

Fiscal Decentralization in Developing Countries - A Review of its Elements

Author
Sylvester W. Taylor

Abstract

The reform of economic systems in developing countries during the 1980s focused largely on increasing the role of the market and improving the environment in which it operates. For some years, there was a preoccupation with the private sector, such that the potential role of the public sector in promoting development received little attention. In recent years, there have been widespread attempts to both redefine the role of the public sector in developing countries and improve its performance. An increasingly important goal of these reforms is the decentralization of government functions. During the 1990s, fiscal decentralization and local government reform were among the most widespread trends in development (World Bank, 2000: chapter 5). Many of these extensive and costly efforts, however, have made only modest progress toward meeting their stated goals. Given this uneven performance, there has been considerable debate about the desirability of fiscal decentralization and how to approach it. This paper examines the origins, conceptual foundations, and practice of fiscal decentralization in developing countries. Several issues are covered. First, briefly consider why fiscal centralization has been historically prominent in developing countries, Second, outline some key elements of fiscal decentralization as it is being promoted in some countries, including some of the challenges being faced. Finally, the researcher makes some concluding observations on how to think about designing more appropriate and effective fiscal decentralization in developing countries.

Introduction

The reform of economic systems in developing countries during the 1980s focused largely on increasing the role of the market and improving the environment in which it operates. For some years, there was a preoccupation with the private sector, such that the potential role of the public sector in promoting development received little attention. In recent years, there have been widespread attempts to both redefine the role of the public sector in developing countries and improve its performance. An increasingly important goal of these reforms is the decentralization of government functions.

During the 1990s, fiscal decentralization and local government reform were among the most widespread trends in development (World Bank, 2000: chapter 5). Many of these extensive and costly efforts, however, have made only modest progress toward meeting their stated goals. Given this uneven performance, there has been considerable debate about the desirability of fiscal decentralization and how to approach it.

This paper examines the origins, conceptual foundations, and practice of fiscal decentralization in developing countries. Several issues are covered. First, briefly consider why fiscal centralization has been historically prominent in developing countries, Second, outline some key elements of fiscal decentralization as it is being promoted in some countries, including some of the challenges being faced. Finally, I make some concluding

observations on how to think about designing more appropriate and effective fiscal decentralization in developing countries.

The Historical Basis of Fiscal Centralization

Although fiscal decentralization has emerged as a focus of public sector reform in many less developed nations, the substantial body of theory and research on public finance in developing countries includes little substantive work on the fiscal role and performance of local government. Most analysis of this topic has been in the form of occasional case studies or chapters in studies of national tax systems, usually conducted by special commissions or international development agencies, such as the World Bank or the International Monetary Fund (IMF). Only a few attempts to conceptualize the issues broadly and/or to compare decentralization and local finance policies across a group of countries have been made (TerMinassian, 1997; Bird and Vaillancourt, 1998). Some of this literature predates the recent emphasis on decentralization, and much of the rest focuses primarily on major urban areas or non-fiscal aspects of decentralization (Manor, 1998; Blair, 2000).

In many developing countries such as Liberia, a general lack of managerial and technical expertise has precluded- or been used as an excuse to avoid the formation of local government institutions and an effective working relationship between the central and local governments. Given the limited pool of human resources and the scarcity of training and educational facilities, some central governments feared competition for qualified staff if decentralized governments were strengthened.

The most important reason local governments have been neglected in developing countries is that strong central governments often oppose decentralization. Some reasons for this reluctance are legitimate, such as the need for nation building in ethnically fragmented societies and central macroeconomic control in fragile economies. Equally important, however, is the reality that the governing elite, who may be dominated by particular ethnic groups, fear the loss of power and wealth inherent in meaningful decentralization. In addition, central ministries and/ or political parties that control substantial resources rarely want to share them with autonomous local governments.

The Elements of a Good Fiscal Decentralization Programme

Considering whether the broad benefits and disadvantages commonly attributed to fiscal decentralization are genuine, I now turn to the key elements that should be included in a good fiscal decentralization programme. These include: an adequate enabling environment; assignment of an appropriate set of functions to local governments; assignment of an appropriate set of local own-source revenues to local governments; the establishment of an adequate intergovernmental fiscal transfer system; and the establishment of adequate access

of local governments to development capital. Each of these is discussed in turn, first outlining principles, and then turning to commonly encountered problems and possible ways to mitigate them.

An adequate enabling environment

An enabling environment for fiscal decentralization can begin with constitutional or legal mandates for some minimum level of autonomy, rights and responsibilities for local governments. This provides a foundation on which to build decentralization, but it does not by any means guarantee successful fiscal decentralization. There are many countries with constitutional clauses and laws on local government that have not managed to decentralize successfully. A good example is Indonesia, which became more fiscally centralized after a major decentralization law was passed in 1974 (Smoke and Lewis, 1996). A number of elements appear to be critical in establishing a sustainable enabling environment for fiscal decentralization.

Domestic political interest has taken the initiative away from the international donor community, which has driven recent decentralization efforts in many developing countries. In African countries such as Liberia, donor agencies were invited to assist only after the respective governments laboriously determined the general direction in which they intended to move.

Although some of these countries have strong enabling environments for decentralization, their perceived political imperative to decentralize has led to some of the other common problems of decentralization discussed below, including attempts to move forward more rapidly and less strategically than a complex process like decentralization merits. Thus, the basic policy frameworks for the decentralization programmes in some African countries like Ghana, at least in some respects, serve as models for other countries, but care must be taken to learn from their mistakes in implementation.

Assignment of appropriate functions to local governments

The problems with fiscal decentralization on the expenditure side appear to be related more to a lack of attention to implementation than to decentralizing inappropriate services. Two aspects are particularly worth noting.

First, no matter what a constitution or law says, central government agencies rarely have a desire to decentralize services they have been providing, particularly if decentralization involves a loss of prestige and resources to these agencies and they perceive each other as competitors. Thus, they almost invariably try to slow the process. Second, if too many sectors are decentralized too rapidly and local governments do not have the capacity to handle these new responsibilities, they will perform poorly. If this happens, central agencies hostile to decentralization can use poor local performance as an excuse for keeping the services centralized.

Although poor fiscal performance of local governments is often a genuine problem, this does not necessarily prove that fiscal decentralization is inappropriate. It may simply mean that the fiscal decentralization or local government reform programme is giving local governments too much functional responsibility too rapidly and without appropriate capacity building and local governance development support from the central government.

The gradual, tailored approach to fiscal decentralization and capacity building is increasingly becoming a common element in reform, albeit to various degrees and in different ways. Some countries are beginning to struggle with how to take incremental, realistic steps toward service decentralization to local governments.

Assignment of appropriate revenues to local governments

Central governments generally attempt to assign local governments' revenue bases that are relatively immobile and should therefore not lead to serious spatial efficiency effects that do not compete seriously with central tax bases and so on.

Four particularly problematic concerns remain on the revenue side. First, assigned revenues are almost never adequate to meet local expenditure requirements. This means that central government transfer programmes are inevitably required. Second, local governments often use too many unproductive revenue sources that barely cover the costs of collecting them. Third, the same lack of attention to implementation discussed above in relation to service decentralization also plagues the revenue side. Fourth, individual local revenue sources suffer from some serious design problems, such as static bases, overly complex structures and ineffective collection mechanisms.

Strategic implementation, as on the expenditure side, is critical for successful property tax reform. Simple and more acceptable reforms should be undertaken before more complex and contentious ones. New systems should be tested in pilot areas, allowing the government to improve them before widespread application. Better linkages should also be created between the tax policy and tax administration officials. This would improve the ability to respond in a timely manner to unworkable rules and problems that develop during implementation.

Developing an appropriate intergovernmental transfer system

Because local own-source revenues generally do not cover local government expenditure responsibilities, virtually all governments have intergovernmental transfer programmes. These serve multiple, often interrelated purposes, three of which are particularly important. First, they help to cover local government fiscal imbalances, supplementing inadequate local own-source revenues to improve the ability of local governments to meet their expenditure responsibilities. Second, they can be used to meet national redistributive objectives, helping to offset fiscal capacity differences among local governments. Third, they can be used to encourage local expenditures on particular goods and services that exhibit positive externalities or are considered to be basic

needs that should be distributed less unequally than the ability to pay for them. Most transfer systems, even in developing countries, are intended, at least officially, to meet these objectives. There are several typical issues and problems involved in designing transfer programmes. First, it is important to recognize explicitly that different types of transfers are appropriate in different circumstances. Unconditional grants, for example, are best for income redistribution purposes, while conditional grants are a cheaper way of encouraging expenditures on particular types of target services. If designed properly, both types can help to encourage local resource mobilization and to ensure over time the provision of a basic minimum of services in all local governments regardless of fiscal capacity.

Developing adequate local access to investment capital

Local governments in many developing countries such as Liberia get most of their capital budget from intergovernmental transfers, but some decentralized governments, typically states, provinces and large cities, are able to borrow. In some countries, there is direct and significant access to commercial banks and the bond market. In other countries, such as Kenya and Indonesia, virtually all borrowing occurs through special government accounts or lending institutions along the lines of a municipal development bank.

Challenges of Fiscal Decentralization

The first system design issue is that normative fiscal principles are not likely to be the starting point for many of the actors involved in fiscal decentralization. Different institutions will typically have different perspectives on how far to push decentralization and what form it should take. There will often be political and bureaucratic resistance to even the most carefully defined programme of fiscal decentralization. Competing central government agencies that would lose power and resources under a fiscal decentralization programme may try to undermine progress. In some cases, local governments may also resist decentralization if they are comfortable being served and financed by the centre.

When such conditions exist, there is a need to develop a political negotiation process for defining the fiscal decentralization goals and strategy. Getting consensus from key institutional actors on how to define fiscal decentralization may be more critical, at least initially, than the specific initial form the intergovernmental system takes. If the process is fair, it should result in a system with at least some basic checks and balances among various organizations and individual employees in key institutions, so that none are too powerful in the process of defining what fiscal decentralization means or controlling its implementation.

The real challenge for fiscal decentralization is to develop a spectrum of options to finance capital investment—from grants and subsidized loans for poorer local governments and non-self-financing projects, to various types of loans and bonds for fiscally sound local governments and self-financing projects. As with grants, the approach

that a central government takes toward enhancing local government access to loans depends on the fiscal context, as does the extent to which these efforts pose any danger to macroeconomic stability.

Conclusion

As economic and political pressures for fiscal decentralization continue to escalate and as forces driving democratization continue to develop, many countries will feel an increasing urgency to decentralize. In spite of this growing interest and support, fiscal reform of local government is likely to be a slow and painful process because serious constraints on decentralization are not going to disappear suddenly, and some standard analytical tools may have limited applicability. Available conceptual frameworks for analyzing fiscal decentralization are useful, but they are not designed to deal with some of the most important factors affecting the prospects for effective fiscal decentralization. Moreover, implementation is complex and requires careful attention.

The most critical problem fiscal decentralization analysts face is a dearth of good comparative information on the extent to and conditions under which the alleged benefits and disadvantages of fiscal decentralization have been realized. Anecdotal evidence and case studies can give us certain insights, but additional policy experimentation and more systematic research is needed to help us understand more broadly the realities of and prospects for fiscal decentralization in developing countries. Such information would lead the way to better conceptual development and more effective public policy.

Sylvester William Taylor

Cand. Master (Agribusiness Management) Rome Business School

MPSM (Master of Public Sector Management) - GIMPA

Tel: (231) 886-570-243/777-570-243

Email: staylor@moa.gov.lr / sylvesterwtaylor9@gmail.com

[linkedin.com/in/sylvester-w-taylor-7b922a143](https://www.linkedin.com/in/sylvester-w-taylor-7b922a143)

Skype: swilliamtaylor

"Those who anticipate the future are empowered to create it"

(John F. Kennedy)

Associated Value: Treat Staff Fairly and Impartially

Associated Principle: Act honestly and do not tolerate or justify dishonesty conduct in any circumstances

Goal: To create an organizational culture that encourages honesty, fairness, integrity, and professionalism in the workforce.

Objective: develop and support policy actions to increase fairness in the workplace.

Rationale: Developing and supporting policy actions that encourage fairness in the workplace is one of the best approaches to eliminate unfairly treatment in the workplace and thus leads to building integrity and professionalism among the workforce.

Bibliography

ALLAUDIN, K. AND P.V. RAJARAMAN. Urban Infrastructure Financing in India: Tamil Nadu's New Financial Intermediary, Times Research Foundation, Calcutta, 1996.

ALONSO, W. "The economics of urban size", The Proceedings of the Regional Science Association, 1971.

ANDERSON, D. "Infrastructure pricing policies and the public revenue in African countries", World Development, Vol. 17, No. 4, 1989.

BAHL, R.W. "How to design a fiscal decentralization program", in Yusuf et al., 2000a. Intergovernmental Fiscal Transfers in Developing Countries: Principles and Practice, Urban and Local Government Background Series, No. 2, World Bank, Washington, DC, 2000b.

BAKER, J. (ED.) Small Town Africa: Studies in Rural-Urban Interaction, The Scandinavian Institute of African Studies, Uppsala, 1990.

BALLASSA, B. "Structural adjustment policies in developing economies", World Development, Vol. 10, 1982.

BEEDE, D. AND D. BLOOM "The economics of municipal solid waste", World Bank Research Observer, Vol. 10, No. 2, 1995.

BENNETT, R. Decentralization, Local Governments and Markets: Towards a Post-Welfare Agenda, Clarendon Press, Oxford, 1990.

BLAIR, H. "Participation and power at the periphery: Democratic local governance in six countries", World Development, Vol. 28, No. 1, 2000.

BRENNER, Y.S. Theories of Economic Development and Growth, Praeger Press, New York, 1966.

BRILLANTES, A. "Re-democratization and decentralization in the Philippines: The increasing leadership role of NGOs", International Review of Administrative Sciences, Vol. 60, No. 4, 1994.