinguish among the attributes of different levels of government concerning regulation or normative design, financing and implementation of the public services. Subnational financing involves mostly revenue sharing and different transfers.

**Significant Local Government Taxing Powers**

It is important to a complete decentralization that subnational governments have independent sources of revenue. Voters will hold their elected officials more accountable if local public services are financed to a significant extent from locally imposed taxes and charges, as opposed to the case where financing is primarily by central government transfers. The local tax must be visible to local voters, large enough to impose a noticeable burden, and the burden must not be easily exported to residents outside the jurisdiction. Minor taxes and nuisance taxes will not do the trick.

If all financing is from revenue sharing and other forms of transfers from higher-level governments there is a danger of the lower level government becoming a spending agent for the center. Such an arrangement can give subnational governments less discretion in deciding how much they will spend, and how they will spend it in the case of conditional grants. The imposition of a hard budget constraint is more difficult when there is no local revenue raising capability. Once a culture of dependency on revenue sharing and transfers is created, subnational governments will always push for more funding from above as opposed to using any own revenue autonomy that may have been granted to them. As the international experience shows, many central/federal governments eventually succumb to demands and pressures from below for more revenue sharing and the pattern continues.

Some will say that this situation results because there are not good choices available for revenue-productive local and regional government taxes. This is simply not the case. Individual income taxes, piggyback excise taxes on a destination basis, property taxes and betterment levies, user charges, taxes on the use of motor vehicles, and even subnational value added taxes all can be viable options if they are properly structured (Bahl, 1999b).

Note that it is not necessary for the local government to take on the administration of a tax to make it local, although in some cases it may be desirable. It is sufficient to establish fiscal independence for the subnational government to have some discretion in setting the tax rate. This act alone can establish accountability.

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27 See Martínez-Vazquez and Timofeev (2005) for a discussion of the issues surrounding the choice of decentralizing tax administration.

28 There are three different ways to provide tax autonomy to local governments: (i) to let them choose their taxes, (ii) to let them change the tax base of existing taxes, or (iii) to let them set the rate of some existing taxes. Of the three, the last one is the least troublesome from the viewpoint of administration and taxpayer compliance costs, and equally effective in providing accountability. See McLure and Martínez-Vazquez (2000).
There is also a question of where in the sequencing of decentralization policy the revenue independence of the subnational governments should be established. There are good arguments for it to be in the first wave of decentralization policies. Accountability of local officials is a key component of the successful decentralization, and to leave out the revenue raising effort reduces the accountability of these officials. Moreover, it is important to get local governments and their voters into a new fiscal culture, one that requires making some sacrifice in terms of tax burden to gain the benefits of higher levels of public expenditures.

There are several other important beneficial effects of subnational government revenue autonomy that are often overlooked. First, subnational tax autonomy is the best way, if not the only way, to address permanently the problem of vertical imbalances in fiscal decentralization design. Second, there cannot be a hard budget constraint on subnational governments unless at the margin they are required to use their own revenue instruments to raise additional revenues. Third, revenue autonomy is a key feature of subnational governments’ borrowing capacity and creditworthiness.

In practice, local revenue sources are often not part of the initial decentralization package. To some extent, this is because there is no constituency for this policy. Central government officials do not want to devolve taxing powers for fear of competing with local governments for the same taxing base. Subnational government officials are loathe to take on the responsibility of making politically unpopular taxing decisions to meet budget needs. Revenue sharing and other intergovernmental transfers are a much easier path. This can allow the central government to retain control over revenues, and it can reduce the accountability of local officials to their constituents.

Indonesia. The Indonesian “big bang” decentralization did not feature any significant increase in taxing powers for local governments. Prior to the time decentralization was introduced, the tax legislation allowed subnational governments access to 11 taxes, none of which had a significant base (Simanjuntak and Mahi (2004). A new law passed in 2000 broadened the taxing powers of local governments, but in a peculiar way. Additional local taxes could be levied and broad criteria were laid down. Any new tax chosen would be required to fit the criteria, with the Ministry of Home Affairs being the judge. The criteria --- tax only immobile bases, no overlap with central tax bases, no distortions to the economy --- were not clear to the local officials and perhaps not to the MOHA either, and quite likely impossible to fulfill. The result was a failure to establish a local government tax system, and this remains a key challenge for the long term effectiveness of the Indonesian decentralization.

Tanzania. Neither has the decentralization program in Tanzania provided for any significant increase in its own source revenues. In fact, concurrent with the present decentralization program (focused primarily on local provision of public services), the local governments have been denied access to certain taxes which they had previously levied. The 1982 Local Finance Act had given local authorities the power to levy a broad range of taxes and to set tax rates. However, apart from the property tax, none of these local taxes were broad-based and so local governments accounted for only about 5 percent of all taxes raised. Still, there was local choice over tax instructions, tax practices varied among local government authorities and something on the order of 10-15 percent of local government expenditures were financed from own sources.

The “open-list” approach to local taxation in Tanzania resulted in a local tax system that was flawed: complicated, highly fragmented, costly to administer and comply with, and inequitable. In 2003, the central government began a process of “rationalizing” local government taxes to remove some of these problems and to make the local tax system more hospitable to economic development efforts (Government of Tanzania, 2004). This led to the abolition of
some local taxes, including the Development Levy (a graduated poll tax), which was the most important revenue source for most local authorities, particularly in rural councils. The rationalization of local taxes caused both significant revenue loss and an increased dependence on central government in transfers. The Government is currently studying the best way to re-introduce some measure of local government revenue autonomy, driven in part by the desire to assure that local governments will be able to finance the maintenance cost of local capital infrastructure.

**Russia.** Russia’s decentralization initially relied heavily on revenue sharing and other forms of transfers. However, the system has evolved to provide subnational governments with limited, revenue autonomy. One problem with ascertaining how much tax autonomy really exists in Russia is that the budget classification system and the definition of specific revenue items do not by themselves reveal the degree of control the subnational governments have over these taxes. Taking into account only those taxes over which subnational governments have discretion over some aspect of the structure of the tax, the relative importance of “own-source” revenues (in total revenues) for local governments increased from 8.4 percent in 1996 to 14 percent in 2001, and at the regional level own-source revenue constituted almost 30 percent of total revenue in 2002, up from 21 percent in 1997. However, more recent measures, such as the elimination of the regional sales tax, have led to a decrease in regional tax autonomy.

**India.** In India, the Constitution assigns exclusive tax bases to the Union (federal) government and to the states. The taxes assigned to the states include the tax on the sale and purchase of goods, tax on agricultural incomes and wealth, land tax, stamp duties on registration fees, excise duties on the sales of alcoholic products, tax on motor vehicles, and tax on goods and passengers transported through roads and inland waterways. This is the equivalent of a closed list of assigned revenues to the states because the residuary powers to introduce any other tax forms reside with the Union government.

The constitutional principle of exclusive bases assigned to each level of government has proved over time to be quite constraining to the states’ revenue autonomy. In addition, the exclusive use of tax bases does not appear to be based on any economic considerations. For example, all income is taxed at the Union level, except for agricultural income that can be taxed at the state level. While the states can tax the sales of goods, the center can tax the production of goods (through excise duties). This situation may be improved with the scheduled introduction in 2005 of a dual central-state destination based VAT. Some of the autonomous taxes in India are inefficient. The “Octroi” is a tax on the import or entry of all goods in any particular jurisdiction, and it represents an impediment to free flow of goods in the domestic market. In addition, the tax on interstate sales of goods on an origin basis also distorts the free flows of goods in the economy and it is unfair to poorer importing states.

**Mexico.** The sources of own revenues at the state level in Mexico comprise the payroll tax (used in 23 of 32 states), annual taxes on automobiles and charges and fees. Other than the capital city, own taxes represent less than 5 percent of state revenues. An additional 6 percent of state revenues come from fees and charges. In recent years, state governments have become more dependent on federal transfers. Municipal governments are on average more self-reliant on their own revenues, raising about one-third of total revenues from their own sources, mostly from property taxes ad water-user charges.

**Design of the Intergovernmental Transfer System**

An important sequencing question has to do with the design and implementation of intergovernmental transfers. The right order of policy formulation is to first ask and answer the
question about which of many objectives the intergovernmental transfer system is to accomplish, and then to design the reformed system.

There are many different kinds of intergovernmental transfer systems, and they have many different types of impacts on local government finances. Some stimulate local spending, some are substituted for local revenue effort, some are equalizing, and some lead to more local government fiscal autonomy than others. Countries too often enter into grant design without fully exploring the alternatives and their differential impacts.

An important first step in sequencing decentralization policy is to determine the objectives of the intergovernmental transfer system, and then move to a design of the program. Typically the objectives will involve a certain degree of equalization to address fiscal disparities arising from differences in fiscal capacity and expenditure needs across jurisdictions, which will call for the design of an equalization grant system, and other objectives such as encouraging higher levels of expenditure in some sectors of national importance by local governments, which will call for conditional transfers. As simple an axiom as this sounds, careful study of the goals of the program are often pushed aside in the rush to get something agreed to.

Even as part of the design of the intergovernmental system, there are sequencing issues. The major issue is that different types of transfers have different objectives, and it is important to sequence grant design according to these objectives. One goal is to reconcile the difference between the assignment of expenditure responsibility and the assignment of revenue raising powers. This vertical balance goal of transfers is arguably the first job to take care of in designing the transfer system. The second step in grant system design is to take care of conditional grants for those functions of national/regional importance where it is feared that under-provision might take place without assistance. Finally, the equalization grants are designed to clean up the inequities in horizontal distribution that result after the first two pieces of the transfer system are designed.

Another way to look at this is that intergovernmental transfers have two dimensions: the size of the divisible pool, and the distribution of this pool among eligible local government units. Some have referred to the divisible pool dimension as having to do with the vertical fiscal balance between the central and subnational governments, and the allocation dimension as having to do with horizontal fiscal balance (Bahl, 1999b). A logical order of the design is to focus first on the vertical share and then move to the design of the distribution among eligible local governments.

**Indonesia**

Indonesia’s intergovernmental transfer program was more or less true to the decentralization-local autonomy goals of the decentralization. The principal component of the transfer system is the “DAU,” which is a general purpose grant. It replaced two grants that had been conditional: one focused on supporting expenditures for infrastructure, and the other a support program for the compensation of government employees working at the subnational level. The goals for the new program were to increase the autonomy of local governments in the

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29 There is often a debate about what is an “intergovernmental transfer.” Grants to lower-level governments are clearly intergovernmental transfers. The confusion comes in the case of shared taxes and tax expenditures. The following examples may help to clarify. If the local government can control either the rate or base of a levy, it is a tax. If the rate and base are determined by the higher-level government, and revenue collections are assigned to the local government, it is a transfer. If the central government allows deductibility of property taxes from central income tax liability, it is likewise a form of transfer.

30 For a primer on transfer design issues see Bahl, Boex, and Martinez-Vazquez (2001).
delivery of their new service responsibilities, to promote the accountability of newly elected local officials, and to distribute the money so as to recognize disparities among local governments in fiscal capacity and expenditure needs.

The vertical share of the DAU was set at 25 percent of central revenues, which gave the subnational government some certainty about their entitlement. This would promote efficient local government fiscal planning. Thus far, the central government has not reneged on distributing this entitlement. The DAU is an unconditional transfer, which gives local officials discretion over its use (until now, through the hold-harmless provision, the funds have been used heavily to support the local government wage bill, over which they have little control). The distribution among local governments is by a formula based on expenditure needs and fiscal capacity, and is meant to be equalizing.

The bigger problem area for intergovernmental transfers in Indonesia has been the tax sharing arrangements for natural resources. The allocation is made on an origin basis with some local governments with rich natural resources receiving very large allocations. Not unexpectedly, revenue sharing from natural resources has led to great disparities and a significant amount of controversy (Bahl and Tumennasan, 2001). The cause of the problem is that the government never really settled on what it wanted to do with this transfer program. One objective was to appease the natural resource regions, which had long felt exploited and were threatening to leave the union. Another objective was to broaden the base for transfers more generally. Yet a third goal might have been to compensate the natural resource regions for the depletion of an exhaustible resource. Whatever the underlying reason, the revenue sharing arrangement for natural resource revenues was put together in a hurry, and remains under fire as the piece of the transfer system that does not match the goals of the fiscal decentralization.

Tanzania

The system of intergovernmental transfers in Tanzania is in a state of flux as Government moving to implement its new decentralization program. Previously, grants to local governments were strictly earmarked, vertical shares were determined in an ad hoc way, and the distribution among local governments was done primarily by negotiation. This was inconsistent with the goals for the decentralization, which are to give local governments more discretion in delivering public services. Beginning in 2004/05, the grants to local governments for primary education and local health services were distributed by formula, with the remaining local government sectoral grants to follow this pattern by July 1, 2005. While this will improve the transparency of the system the determination of the vertical shares will continue to be done on an ad hoc basis. At the same time, the grant system will remain essentially conditional although the nature of the central government control (conditions contained in local budget guidelines as opposed to systematic hands-on intervention of central government officials) should allow local governments considerably more autonomy over the delivery of local services.

To some extent the Tanzanian government got the sequencing right. First it established the goals for the system of intergovernmental transfers -- to allow discretion in local service delivery and to distribute amounts in a more objective way -- and then it reformed the system of transfers to remove many conditions and to substitute a formula for a negotiated allocation.

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31 In 2005 the Government is planning to introduce a separate (from the DAU equalization transfer) grant to address the funding of the local governments wage bill. This will bring more transparency to the DAU but it also is likely to reduce the pool of funds that had been set aside for equalization purposes.
Russia

In the early transition years most transfers in Russia were negotiated subventions to those regions that the center felt did not have adequate resources from own revenues and revenue sharing to fund some minimum expenditure budget. The process lacked transparency and was subject to manipulation, but with hindsight it was effectively equalizing. Although the federal government introduced a more transparent formula-driven equalization transfer system for the regions in 1994, the results of the formula were subject to political manipulation for a period of several years. It was not until 1998 that a new improved formula was introduced and the outcomes of the distribution were reflected in the annual budget allocations. The current equalization transfer system (Fund for the Financial Support for the Regions) is based on an index of expenditure needs which is used to “normalize” or adjust per capita revenues. The formula assigns equalizing transfers to regions for which the normalized per capita revenue falls below some threshold. Starting in 2005, the index of expenditure needs is calculated as the weighted sum of three sub-indices for relative differences in wages, housing and utility costs, and the price level.

Other improvements in Russia’s transfer system have been the practical elimination of “mutual settlements,” which were non-budgeted transfers that provided (some) regions with a soft budget constraint, and the introduction of conditional grants including funding for what have been until recently unfunded expenditure mandates to the regions in the area of social welfare.

India

Transfers from the Union government to the states come from three different sources, which are not always coordinated. First, grants-in-aid for equalization purposes and others recommended by the Finance Commission, which is appointed by the President every five years. In addition, the Finance Commission distributes the revenues from shared taxes. All these transfers are unconditional.

Second, formula-based transfers are distributed by the Planning Commission to fund the states’ development plans, which are a combination of grant funds (30 percent) and loans (70 percent), although for the “special category” states those shares are 90 and 10 percent respectively. These are all conditional transfers, but the conditionality is basically inoperative for the general category states, since the transfers for these states are not all related to their investment plans. In fact some of these states use these funds to pay for current expenditures, such as salaries.

Third, specific conditional matching and non-matching grants implemented by the line ministries of the central government, for a variety of central government “schemes,” such as poverty alleviation, family planning, etc, with total number of schemes exceeding 100. Part of these funds is passed on to the local government, in theory based on recommendations by the State Finance Commissions. The monitoring of these transfers purportedly is poor and many have deviated from the basic justifications for this type of conditional grant.

Overall, this is a system of transfers that seems ambivalent about what it is trying to accomplish. One can point to a number of problems, beginning with the need to do a better job of identifying expenditure needs and fiscal capacity in the equalization transfers. The Finance Commission formula is not truly an equalization grant system but rather a general or unconditional grant funding for revenue sharing which has equalization grant features. The transfers from the Planning Commission (State Plan Assistance) also pursues equalization, mixed with other objectives: tax effort, improved fiscal management, “national objectives” and “special problems.” These two sets of transfers are not well integrated in terms of the roles they are
supposed to play. The mixing of equalization and other objectives confuses the main role and results of the equalization transfers.

**Mexico**

The transfer system in Mexico is composed of *participaciones* or revenue sharing and *aportaciones* which is the system of grants, proper. The current system of revenue sharing dates back to 1980 *Sistema Nacional de Coordinación Fiscal* (National System of Fiscal Coordination), which originally distributed a share of federal revenues to the states in proportion to the revenues collected by each state prior to relinquishing part of their tax authority to the federal government. Currently these revenues are distributed largely according to population and the previous year’s allocation (adjusted for tax effort). There are also some other minor forms of revenue sharing from specific taxes. All transfers (other than revenue sharing) are earmarked transfers for infrastructure investments and a variety of social programs. The most important set of these transfers is the so-called “Ramo 33” (for the number of the budget line item under which they appear), and include transfers for the payment of teacher salaries and health workers, and to a less extent for capital investment and other specific activities. The states also receive a variety of matching conditional grants from line ministries. The resulting distribution of per capita allocations is only neutral with respect to income and the distribution criteria tend to lack transparency.

**Subnational Governments Must Face a Hard Budget Constraint**

Fiscal discipline is a key element of a successful decentralization strategy. It is important that it be introduced when the program begins. If subnational governments are not forced to operate with balanced budgets, they become accustomed to looking to the higher level governments to cover their shortfalls. The moral hazard here is that the subnational governments will consciously overspend, knowing that their losses will be made good. Furthermore a soft budget constraint will tend to discourage own tax effort and encourage inefficient and even wasteful spending. As many countries have learned, it is difficult to break the culture of a soft budget constraint.

A hard budget constraint implies that those local governments who are given autonomy will be asked to balance their budgets without recourse to any end-of-year assistance from the central government. Central governments must enforce this rule, and local governments must believe that they are “on their own.”

Enemies of the hard budget constraint include fiscal measures such as the following:

- Deficit grants, i.e., year-end grants to cover revenue shortfalls;
- Bailouts on delinquent debt;
- Direct coverage of year-end shortfalls on certain items of expenditure; and
- Provision of local revenues that are inadequate to cover the expenditure needs of local governments.

A hard budget constraint is not always a central tenet of decentralization. Many central governments prefer to hold to a paternalistic approach to intergovernmental fiscal relations. The following is not an unheard of scenario. The fiscal year begins with a vertical imbalance between local government expenditure needs and revenue authority, and perhaps even an uncertain level of grant distribution from the center. A year-end budget deficit is, in effect, planned, and deficit grants are a guarantee that local governments come to depend on.
In other cases, there may simply be a flawed design of the intergovernmental fiscal system. Brazil’s states did not face a hard budget constraint and increased current expenditures in the 1990s even when the resources were not available to cover debt repayment. Ultimately, there was a federal bailout.

**Indonesia**

The Indonesian decentralization is built on the idea of a hard budget constraint for local governments. In effect, local governments may spend until their funds run out, but then may spend no more. This seems to work in the Indonesian system because the initial amounts of transfer were pegged at levels to cover at least all personnel costs.

**India**

India is a case at the exact opposite end, with the states operating under a de facto soft budget constraint sanctioned by Union government policies. Many states governments in India run large recurrent budget deficits and borrow to finance current expenditures. In some cases these deficits reach 50 percent of the budget or more and current expenditures are routinely financed through borrowing in many states. Although some states are fully fiscally responsible, there are no consequences to good fiscal behavior, just as there are no consequences to bad behavior. Actually, irresponsible fiscal behavior at the subnational level is facilitated, if not encouraged, by institutions and practices originating with the Union government.

The Constitution allows states to borrow from the Union government and from the markets but with the proviso that if the state is indebted to the Union government, then it requires permission prior to borrowing from market sources. The states also borrow from public provident funds, a share of national government certificates state residents buy through the post offices, and a few other odd sources. The composition of state borrowing is heavily tilted toward intergovernmental dealings. Central government loans represent around 60 percent of the state governments’ total debt, while private market lending represents around 22 percent and the rest of the loans come from borrowing from special sources including required holdings of state government bonds by commercial banks, borrowing from pension funds and shares of rural small savings (Rao and Singh, 2002). Although it would appear that the Union government should be able to control states’ overall borrowing, the Union government does not exercise its constitutional power to prohibit market borrowing to defaulted states and routinely has forgiven past loans to state governments. In addition, the states in practice are able to increase their borrowing capacity through the creation of separate corporations for the financing of public sector projects under state and central government guarantees and then borrowing from public enterprises.

It is fair to point out that the Union government has attempted in the past to harden the budget constraint by using a series of different tools with varied success. In 1999-2000 the Union government and 11 states signed MOUs in which the states promised fiscal reforms in exchange for the ability to use overdrafts backed by future revenues from tax sharing and grants. The actual experience was mixed and in some cases the overdraft advances were converted into long-term bonds. A different approach has been the attempt to tie some portion of intergovernmental transfers to state government fiscal reforms. In particular, the Eleventh Finance Commission presented a plan that pooled 15 percent of grant funds with an equal amount added by the Commission to compensate those states with an approved and implemented fiscal restructuring plan. The approach, it was felt, did not work because of the small scale of the incentives and because of biases in the scheme against poorer and smaller states. More recently, some states have passed “Fiscal Responsibility Acts.” This is a promising development but it is too early to tell whether it will be successful.
**Mexico and Russia**

Providing for a hard-budget constraint, among other things, requires that the central/federal governments are committed to not bailing out subnational governments. Verbal or even written commitment not to bail out sometimes is not enough to deter moral hazard on the side of lenders as well as borrowers (the local governments). There may be the perception that some local governments are too big and important to let them fail or there may be a history of bailouts in the past. This is the problem that Mexico’s federal government faces today: making everyone believe that it will enforce a hard-budget constraint with no bailout for state governments, after a very recent history in the 1990s of consistent bail-out policies. Russia, on the other hand, has never run into this problem in over a decade of decentralization. Besides the fact that subnational debt has been much lower than in Mexico, the Russian federal government never intervened when, at the end of the 1990s, several subnational governments defaulted in their domestic and foreign debt.

**The Decentralization Law**

It is essential that there be legislation governing decentralization, and it is essential that the legislation not be ambiguous. The rights and powers of subnational governments need to be clearly stated, and there needs to be a basis for the courts to decide disputes. It would seem almost axiomatic that the development of the decentralization law should follow the policy design. Otherwise, how could it reflect the goals of government and the consensus resulting from the national debate?

There is much more to be said about defining the best legal framework for decentralization. The fundamental question would seem to be how much of the decentralization framework should be in the constitution and how much should be in the decentralization law. This is a crucial sequencing decision, though for countries with longstanding traditions of decentralization, this question may have long ago been resolved. What shape decentralization takes in federal systems is fundamental to the very nature of the state and therefore the division of powers and responsibilities among the federal and subnational governments is an intrinsic part of the constitution in these countries. This is, for example, the case of three federal countries considered here: India, Mexico and Russia.

How much detail there is in the constitution about intergovernmental relations and how much is structured in separate laws varies from country to country. India’s Constitution is much more detailed about how fiscal relations (expenditure and revenue assignments and so on) should be structured than are the Constitutions of Russia and Mexico. In the case of Russia, two fundamental codified laws (the Budget Code and the Tax Code) now represent the legal backbone of the decentralization system. In the case of Mexico, the most important pieces of decentralization have been built by specialized laws either on the financing side (e.g., the National System of Fiscal Coordination law) or the expenditure side (e.g., the Education law) of the budget.

Although all power resides with the central government in unitary states, it is not uncommon in the constitutions of these countries (e.g. Indonesia and Tanzania) not only to acknowledge the existence of subnational governments but also to address some of the fundamental issues on how intergovernmental relations should be organized, but typically with much less detail and concreteness than in the case of federal country constitutions. In the case of unitary countries it is more common to find specialized laws focused exclusively on fiscal decentralization issues (for example, Law 22—on expenditure assignments—and Law 25—on revenue assignments and transfers—in the case of Indonesia, Although Tanzania’s constitution
makes reference to the role of local governments, the (fiscal) powers of local governments in Tanzania emanate primarily from the Local Government Acts (1982).

Thus, what is essential is to have explicit and clear legal rules governing decentralization; it is not so ‘essential’ how this is done. Often one hears the commentary that these rules should always be part of the country’s Constitution. This position is taken by those that fear the discretionary and potentially abusive exercise of power by the central government. Having these rules in the constitution is a measure of protection for local governments’ interest, probably a protection that is as good as it gets. Changing the country’s constitution requires jumping through many more hoops, but it can be done and it has been done. On the other hand, there also are some drawbacks to using the Constitution as the vehicle for structuring intergovernmental relations. An important one is the lack of flexibility and adaptation to changing needs and circumstances. If one views the intergovernmental fiscal relations as a continuous changing reality and sees a need for the legal system to adapt to this changing reality, then the role of the Constitution should be just to announce general principles and leave the details to laws and regulations.  

The case of India illustrates some of the perils of putting too much detail about intergovernmental fiscal relations in the Constitution. In particular, the decision to specify revenue assignments between the Union and the states in the Constitution has resulted in inflexible and outmoded revenue assignments for India. The Indian Constitution assigns to the states, among others, the tax on the sale and purchase of goods (but not services) and tax on agricultural incomes and wealth (but not incomes from other sectors). Any tax residuary powers are vested with the central government. This has led to the paradoxical situation that the sales (and purchases) of goods are taxed at the state level, the sales of services can only be taxed at the federal level. Allowing state governments to tax services would require a constitutional amendment. This situation has made it very difficult to reform indirect taxation in India, i.e., to introduce a VAT at the state and federal levels. Similarly, because the states can only tax income from agriculture, this has ruled out an income tax or piggyback income tax at the state level. Again, introducing this type of reform will require a constitutional amendment. Although there have been constitutional amendments for other issues in India, this is a difficult thing to accomplish.

Similar problems arose in Brazil. The 1998 Constitution gave state governments significant tax authority and guaranteed transfers, but it did little by way of specifying expenditure responsibilities for the states (Roddan, 215). The result was confusion over responsibility for service provision. On the other hand, the constitution restricted the right of states to dismiss public employees or reduce their salaries. This significantly compromised the position of the states in regards to control over their budgets.

32 The constitution can be effectively used to state general principles of tax assignments and other aspects of decentralization. One example of that is the prohibition of border taxes or similar levies that impede commerce and trade between subnational jurisdictions, as is the case, for example, with the ‘commerce clause’ in the United States Constitution. But even in this case the constitution may be misused as the case with the general principle of exclusivity of tax bases, adopted in the constitutions of several federal countries, including India. The assignment of revenue sources at different levels of government can be more effective when different levels can levy their taxes on the same base.

33 Other items in the closed list of taxes assigned to the states include stamp duties on registration fees, excise duties on the sales of alcoholic products, tax on motor vehicles, and tax on goods and passengers transported through roads and inland waterways.

34 The division of tax bases between the union and state governments appears to be quite arbitrary from today’s perspective although for sure there were some reasons that would have seemed relevant to the framers of the Constitution many decades back. This illustrates the point that the constitution is a more inflexible legal vehicle for structuring intergovernmental fiscal relations.
Whatever the approach chosen, relying more on the Constitution or more on other laws, it is clear that no legal documents can be as complete as to eliminate all possible ambiguities or differences in interpretation of the same legal text by two parties with potentially conflicting interests. Therefore, as the old wisdom goes, there is no system of federalism—and we will add, or of a decentralized system—-that is complete without an independent and strong judiciary. With the exception of Tanzania and perhaps India, an independent judiciary is a perfectible element in the decentralization structures of Indonesia, Mexico and Russia.

Implementing Regulations

The implementing regulations must fit between the development of the Law and Implementation. Without the law, the regulations become decentralization policy, a most undesirable state of affairs. If there are no regulations, those who put the decentralization programs in action are free to do so as they wish. Sequencing, in the case of the implementing regulations, is important.

The implementing regulations specify the detail for the roll out of the decentralization program. Like the law, these regulations follow the policy paper by providing the detail that governs the administration of the new system. Unlike the law, the implementing regulations can be easily changed. A different issue that arises is what should be included in the law and what should be included in the implementing regulations. The international practice varies with the legal traditions of different countries. For example, Russia’s legal tradition of codified laws follows the continental legal tradition of incorporating in the law more detail and interpretation than is the case in the common legal tradition. In Indonesia, laws contain very little detail because traditionally the country has relied on the implementing regulations to structure many important aspects of a reform. At times, important aspects of a reform appear at a third stage in the explanations to the implementing regulations.

What is the right division of content between laws and regulations? The Law should include those things that Government feels are to be relatively permanent in decentralization policy. For example, provisions for the election of local officials, basic expenditure and revenue assignments, the fundamental structure of the equalization grant, or the civil service status of local and central government employees are not likely to change over time—or at least should not change frequently—and properly belong in the law. Other factors, such as the weighting parameters in the intergovernmental transfer formula or provisions for revenue sharing rates or administration arrangements, may change with economic development and other changing circumstances and probably belong with the implementing regulations rather than the law.

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

On the other hand, if the implementing regulations are not written before the start of the implementation period, then it is left to those who administer the new program to decide on the elements of the decentralization. For example, if the exact assignment of functions is not made clear, then it may be left to the subnational governments to decide what they will and will not deliver.

Tanzania’s more gradual reforms have generally followed the “correct” approach of first reforming legislation, and then introducing the implementing regulations. The biggest problem in
Tanzania in this regard has been that rather than replacing the previous legislation and regulations, the existing legislation tends to be amended with additional clauses. Over two decades of incremental reform, this has led to numerous instances of unnecessary duplicative clauses. As a result, a major review and “cleaning up” of the Local Government (Finance) Act will be needed in the near future.

**Implementation**

Implementation of a decentralization program involves more than simply a passing of administrative responsibilities to lower levels of government. It involves developing a strategy for implementation and a significant amount of planning, and fail safe provisions to accommodate failures in the early stages of decentralization.

**Big Bang or Gradual Implementation?**

A gradual implementation of reform is thought by many to be more desirable than a hurried up, “big bang” approach. There are multiple reasons why this might be preferred, including (i) limited available information to allow good predictions on how things will eventually work out, in contrast to how they were planned, (ii) the cost of reform can be substantial, and gradual approaches allow this to be spread out over a number of years, and (iii) gradual approaches carry much less risk.

To argue for the proper sequencing of reform as we do in this paper is probably to argue in favor of gradualism in its implementation. The question is what form of gradualism is best. Systems that are politically centralized, like China today, may have the luxury of trying out pilot reforms to check for problems and ‘wrinkles’ before rolling out the reforms for the entire country. But piloting and experiments are not always possible and may not even be desirable if there is urgency to the problems that need to be addressed. Gradualism may also be understood in the context of asymmetric approaches to decentralization. For example, the Spanish Constitution in the post-Franco era allowed for several speeds of decentralization reform, to a large extent based on historical autonomic demands of a handful or regions vis-à-vis the rest of the country. Decentralization reform in that country was spread over several decades, but some regions got on with the reforms much faster than others. In Colombia, the asymmetric approach and differences in speed of implementation were based more on administrative capacity reasons than on historical reasons. In short, even though there are different interpretations of gradualism, many of them acceptable in their particular country context, we believe that the best interpretation of gradualism is the paced implementation of the sequencing being presented in this paper.

But two important qualifications should be added to that statement. First, we must not see the type of gradualism being proposed here as a substitute for a comprehensive blueprint for decentralization reform. This confusion has often been found in the general debate in the economics literature over the proper pace of or approach to economic policy reform. As already stated several times throughout this paper, in our view a gradual implementation approach should always be based on an explicit plan with goals and the institutional changes necessary to get there.

35 At present all regions in Spain have reached the same level of decentralization but asymmetries persist, especially in revenue assignments, with special privileges for the Basque Country and Navarre, because of constitutional design based on the interpretation of separate historical traditions.

36 For example McMillan (2004) recently argues for a step-by step approach to (general) economic reform but identifies this approach with the absence of any comprehensive blueprint.
A second qualification as regards the superiority of a gradual approach is that policy makers usually do not have the opportunity to reform in a gradual fashion. It is well accepted that timing is critical in policy success. For example, an economic crisis and political transition from an authoritarian and highly centralized regime may provide a very limited window of opportunity to advance reforms that, it may be believed, under other circumstances may be very hard or impossible to introduce. Going for a big bang approach to decentralization reform in these circumstances can be a measured and acceptable risk. That was the situation in Indonesia after the resignation of President Suharto in 1998. With several years now passed, Indonesia’s big bang reform appears to have been successful.\(^{37}\) Perhaps one can look to other transitional countries that implemented very rapid decentralization reforms accompanied by other general economic reforms, such as Estonia and Poland, where the big bang approach has worked.

None of the other countries of reference in this study implemented a big bang approach,\(^{38}\) not even Russia, which in some circles has been often interpreted as an example of failure of the big bang approach to general economic reform. The evidence from other developing countries is that a big bang approach can fail to deliver. For example, Giugale et al. (2000) point out that the Latin American experience with decentralization shows that big bang, abrupt reform efforts in countries such as Brazil, Colombia, Bolivia and Venezuela during the 1980s and 90s generally failed.

A carefully designed program can capture the advantages of both the gradual approach and the big bang. A comprehensive program for fiscal decentralization can be introduced with all elements implemented at the same time, and still have a chance to be successful. Returning to Figure 1, if the national debate, the white paper, the law and the implementing regulations are developed in the right order and in place, a big bang decentralization can go forward with minimum risk.

**Transition Measures: Hold Harmless versus Cold Turkey**

Many forms of fiscal decentralization reform imply that there will be distinguishable winners and losers among the subnational governments. Sometimes, politically and/or economically powerful subnational governments may effectively veto the reform unless their concerns about the losses generated by the new system are taken into account. For example, the powerful tax rebate system introduced in China to compensate the rich coastal provinces for the other effects of the 1994 reform can be interpreted in this light. More often, a particularly difficult issue arises when the system of distributing intergovernmental transfers among local governments is dramatically changed, as for example from a negotiated system to a formula-based system. This change will almost certainly produce local governments who make big gains from the new formal transfers, and others who face big revenue losses. Usually, the local government service delivery system, and the local political system, cannot withstand large one time shocks without causing turmoil in the delivery of essential services. In these cases, some form of phase-in of the new system is called for.

Indonesia’s big bang decentralization called for a switch from an infrastructure grant program, and a grant program designed to finance the compensation of government employees working at the local level, to a formula-based unconditional grant program. The “entitlements” under the old system had built up over time, and it was exactly these inequities that the new

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37 The Indonesia approach included some safeguards such as the provision (which apparently was never used) that provinces would assume responsibility for service delivery if local governments were unable to do so.  
38 India can be interpreted as a paramount example of gradualism in reform, and one that also illustrates well that gradualism per se does not deliver success either.
system was designed to eliminate. Nevertheless, a significant shock would have resulted had the new formula system been introduced in one fiscal year. Instead, the decision was made to phase in the new system over a period of years, and in years one and two, to hold all “losing” local governments harmless at their pre-reform levels. The mistake in the Indonesian transition was that the period it would take to phase in the new formula was left unspecified, leaving the door open for politicians to use hold harmless provisions to advantage their constituent local governments. The result was a longer phase in period than might have been desired.

Tanzania is also moving to a formula grant from a system where the distributions to local governments were negotiated. The same situation exists as in Indonesia: there is no reason to expect that any fair formula for supporting health and education finance will bear any relationship to the previous negotiated distribution. There would be winners and losers. As big a concern was the possibility that winners might include previously under-funded local authorities who would not have the capability of efficiently handling a large windfall gain in revenues. The government has decided to use a hold harmless approach and to phase in the new grant program over a period of years. Although the transfer system currently holds local governments harmless against their previous year’s transfer levels, one year into the program, the exact transition period has not yet been defined. However, the Government is in the process of deciding on a deadline for phasing out the hold harmless provision.

But not all countries provide for a formal hold harmless transition system. When no formal transition system exists, it does not mean that there is not an informal one. For example, the introduction in Russia of a formula-driven system in substitution for negotiated ad hoc transfers did not provide for a formal transition mechanism. But the federal government continued to use “mutual settlement” transfers as the means to cushion the impact of the changes. On top of that, the Duma or parliament intervened and changed the actual allocations of the formula-driven transfer to fit what it thought was the “just” allocation for four years until a new formula was introduced in 1998. South Africa, on the other hand, defined a four year phase in period for its formula-based, equitable shares grant to local governments.

In other cases there is no need for hold harmless provisions because most of the reforms are done in a gradual fashion anyway without any large changes in the distribution of transfers. This has been the case of India, with its gradual reforms of intergovernmental transfers implemented over a period of sixty years. Other countries may make a hold harmless provision unnecessary because the change is implemented in such a way that there are no net losers or the change is even made voluntary for subnational governments to take or leave. This latter illustrates the path followed by Canada and Mexico to the reforms of the revenue assignments over the last three decades.

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39 Part of the concern by Parliament for phasing in the transition to a new transfer system is that the loser local governments may not have had enough funds to pay the salaries of their employees (many of whom recently had been shifted down from the central government payrolls.) As already pointed out above, the current policy is to go back to direct transfers for employee salaries and discharge the equalization grant from the hold harmless provision, which has limited its effectiveness for the last three years.

40 Several problems are preventing the Government from phasing out the hold-harmless provisions sooner rather than later. First, the Public Service Act/Regulations technically still allows central ministries to appoint teachers at the local level. As long as this is the case, local governments have to be held harmless for decisions they have no control over. Second, with elections at the end of this year, politically this is not seen as a good time to announce the phasing out.
Transition Measures: Asymmetric Decentralization

The transfer of fiscal powers to local governments may or may not involve a one-off delegation of the same authority to every local government. Governments in many countries believe that there must be a uniform intergovernmental fiscal system under which all subnational governments must operate. Certainly there are good arguments for this. If all subnational governments have the same expenditure responsibilities and revenue raising powers, management of the system and evaluation of its success is much easier. Moreover, there is no hint of political favoritism as ad hoc differentiation among local units is not permitted. Uniform symmetrical systems seem more fair. By design, Tanzania’s system of local government finance is perfectly symmetric.

There is another view, that uniformity may not be a necessary condition for effective decentralization. In fact, a better route may be to begin fiscal decentralization with the larger local government units and to let the smaller ones “grow into it”. Subnational governments have very different capabilities to deliver and finance services, and certainly different capabilities to borrow. It may be necessary to set up a system where these differences are explicitly recognized, i.e., where different local governments are given different financing powers and expenditure responsibilities. Places that are in the lower tier of capability could rely more heavily on grants and perhaps have less expenditure responsibilities, while local governments with greater administrative capacity or more developed places in general could rely more heavily on local taxation, and could borrow to finance capital outlays. In countries that choose this route, it is necessary to have a clear set of rules about when a local government graduates from one status to another, and to have systems in place for training, and so on, that allow local governments to graduate faster if they so desire. It is not at all uncommon to see such gradations, e.g., the Kenyan municipalities and cities, large cities in some American states, South African municipalities and cities, Indian urban governments, and many national capital districts are given special fiscal powers. Countries like Spain and Colombia have successfully used asymmetric approaches in the decentralization of expenditure responsibilities.

Asymmetric approaches to revenue and expenditure assignments are used sometimes in response to either special political demands or separatist forces. At some point during the transition, the Russian federal government had secret treaties providing asymmetric status to a number of Russian regions to accommodate all sorts of demands. More uniform treatment of all the regions in Russia have followed after years of recentralization and hard discipline introduced by President Putin (Martinez-Vazquez, 2002). Many other decentralized countries (e.g., Canada, Spain, etc) function with different forms, at times quite radical, of asymmetric federalism (see Bird and Ebel, forthcoming). But even in systems where asymmetry is involved, there are certain common features that tie all local governments together. There should be one law common to all local governments in the system, and one uniform set of accounting and auditing rules. But when it comes to spending and financing, it would seem that a strong case could be made for asymmetric decentralization (Bahl, 1999b).

Capacity Building

Perhaps the biggest constraint to the implementation of a decentralized system of government is the lack of administrative capacity by local governments. When decentralization takes place and the administrative capacity is not there, what may follow is poor performance in

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It is very difficult to identify a set of characteristics that prescribe when a local government should move to the next class of fiscal autonomy. Most countries use population size as the classification criteria.
service delivery with all sorts of inefficiencies, waste, corruption, and lack of accountability. Systemic failure of local governments to deliver services is in the long term the worst enemy of decentralized governance. Sooner or later the solution found will be to recentralize the public finances.\footnote{Political memories tend to be short and it may not matter much that service delivery was not better under a previous centralized approach.}

The lack of local government capacity also has been used to justify tepid decentralization or no decentralization at all. This is the most common reason given in “half-baked” decentralization processes, such as in India or Mexico, where decentralization has stopped at the intermediate level of government and has not reached third-tier local governments in a meaningful way. Full decentralization reform to local governments has been stalled in Tanzania because of the alleged lack of capacity among most local governments. Almost at the other extreme, the big bang decentralization reform in Indonesia was carefree about the lack of capacity among many local governments and fully decentralized to local governments in effect completely bypassing the intermediate (provincial) level of government. The reform was uniform and there was little accommodation for lack of capacity at the local level.

In many ways the issue of lack of capacity at the local government level is a “chicken and the egg” dilemma. Decentralization may not take place because of the lack of capacity but capacity has never developed because there never has been any meaningful degree of decentralization. The right approach to this issue is a pro-active policy that combines capacity training and asymmetric measures with progressive devolution of responsibilities and financing instruments. It does not make much sense to wait for decades, like in India, for the capacity to appear at the local level. At such a pace local governments may never be ready. But the need for resources and a strategy may not be the main obstacle to developing capacity at the local level; rather, the problem may be entirely political. This is true because intermediate level governments, even though they may demand as much decentralization as possible from their central governments, like to act as highly centralized mini states vis-à-vis their local governments.

**Contingency Funds**

Like most other government policies, decentralization policy is designed and implemented with limited information and therefore there is always the risk that things may not come out as expected. For this reason, it is important to provide the implementation process with contingency funds to cover unforeseen circumstances. When Indonesia embarked on its big bang decentralization the Government arranged for several contingency funds to help with the finances of those local governments that may have run short of funds to pay employee salaries and the like.

**Monitoring and Evaluation**

Many developing countries and countries in transition may be characterized as very centralized systems of government and are likely to remain centralized for quite some time. A plausible scenario in such countries is that fiscal decentralization will be to a large degree controlled and regulated from the center.

In some cases the control will reflect hesitancy on the part of the higher-level government to give powers to a new group of bureaucrats. But in other cases, regulation and oversight are seen as a needed feature of the fiscal decentralization structure. The following are some examples of why this is the case.
As subnational governments move toward debt financing of capital improvements, central governments will be called on to establish disclosure requirements and enforce borrowing limits.

The center must monitor the fiscal performance of local governments, and identify those in financial difficulties as well as those exerting weak revenue mobilization efforts.

The success of central government finance instruments (transfers, subsidies, local taxes) should be monitored annually and fine-tuned periodically.

Compliance with the terms of conditional grants, expenditure mandates and taxing limits need to be confirmed by the center.

There is need for the center to provide technical assistance to local governments, in several areas. Especially the smaller local governments require assistance in areas such as accounting, treasury, tax administration, data processing, and project evaluation.

Typically, central and state governments in most developing and transition countries are not up to this task because they do not have a strong ability to lead the development of local government finances. The two ingredients necessary to this job are (a) a fiscal analysis unit, probably best located in the Ministry of Finance, with staff adequate to continuously monitor local government finances, and (b) an extensive data system that will allow quantitative monitoring and evaluation. There are a number of options for setting up a fiscal analysis unit.

Probably the best approach is to create a cell within the Ministry of Finance that is charged with guiding the development of the intergovernmental fiscal system. The advantage of placement within Finance is coordination with those responsible for other fiscal control measures, e.g., tax policy and borrowing. Both South Africa and Indonesia had effective fiscal planning units placed within the Ministry of Finance during the height of the decentralization process. Units within the budget departments of the Ministry of Finance in Mexico and Russia perform similar functions. In Tanzania, the Local Government Reform Program, placed within the President’s Office – Regional Administration and Local Government, was essentially unable to perform these analytical functions until it established an inter-ministerial working group co-chaired by the Ministry of Finance.

Another option is to create an independent unit whose primary duty is policy research and advisory. South Africa’s permanent Fiscal and Finance Commission is such a unit. Uganda’s Local Government Finance Commission is also permanent, but India’s central and state finance commissions are constituted every fifth year. Most countries, however, do not have such units.

A key underlying requirement for successful fiscal decentralization is a uniform structure of subnational government accounts that are regularly and properly audited. There are problems with the availability of such a comprehensive data system in most developing countries. A census of government finances, reporting the actual financial outcomes for every subnational government, is essential information if the performance of the intergovernmental system is to be monitored. Yet, it is not common in developing countries to have an up-to-date information system that describes the finances of subnational governments in detail. Rarer yet is a fiscal analysis model that is used to track the performance of local government finances (Bahl, 1999b).

43 Since then the Indonesia unit was disbanded with the reorganization of the Ministry of Finance.
44 Other approaches to monitoring the decentralization processes can be used including reliance on the legislative branch, associations of local governments and so on. See Boex and Martinez-Vazquez (2004) for a discussion and evaluation of the different approaches.
Breaches in Sequencing: Causes and Risks

The primary question we raise in this paper is whether sequencing matters in developing and implementing a fiscal decentralization policy. Our answer is that it does, and that mistakes in sequencing can lead to significant resource costs and possibly to a loss in confidence in the decentralization initiative.

We also raise two secondary questions in this paper. First, we ask whether there is something akin to an optimal sequencing for decentralization policies and implementation. Our answer is that there is, and that following these sequencing rules might minimize the costs and the risks of implanting fiscal decentralization. Second, we ask about the extent to which countries follow these optimal sequencing rules. The answer would appear to be that in general, they do not.

What to make of this gap between theory and practice? One might consider a couple of conjectures:

- The basic hypothesis can be rejected, sequencing does not matter, and countries are better off attacking specific problems observed with respect to fiscal decentralization, taking them on one at a time depending on their contemporary importance.

- There are many potential reasons why so many countries appear to be out of step with what we see to be the normative, textbook approach. It may be simply lack of information or awareness, or it could be the result of institutional and political constraints. Whatever is the true explanation, the fact is that out-of-sequence decentralization processes can go on when the risks are low. When the risks are high, we would expect the entire process of decentralization to come to a halt in the middle of some institutional, political and/or economic crisis. In this case decentralization is abandoned or re-constituted as part of a new major policy initiative.

In this section, we address in more depth these two possibilities.

Sequencing Does Not Matter?

One might argue that the order of introducing decentralization policy does not matter, that sooner or later the structure of decentralization in a country will end up at the same place no matter how one goes about it. Look for example at the U.S., as strong an example of working fiscal decentralization as there is. There was probably never a comprehensive “white paper” on state and local government finance, yet the system grew up to be quite functional. De facto, this is exactly the position that seems to have been taken in many industrialized and now developing countries.

The question is whether this is a wise strategy for developing countries, most of who are in the early stages of decentralization. Certainly one can understand the appeal. Decentralization policy is after all a political decision, and the design and implementation of such a program will be driven by bargaining and political timing. Even so, we would argue against the “make it up as you go” strategy, for the following reasons:

First, it does not give the country leaders a chance to develop an end strategy for decentralization, that is, it does not let them design a program that will eventually achieve the objectives of the decentralization. If the strategy is made up annually to respond to current problems, the decentralization is not likely to end up as it would if a designed strategy were followed.
Is this a bad thing? One might argue that even if there were a framework, it could be changed over time by new political parties. Moreover, a program that responds to current problems might not be a bad strategy, i.e., oil the wheel that squeaks.

A problem with this approach is that it invites the prospects of being driven exclusively by politics. Absent a policy frame, self-interested groups might make amendments to specific policies that are not consistent with the other pieces of the program that are already in place. The danger is that over time, a system can lose focus.

An example of this danger is the Indian system of intergovernmental transfers. Over time, the Finance commission has concentrated primarily on equalization transfers and on supporting a proper vertical share. The Planning Commission focused on capital grants, and mixed loan and grant programs. The line Ministries operated a plethora of conditional grants, whose purposes and impacts are by now largely unknown. Few would argue that the Indian system of intergovernmental transfers has ended up “in the right place” to support fiscal decentralization.

Will a country’s decentralization structure evolve to the same place no matter how its introduction is sequenced? Not likely, we think. And if one believes that decentralization is on the government’s policy agenda to achieve a specific set of objectives, one will conclude that sequencing matters.

The second reason is that even if one could eventually reach a “good” decentralization structure by making policy decisions on an opportunistic basis, there are considerable costs to be borne. Some of these are the costs of the inefficiencies introduced by unplanned (and perhaps unwise) interim decisions that might be made as a result of political influences.

Take the case of the U.S. and other decentralized industrial countries. Many of them arrived at their current decentralization status after long tortuous histories of constitutional debate and other forms of political friction and countless economic inefficiencies and fiscal troubles. It is unlikely that developing countries in the process of decentralization today could afford to spend the time and the resources that it took many of these industrialized countries to complete their decentralized systems. As is the case for many policy issues, the example provided by many industrialized countries in the sequencing and timing of decentralization is one of how not to do things.

Out of sequence policies in developing countries can also impose significant costs. In Indonesia’s transition from an ad hoc transfer system to a formula-based system, a hold harmless arrangement was put in place to protect the system from too much “shock”. But, there was inadequate planning for this and no sunset period was defined for the hold-harmless arrangement and Parliament simply extended it. This in effect stalled the introduction of the new system of allocating transfers to local governments. Does this introduce some costs? It does, in the form of the impacts during the lost years of moving to the new system, and in terms of the later bickering and political maneuvering that will take place as the final transition to the new system is developed. These might be costs associated with making unwise decisions that moved the country away from its distributional goals for a number of years. Or these might be the costs of financing infrastructure choices that were not in step with what a decentralized system would have produced. As a country moves further away from its goals, the cost of getting back on track can be significant.

Brazil had to eventually bear the cost of a constitutionally mandated revenue base for states, but a murky expenditure assignment that led to fiscal indiscipline at the state level. These costs could have been avoided if fiscal design had preceded the constitutional provisions. India’s design of intergovernmental transfers has now led it to the point where state fiscal deficits seem
more encouraged than discouraged. There are numerous other cases of the cost of poor sequencing.

Third, there is another kind of cost, i.e., the cost of undoing a culture that is out of step with decentralization. For example, when countries adopt interim measures that lead to soft budget constraints and near-total revenue reliance on transfers from higher level governments, it creates a sense of dependency, and a feeling that the financing of government services is a function that “belongs” to the higher level government. What makes matters worse is that both central and subnational governments can come to accept this culture. As many countries have learned, it is extremely hard to move away from the culture of dependency.

Tanzania is a case in point. The central government has long held to a model of financing local governments through a system of conditional grants. Local governments have had some taxing powers, but have been primarily dependent on transfers for covering their budgets. Moving the central government toward a more transparent system of block grants has taken several years of effort and planning. But, even in the midst of this decentralization, the center has trimmed back local taxing powers and reinforced the culture of dependency. It has been argued that the absence of a detailed policy document that spells out the financing arrangements for the fiscal decentralization opened the door for this problem.

**Sequencing Matters**

The alternative approach is the one we argue, that countries are better off if they plan their decentralization policy and properly sequence its introduction. There are a number of arguments to support this. The following is the rationale.

First, the transition costs or friction costs will be less under a planned system, because the pieces of the decentralization are more likely to fit together, and because there may be less chance for policy or administrative mistakes to be made. Moreover there is less likelihood of having to undo mistakes of the interim period. As noted above, these mistakes can be very costly in terms of resources lost and in terms of a loss in confidence in the decentralization program.

Second, a proper ordering of decentralization allows government to keep its eye on the future, and on the plan for the continued evolution of fiscal decentralization. It is much better to tag reforms to the program on to an existing framework than to start off in new directions that may not fit. And, it is much better to anticipate implementation problems than to discover them in the process of implementation. For example, under a planned development of decentralization, capacity development at the local government level might begin early or be phased in under an asymmetric plan. Under the “make it up as you go” approach, capacity development may be ignored for years and then found wanting at the time policy points to granting more expenditure responsibility to local governments.

**Why Countries Deviate from the Optimal Sequencing?**

There are many potential reasons why so many countries appear to be out of step with what we see to be the normative, textbook approach. We can think of two overall reasons. First, the desirable sequence is complex and demanding in design. Second, it requires sustained discipline and vision for its implementation.

In terms of design, governments may simply lack of information or awareness of the desirability and convenience of the proper sequencing for their decentralization policy. This is likely to be a powerful explanation. In practice, policymakers appear to make more obvious and immediate design mistakes in fiscal decentralization design, such as providing negative incentives to revenue mobilization in transfer systems or decentralizing revenues without having assigned
expenditure functions to local governments. Thus, it should not be surprising that they will not be knowledgeable or aware of the more complex concept of proper sequencing. The truth is also that even if policymakers were aware of the need for sequencing, it would not be easy for them to find answers. Little has been written and less publicized on this issue in the academic and policy literatures on fiscal decentralization.

In terms of implementation, policymaking in real life, as opposed to a textbook scenario, is subject to long lists of, sometimes powerful, political and institutional constraints. One set of political constraints has to do with the need for sequencing, as policymakers are aware of the opportunity for the introduction of substantial reforms provided by changes in political regime or the threat of such changes. It can be perfectly rational for policymakers to take advantage of these windows of opportunity knowing that they are shortchanging the process and that the outcome may be less than perfect and that it will need “repairs” in the future. A related set of political constraints has to do with the average period governments are in power; for example, a four year election cycle may not be long enough to see the results of a decentralization reform, and therefore the temptation to short-circuit the sequence. In general, one would expect countries with less stable political regimes to breach the desirable sequence for decentralization more often than countries with more stable governments.

Numerous institutional constraints can bind governments to breach the desirable sequencing of fiscal decentralization. Besides political costs in coalition governments and relative administrative ease, policymakers may be forced to balance tradeoffs involving existing administrative capacity, regional equity issues, lack of accountability mechanisms at the local level, and reform thrusts in other policy areas, such as tax policy or civil service.

Regardless the causes for breaching the sequencing of fiscal decentralization, there are differential risks associated with those actions.

**Sequencing and Risks**

Mistakes in sequencing can impose serious costs on society, as noted above. However, not all missteps will have similarly significant consequences. The costs of a poorly sequenced decentralization program can range from ineffectiveness and subsequent failing support of decentralization efforts, to macroeconomic instability and even chaotic situations and fundamental failure in public sector delivery, to minor delays and confusion about responsibilities. The specific consequences of a particular misstep in the sequencing design of decentralization reform are particular to each country. Still, some general principles about these risks, and about the cost of recovering from sequencing mistakes, can be enumerated.

**Risks Associated with Sequencing Mistakes**

Conceptually, one could attempt to quantify the potential risks associated with sequencing mistakes as being proportionate to the size of the “contingent liability” associated with decentralization reform i.e., the relative share of fiscal resources being decentralized. This would become a liability to the public sector if the reform is unsuccessful. As a first, rough approximation, we might think about quantifying the expected risk or the product of this liability and the likelihood or probability of failure implied by the particular sequencing misstep. As such, fiscal decentralization reforms that involve fewer budgetary resources, or minor taxes and no borrowing authority (rather than major expenditure responsibilities, major taxes, and borrowing powers) are fiscally less risky. Proposed reforms that have major obstacles in implementation (e.g., reforms that require significant reform of regulatory processes and procedures) have a higher probability of failure resulting in potentially greater fiscal risks.
Of course, one way to minimize the risks associated with fiscal decentralization is to reduce its scope. Think small. But, in doing so the country forgoes large potential benefits also associated with decentralization. Some analysts, and politicians, might see another way to minimize risks as to design and implement only small parts of the program and take a piecemeal approach to decentralization. But, if the full system is not designed, the pieces may not fit together in this process and the costs (risks) go up.

Clearly, there is a tradeoff between risks and benefits of decentralization and where a particular country lands on that line should depend not only on how risk averse government feels it can be as regards to implementing fiscal decentralization. In the aftermath of Suharto, Indonesia was in a position where the introduction of fiscal decentralization had become a much less risky proposition than in the past, so a big bang approach became politically feasible. India’s state deficits may be forcing more risky approaches to fiscal decentralization. But Russia seems to be moving in the other direction.

A quantification of the general risks associated with sequencing mistakes will not be attempted here. We focus instead on qualitative assessment of the risks associated with the common missteps or deviations from our normative blueprint for sequencing. For example, what are the risks of a program that is implemented before it is fully designed, as in Indonesia’s big bang? What are the consequences of fixing revenue entitlements before fixing expenditure responsibilities (Brazil) or giving subnational governments borrowing authority without imposing a hard budget constraint on them (India)? Clearly, service levels may have deteriorated dramatically during the initial period and the future of the entire program may have been put in danger because of the support it would have given to the political opponents of decentralization in that country. The risks eventually did not materialize in Indonesia. An interesting aspect of the Indonesia experience was also that some contingency funds were available to mitigate some increased costs of the transition, but these funds never had to be used.

In offering policy advice to countries about sequencing issues, it is important to distinguish between what is a high risk mistake versus what is lower risk mistake. In Table 5, we attempt a summary of the factors that might risk choices, with a matrix that links the sequencing mistakes to the possible costs and consequences.

**High-Risk Sequencing Choices**

1. Failing to develop a comprehensive policy document that defines a framework for the fiscal decentralization. This is perhaps the most controversial of sequencing rules, probably because so much political capital must be used up in making the overall plan transparent. But most hard policy decisions are politically difficult, and the view here is that the consequences and costs of not taking on this risk at an early stage are quite significant. If the overall framework is not developed, the decentralization law will have no foundation, implementation will lead policy, the decentralization strategy will drift and lose focus, and it will not likely achieve the objectives that have been set for it.

   There will be resource costs associated with refitting the program because some of the policy pieces have failed. Moreover, the time cost of piecemeal design can be significant, e.g., years of equalization in local government capacity development might be lost.

2. Not installing a hard budget constraint on subnational governments. By creating a culture of dependency, the government creates a long term problem with fiscal discipline, and one that is difficult to deal with as time goes on. Local officials, especially elected local officials, much prefer to finance expenditures with grants from higher level governments than to raise taxes, and much prefer borrowing to finance services with current benefits. At the extreme, the
absence of a hard budget constraint together with a delinking of borrowing from the creditworthiness criteria can invite macroeconomic stability problems.

3. **Getting the “finance follows function” rule out of order.** Not developing a clear set of expenditure assignments before developing revenue assignment and a vertical share of transfers is a mistake that continues to plague decentralization programs. This leads to inefficiencies in service delivery, unwanted fiscal disparities and is an enemy of the hard budget constraint. In some cases, it will lead to central deficits and macroeconomic instability. This is the most common of the sequencing mistakes. It is the rare decentralization program around the world that does not feel constrained by an unclear or inappropriate expenditure assignment. As problematic a situation is to reassign expenditure responsibilities to subnational governments without assigning appropriate revenues to finance these new functions.

4. **Passing the decentralization law, or placing decentralization provisions in the Constitution, before developing the objectives and framework, i.e., the plan for decentralization.** This can carry great consequences, especially if constitutional provisions get out in front of a clearly thought out set of goals for the decentralization.

   The consequence of this misstep in sequencing can be an intergovernmental structure that encourages fiscal indiscipline, an assignment of revenues and expenditures that do not match and cannot easily be changed, and an inflexible system that is outgrown by the economy. The costs may be the instability that comes with fiscal deficits at the subnational government level, service levels that are made more inadequate by the mismatch between resources and expenditure responsibilities, and unwanted fiscal disparities.

5. **Failing to develop a clear set of implementing regulations, based on the decentralization law and done prior to implementation, creates significant problems.** This can lead to various levels of government choosing the method of implementing the decentralization that best suits their interests, to costly use of resources, and to inefficiency in service delivery.

6. **A capacity development program for subnational governments was not put in place.** A best route is to begin preparing local governments for their new responsibilities as soon as possible in the process of decentralization. The longer one waits to begin this process, the longer the time before local governments can assume new responsibilities for fiscal leadership. The lack of capacity development can lead to incomplete decentralization programs, for example, those that stall at the intermediate level of government and never reach the local level.

**Lower-Risk Sequencing Mistakes**

Certain other deviations from an optimal ordering of decentralization policy and implementation impose costs, but are lower risk in that they can be more easily corrected.

1. **Failure to provide subnational governments with significant revenue-raising autonomy.** It is the rare developing country that assigns significant taxing powers to subnational governments at the onset of decentralization. Getting buy-in on this from the central government, and getting proper capacity developed at the subnational level are stumbling blocks that would seem no more severe many years into a decentralization program that at the outset. However, a culture of dependency does take hold, and subnational governments do become accustomed to an intergovernmental system where they rely on central transfers. The accountability that comes with local revenue raising is lost and is another component of this culture of dependency. The better route is to lay out the plan for local government financing as part of the general strategy for decentralization. That is perhaps the one time that all of the possible options can be placed on the table.
2. Failure to provide borrowing powers to subnational governments. Clearly it is desirable to set up a regime for creditworthy subnational governments to finance capital facilities with debt. If the borrowing program is not set up at the outset, this raises some efficiency costs that might have been avoided (e.g., under-financing long lived assets from current account revenues). But the later introduction of borrowing powers is a sequencing mistake of lesser order. The introduction of borrowing powers without a hard budget constraint, as noted above, is a sequencing mistake of a major order.

3. The absence of a national debate to gain consensus about decentralization policy. Obviously, consensus is important, and support for a program can be developed by allowing wide inputs. But in fact, many countries do not have such a national debate, unless it is forced. The absence of a national debate may endanger the sustainability of fiscal decentralization.

4. Failure to establish a monitoring and evaluation system. It is important to set this up at the outset so that the decentralization program can be monitored and evaluated, and possibly fine-tuned with policy adjustments. However, it can be set up at a later point in the process, and this is in fact the case in many countries. The costs implied are the failure to catch problems in the early stages, and the limited information that is available to politicians as they make changes in the system.

6. A capacity development program for subnational governments was not put in place. A best route is to begin preparing local governments for their new responsibilities as soon as possible in the process of decentralization. The longer one waits to begin this process, the longer the time before local governments can assume new responsibilities for fiscal leadership. The lack of capacity development can lead to incomplete decentralization programs, for example, those that stall at the intermediate level of government and never reach the local level.

The process of devolving responsibilities can be proceed much more smoothly if there has been a decentralization of service delivery prior to the decentralization initiative. In this case, it is simply a matter of passing service delivery responsibility over to the subnational governments, and perhaps a transferring central employees based in the region to the local government, as was done in Indonesia.

The decentralization of service delivery responsibility to subnational governments before they are ready to begin delivering these services is a major risk. The consequences are a possible breakdown of services and a major challenge to the entire program.
The actual rhetoric in the national discussion usually involves consideration of a menu of the inherent advantages of decentralized governance. This discussion often moves in the direction of fiscal decentralization as an economic development strategy. Intuitively, the argument is reasonable. The government closest to the local or regional economy is in the best position to decide on matters such as the best regulatory environment for local business, the right infrastructure investments to make, the proper structure of taxation, and in general, the enabling environment best suited to develop the local economy. Martinez-Vazquez and McNab (2003) develop the argument that the possible effects of decentralization on economic development are indirect, i.e., decentralization positively impacts allocative and possibly technical efficiency, which in turn may positively affect development and economic growth. Despite long standing beliefs to the contrary, decentralization may have positive effects on macroeconomic stability (Gramlich, 1995; Shah, 1999; Rodden and Wibbels, 2002; and Martinez-Vazquez and McNab, 2005) and the incidence of corruption (Gurgur and Shah, 2000; Arinkam, 2000; and Fisman and Gatti, 2002), and therefore on economic growth. Much less is known about the impact of decentralization on income inequality, but clearly it depends on the design of equalization schemes.\(^{45}\) Whatever the reason, the search for empirical evidence on the relationship between decentralization and economic development has not produced conclusive evidence. (Zhang and Zou, 1997,1998; Davoodi and Zou, 1998; Lin and Liu, 2000; Martinez-Vazquez and McNab, 2005).

That said, it is almost always the case that advocates of fiscal decentralization believe that this is a route to faster and better quality economic development. The reasons for this expectation, however, are rarely articulated in the development of the policy strategy. If they were, it would be another clue about how decentralization policy should be designed.

A second argument for moving to a decentralized fiscal system is that it is a required follow-on once the political system has been decentralized with democratically elected governments at both the central and subnational government level. Those interested in the politics of development would argue that this factor has been paramount in stimulating at least the rhetoric and probably the demand for fiscal decentralization. And, it is not all rhetoric. Elected politicians at the subnational government level push hard for increased powers to shape budgets (though they are much more enthusiastic about having power to spend than they are about having power to tax). Even in China, where provincial leaders are appointed by the central government, they push hard to cause a greater flow of resources to their provinces. However, politically driven decentralization processes run the risk, as the current cases of India and Spain demonstrate, of an unbalanced structure where most of the fiscal powers on the expenditure and revenue sides of the budget remain at the state or provincial level, with these governments acting as centralized regimes towards their local governments.

Administrative efficiency is a third reason. Centralization may be an inefficient management approach, especially in large countries. Fiscal management, i.e., supervision of some part of the budgetary affairs of every subnational government can become costly and can lead to poor public service outcomes in large countries. A relatively small number of central officials cannot make the important fiscal decisions for every local government, on a case-by-case

\(^{45}\) For the case of China, Qiao, Martinez-Vazquez and Xu (2004) find the a clear tradeoff between economic growth and regional equalization schemes.
basis. There are just too many complications and too many special circumstances for this to be a viable approach. China and India have populations in excess of one billion, and China has 58,545 subnational governments\(^{46}\) (Bahl 1999a), while India has 237,687\(^{47}\) (World Bank, 2000). Brazil has a land area in excess of 8.4 million sq. km., and Indonesia is composed of 6,000 inhabited islands. How could Russia, a country with 11 time zones, be managed efficiently from Moscow, by a relatively few senior officials? Yet, as late as the mid-1990s, the budget of each of the 89 regional governments in Russia was being approved in Moscow on the basis of face-to-face negotiations. Some form of decentralized governance would seem an imperative in large countries. The management problems associated with centralized control are not limited to large countries. Even in small nations, the combination of a poor transportation and communications network can make the national capital very remote. In Nepal, for example, many of the 4,053 local governments are long journeys from Kathmandu (World Bank, 2000).

Another part of the rhetoric on decentralization has to do with diversity and the most fundamental concept of economic efficiency. Fiscal decentralization is a strategy that sells because people want different things from their local governments. Fiscal centralization implies some degree of uniformity in government services, and in revenue raising. But there is a resentment of enforced uniformity, and various regions within countries have pushed hard for autonomy to choose a package of services that better fits their demands. Countries with variations among regions in language (e.g., India, Sudan), ethnic background (e.g., Indonesia, Nigeria, the Philippines) or climate and terrain (e.g., Russia) are usually good candidates for fiscal decentralization. Even countries that are relatively homogenous in population mix and climate may be pressured for different service standards in urban and rural areas, or in regions with different economic bases. This is often a very important reason why a decentralization initiative is proposed. This is also the fundamental rationale for decentralization in the theory of public finance (Hayek 19??; Tiebout, 1956 and Oates, 1999).

To some degree, the current interest in decentralization, and the rhetoric supporting it, may be linked to the fact that the time has come to give local government autonomy. Local elections, improved administrative capacity of subnational governments and “local nationalism” have made the demand for fiscal decentralization irresistible in many countries. If it is not given in a formal way, it may be taken using “backdoor” approaches. A good example is found in Chinese local governments who were denied formal taxing powers but levied informal (often illegal) taxes and fees which support off-budget accounts hidden away from central control and supervision (Wong, 1998; Bahl, 1999). But these “backdoor” approaches can bring inefficiencies in terms of how the funds are raised and in terms of spending from segmented, extra budgetary accounts, and they compete with central government revenue mobilization efforts. Central governments might conclude that it is far better to structure a program of fiscal autonomy than to have it taken by subnational governments on an ad hoc basis.

Perhaps the most compelling argument of all has to do with service delivery. The level and quality of local public services that has been provided in most developing countries is appalling. This dismal performance has taken place for decades under the watch of centralized governance systems. “The job is not getting done anyway, let’s try another approach” is an argument that gets a great deal of sympathy and support. There seems to be a feeling in many camps that more local control over expenditure decisions can make things better. There are at least intuitive arguments to support this. Subnational governments are positioned to determine the best location of capital investments, they can recognize unwanted service level disparities

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\(^{46}\) China has: 151 prefectures and 185 prefecture level cities; 1,903 counties and 279 county level cities; 56,000 townships, towns and city districts.  
\(^{47}\) India has: 3,609 urban local bodies; 474 zilla parishads in rural areas; 5,906 panchayats samithis; and 227,698 gram panchayats.
within the local area, they may better control the performance of employees working at the local level, and they might be better at maintaining the local public capital. Local voters who may want to express displeasure about service levels, feel more likely to be “heard” by local politicians and bureaucrats than by central politicians and bureaucrats. There is, of course, the risk that decentralization will fail to improve the level and quality of public services, but the risks associated with doing nothing are often perceived as a worse alternative, a continuation of the dismal performance of the centralized approach to service delivery.

Finally, decentralization may be a part of a national strategy to hold countries together, or even as a strategy for nation building. Some countries that were formed out of unnatural partners have dissolved when the opportunity arose, e.g., Czechoslovakia and Yugoslavia. Others are probably holding together better because of heavy doses of decentralization and autonomy, e.g., Belgium, Bosnia, Canada, and Spain. In some cases, the fall of strong central regimes has prompted a call to move governance away from the central level and has stimulated fiscal decentralization initiatives. Indonesia, South Africa and Russia are cases in point. Other troublesome partnerships have played to special autonomy measures to try and hold the country together. Nigeria and The Sudan fall into this category. We also may note that even in the case of re-unifications, decentralization plays an important role as in Vietnam, Germany, and China - Hong Kong.
### TABLE 5
The Potential Costs of Not Sequencing Decentralization in the Right Way

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<th>Mistake in Sequencing</th>
<th>The Consequences</th>
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<td><strong>No National Debate</strong></td>
<td>The real reasons for the underlying demand for decentralization are not identified, or the government goals for decentralization are not communicated and sold to the public. Either way, the support for the fiscal decentralization program may not be broad-based, and the program may fail or stall.</td>
<td>The debate may occur later, perhaps years into the program, and the program may be altered dramatically to gain support. A major political cost may be the abandonment of decentralization efforts after confusion about what ought to be done sets in and provides support to the opponents of decentralization. The “false start” or “frictional” costs could also be considerable in terms of the institutions that might have to be abandoned, and in terms of the loss of creditability to the government. Moreover, the gains that might have accrued from a more targeted decentralization during the intervening period will have been lost.</td>
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<td><strong>No Policy Framework</strong></td>
<td>Central authorities “make it up as they go,” responding to immediate needs and political expediencies. The pieces of the decentralization policy may not fit together in a coherent way, and interest groups have more leeway in adjusting the program to match their needs. The result is that the basic objectives of the decentralization may not be achieved (i.e., the resulting structure of the decentralization may bear little resemblance to the one that would have been designed to solve the problems it addressed), or if the results are achieved it may take so much longer to do so.</td>
<td>There can be substantial time delays in achieving the desired results and a considerable amount of resources can be wasted on the trial and error process. Therefore the false starts and frictional costs could be quite substantial, if the direction and substance of decentralization policy are changed repeatedly once the process gets underway. The confusion that will follow at all levels of government is likely to harm the efficient use of resources and the commitment of policy makers to any set of institutions. For example, if expenditure assignments begin under one schedule and then are changed to</td>
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<td>Pass the Law Before Doing the Framework</td>
<td>In effect, the Law becomes the framework and provides only general guidelines for the reform. Typically, laws do not have specificity. This means that there is no plan to develop the implementing regulations or the implementation. The consequence might be that whatever is easier to implement may become the decentralization. Or, to the contrary, the consequences of various types of implementing policies have not been thought through and implementation may lead to problems such as unanticipated deficits at the local level or a break down of public services. Eventually, a framework will need to be put in place. When it is, it will be significantly constrained by the existing law.</td>
<td>The law(s) may be disjointed with contradictory sections and pursuing conflicting goals. The law will eventually have to be rewritten, based on an overall direction for the decentralization. But, positions based on the existing law will have hardened and significant political and time costs will be imposed in forcing changes. If not backed by a comprehensive coordinated policy framework, the law itself may be flawed, leading to such significant costs as budget deficits because of a mismatch between expenditures and revenues, inadequate level and composition of transfers, or the granting of inadequately constrained borrowing rights and anemic infrastructure development. Depending on the number of years it takes to get the law “right”, significant frictional costs will be involved.</td>
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<td>Let Finance Lead Function</td>
<td>A serious consequence of of “over assigning” revenues is that the financial viability of the central government might be choked off, leading to budget deficits, and eventually to macroeconomic instability. Local governments might pursue public projects that are not essential or that do not yield returns. This can lead to misallocation of resources and inefficient public spending.</td>
<td>Recent experiences in a number of Latin American countries bear witness to the serious and disruptive destabilizing consequences of decentralization design where finance has led function. In these countries, while revenues had been decentralized, little</td>
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<td>Mistake in Sequencing</td>
<td>programs that are not expenditure priorities or in the national interest or perhaps may counteract existing equalization policies. On the other side of the equation, the consequence may be that expenditure responsibility is over assigned relative to revenue endowments, hence a hard budget constraint may be forgotten or inadequate service levels will result. Certain locally assigned expenditures may simply be ignored, or “backdoor” approaches to revenue generation may result. This approach thwarts an approach that would identify a minimum level of services that is affordable.</td>
<td>provision was made for decentralizing central government expenditure responsibilities. Furthermore, when revenues are over assigned, then “a culture of entitlement” may be perpetuated where local governments will resist giving up these claims on revenues. The costs of re-contracting can be very high, because moving expenditure responsibilities can impose some costs associated with retooling to deliver new services, and granting new revenue raising powers can impose new administrative costs. On the other hand, if there is a fundamental imbalance between expenditure assignments to local governments and their revenue sources, then a “culture of dependency” and soft budget constraints may be institutionalized.</td>
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<td>Insufficient Subnational Government Revenue Raising Powers</td>
<td>If subnational governments are not given adequate revenue raising powers, it will be difficult to enforce a hard budget constraint and a resulting consequence could be fiscal indiscipline. Another consequence will be less accountability of elected local councils to their constituents for the quality of services delivered since they are not burdened with forcing tax increases on local voters. Without some adequate amount of taxing power to repay bonds, the subnational governments will not be able to support a proper local government credit financing program. Finally, the subnational government will have to be financed with transfers from higher level governments, developing a culture of dependency</td>
<td>When insufficient revenue autonomy leads to a lack of fiscal discipline, this will likely cause scarce central resources to be diverted from other, perhaps higher priority uses. The absence of accountability leads to a poorer service quality that otherwise would have been the case, and then there is a cost associated with the loss of public service benefits. Without sufficient revenue autonomy it will be much harder, if not impossible, to develop local credit markets, and consequently the development of necessary infrastructure will be slower. Finally, there may be a cost in terms of overall national government revenue mobilization, which may have been a result of increased local revenue mobilization.</td>
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<td>Fiscal decentralization leads political decentralization</td>
<td>If local councils are not elected, then the consequence is that effective accountability to local voters will be lost. More likely, accountability will be upwards to the higher level government. This means that one of the main advantages of decentralization will be lost, in part or completely.</td>
<td>Local voters are unlikely to get the package of services that they most need and desire, hence decentralization will deliver a lower level of welfare. In some cases the provision of basic services, such as health and education, can suffer because upper level government officials may be more focused on other things, such as economic development and infrastructure. Also, if consumer-voters do not get what they most want, they may be less willing to pay for services hence revenue mobilization potential may not be realized. Finally, if local residents do in fact know what is best for them and for their economy, then economic development may also suffer.</td>
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<td>Decentralization of spending and borrowing autonomy before establishing a hard budget constraint</td>
<td>This is a serious mistake. If subnational governments are not required to balance their budgets, and if they are given borrowing powers, then repayment by the subnational government will become a contingent liability of the higher level government. If borrowing is not tightly controlled, this can lead to debt financing of current expenditures, and to a general pattern of overspending and fiscal indiscipline.</td>
<td>The costs of fiscal indiscipline can be significant. Covering the debt of subnational governments, especially where it is significant in amount, can compromise the fiscal position of the central government, and even its creditworthiness. Once a pattern of fiscal indiscipline is established, it becomes difficult to reverse, and contingent liabilities of the higher level government continue to accrue.</td>
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<td>Decentralizing Finances Before Decentralizing the Civil Service</td>
<td>In this case, subnational governments would have discretion in determining their expenditure package, and perhaps even some revenue raising powers, but would not have control over their employees. If hiring, firing and promotion are decision left to higher level governments, then subnational governments will not be able to control the delivery of services for which they are responsible. Moreover, if compensation is determined by a higher level government, then local governments will not have control over a significant portion of their budget.</td>
<td>The cost of not decentralizing control over local employees is possibly a lower quality of services (though it might be argued that central control guarantees a better service delivery). Another cost is that subnational governments might be presented with pay increases in the form of unfunded mandates that compromise the integrity of the local budget planning process. Finally, the centralization approach denies subnational government voters the opportunity to hold their officials fully accountable for the quality of services that are delivered.</td>
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<td>Implementation is Carried out before Clear Implementing Regulations are in place</td>
<td>The consequences are that the actual structure of the decentralization will be in the hands of those who are implementing the program, rather than being guided by the law and the policy paper. Thus, front line bureaucrats may end designing policy on their own without any type of coordination. Decisions might be made more on a basis of administrative expediency, or even self-interest, than on a basis of the objectives of the program. Also, this is a recipe for murkiness in how to go about doing decentralization, e.g., assigning clear responsibility for service delivery, or following a clear tax code.</td>
<td>If implementation is flawed because there are no clear regulations issued beforehand, the integrity of the decentralization program may be significantly compromised. In addition, there will be a cost in terms of service delivery or perhaps inadequate tax and borrowing practices. Budget preparation and implementation could be flawed and therefore costly, and local government employees might not be adequately prepared to assume new service delivery responsibilities.</td>
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<td>Implementation Begins before a monitoring and</td>
<td>The consequences are that the government misses a chance to measure the effectiveness of the decentralization program in terms of accomplishing</td>
<td>The program may go on for several years with a flawed structure. This could result in the public losing faith in the program and in a lowering of the</td>
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<td>evaluation capability is in place</td>
<td>the goals that are set for it. As a result, fine tuning or reconstruction of the program might not be done, or at least might not be done with the benefit of measurement of the problems with the system.</td>
<td>overall effectiveness of the decentralization initiative.</td>
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