

Decentralisation and the Implications for Local Government Finance

Nick Devas

Decentralisation: A global trend

Decentralisation is not new. Almost every country in the world (except some very small states) has some form of sub-national government structure, whether to maintain control or to deliver public services across the country, or both. Sub-national structures range from elected state, provincial, municipal or local governments with high degrees of autonomy, to local agents of the central state with minimal discretion – with numerous variations in-between.

Within the Commonwealth, the local government system varies widely, a reflection of the Commonwealth's diverse nature. Variations arise in terms of constitutional protection for local governments (about 25 countries), number of tiers, gender participation, financial autonomy and intergovernmental transfers. Many Commonwealth countries do not have a local government system *per se*, while in others local governments have limited functions and autonomy.

As decentralisation is a global trend, Commonwealth countries are at different stages of reform; the pace of implementation also varies. In low- and middle-income Commonwealth members, decentralisation is closely linked to the new global agenda for poverty reduction and attainment of the Millennium Development Goals. In high-income member nations, the pressure comes from the need to squeeze greater 'value for money' from existing fiscal revenue and central government transfers. At the same time, in many countries there has been new thinking about shifting away from the direct provision of services by government to more indirect approaches in partnership with the private sector (e.g. public-privatisation partnership legislation in Fiji Islands) and community based organisations (e.g. citizen community boards in Pakistan).

The decentralisation debate addresses the central problem of public administration – that of 'delegated discretion' (Fukuyama, 2004). The centralisation/decentralisation debate tends to be cyclical. Central governments have a natural tendency to centralise, until some countervailing pressure forces decentralisation. Colonial governments often used decentralised government arrangements as a way of extending their control, e.g. through 'indirect rule' or as providing 'education for democracy' in the run-up to independence (Mawhood, 1993; Olowu and Wunsch, 2004). From the 1940s to the

1970s there was a centralising tendency in much of the world: under communism in central and eastern Europe, the Soviet Union and China; in newly independent countries, where governments sought to consolidate their authority; and as a result of attempts at central economic planning in much of the developing world.

Since the 1980s, there has been a strong tendency to devolve functions, with most countries adopting some form of decentralisation. This has been driven by:

- The failure of the central state to be sufficiently responsive to citizen needs and regional differences;
- The failure of centralised economic planning to deliver results;
- Democratisation in large parts of the world, with demands from local communities to control their own resources in accordance with local needs and priorities;
- The rise of secessionist movements demanding autonomy from the centre;
- Urbanisation and the growth of large, complex cities, necessitating more responsive systems of city governance;
- Budget problems of national governments, for which decentralisation of responsibilities is often seen (erroneously) as a solution;
- Donor pressures on governments to decentralise as a way of improving service delivery at the periphery, and of getting around obstructions at the centre.

Often, adverse or limited results from earlier attempts result in renewed centralisation, only to be followed by further attempts at decentralisation when the shortcomings of excessive centralisation become evident once more.

Within Europe, the basic treaties of the European Union specify subsidiarity as a principle – that is, that government functions should be carried out at the lowest level that can perform those functions effectively and efficiently.

In practice, decentralisation (or its reverse) is not a once-for-all reform, but rather a continuous process of change in response to particular circumstances and drivers.

The case for decentralisation

The arguments for decentralisation essentially fall into three overlapping groups: administrative, political and economic.

Administrative arguments

It is simply not possible to make every decision about every part of a country from the centre. The centre lacks detailed knowledge about local needs and conditions. Since services have to be delivered at the local level, at least some decisions have to be made

locally. This is similar to the way in which commercial organisations decentralise certain decisions to local managers. The larger and more diverse the country, the greater is the administrative need to decentralise.

Political arguments

Democratic governance implies that citizens exercise choice about how resources are used and services delivered in their communities. Local self-government increases opportunities for participation and accountability, thereby deepening democracy and increasing democratic legitimacy. This is especially so where a country's population is diverse, and needs and preferences vary between regions. In principle, decentralisation can increase opportunities for participation and access to decision-making by otherwise excluded groups, as well as increasing accountability, through proximity of decision-makers to citizens. It also provides a means of accommodating the legitimate aspirations of regionally-based ethnic groups for a degree of autonomy.

Economic arguments

Decentralisation, it is argued, can bring about an improved allocation of resources, as decisions about resource use better reflect the needs, priorities and willingness to pay of local citizens. As a result, service delivery should improve. So should cost recovery and resource mobilisation, as local charge and taxpayers will be more willing to pay for services that benefit them (although the evidence on the last point seems quite weak).

... the power over the production and delivery of goods and services should be rendered to the lowest unit capable of capturing the associated costs and benefits.

World Bank, *World Development Report 1997*, p. 120

Fiscal federalism: The classic theoretical case for decentralisation is often referred to as fiscal federalism (Oates, 1972). This argues that, since the efficient scale of production for most public goods is smaller than the national level, economic benefits will be maximised where decisions about those public goods are made within the jurisdiction which relates to the scale of production of those public goods, so as to reflect differing preference patterns. Under such an arrangement, costs and benefits can be internalised – that is, the costs and benefits of a service fall on those within that jurisdiction who make the decisions. The problem is that public goods have differing spatial characteristics and economies of scale, so that different 'local governments' would be required for each service. Since that is generally impractical, a compromise has to be found in terms of the optimum size for a multi-purpose local government (although in many countries there are special-purpose authorities, for example school boards and police districts in the USA).

Public choice: Tiebout (1956), in his application of public choice theory to decision-

making in local government, argues that citizens will vote for a combination of taxes and benefits that best suit their interests ('voice'), and/or will relocate to the jurisdiction which offers the best combination of services and taxes ('exit'). Although there are examples that support this 'exit' model (e.g. firms and rich residents relocating out of New York City), this theory makes unrealistic assumptions about citizens' ability and willingness to relocate, as well as about the information available to them, particularly in developing countries.

Variety, experiment and competition: A further economic argument for decentralisation is that it allows a variety of experiments and initiatives that can, through comparison and learning, improve the overall performance of the system. Furthermore, competition between jurisdictions may enhance overall performance of the governmental system. By contrast, centralised systems tend to standardise and fossilise. But this assumes that experimentation, innovation and competition are possible within the system, and that there are mechanisms for mutual learning. These are relatively rare in developing countries.

Poverty reduction and gender equality: It is often argued that decentralisation can contribute to poverty reduction by bringing decision-making closer to where the poor live, increasing the voice of and accountability to the poor, and by more accurate targeting of social spending. It could bring positive results if the decentralised system incorporates mechanisms to redistribute resources between regions or local governments. However, where poverty arises from inequalities within the region or local government, decentralisation could even worsen the plight of the poor as a result of local elite capture. The evidence on the impact of decentralisation on poverty is very mixed (Jütting *et al.*, 2004). A general conclusion is that decentralisation alone is unlikely to have a positive effect on poverty and inequality unless there are particular initiatives to address these issues. More specifically, unless decentralised government systems make provision to ensure the representation and voice of women, decentralisation is unlikely to bring about greater gender equality.

The arguments against decentralisation

The following are common arguments against decentralisation:

- a) **Fragile national unity**, particularly in newly independent nations, and the perception that decentralisation could result in fragmentation and reinforce ethnic divisions. In practice, however, while tight central control in a diverse nation may work for a while, it can often collapse dramatically (e.g. USSR, Indonesia). By contrast, decentralisation may provide a safety valve for those seeking a degree of autonomy.
- b) **Increased inter-regional inequality:** Since some regions have greater resources and greater economic potential, according regions greater autonomy may increase

inequality across the country. Although there are ways of combating this, through intergovernmental fiscal transfers (see chapter 6) and redirecting investment, the evidence from many countries (for example China, Mexico, Indonesia and, to a lesser extent, India) is that decentralisation has, in practice, increased inter-regional inequality (Rodríguez-Pose and Gill, 2004).

- c) **Decentralisation is unnecessary** (in the sense of devolution) because local needs and priorities can be determined by central officials placed in the regions (i.e. deconcentration) without the need for devolution of political power. It is often argued that such 'benign centralism' may do more to achieve local development (as evidenced in several countries in east and south-east Asia) than factious local democracy. But this approach leaves open issues of citizen voice and local accountability for decisions.
- d) **Cost and inefficiency**: Decentralisation can add to the costs of public administration by increasing the numbers of elected representatives (who generally require some remuneration) and local officials. However, these costs may be necessary if services are to be brought to the local level and decisions made in a participatory and accountable manner. Decentralisation may also result in inefficiency, where services are provided by each small community at below the efficient scale of operation (a major issue in central and eastern Europe post-1990). This problem can be overcome (as in France) by joint operation between local governments and/or contracting services from other local governments or private suppliers (i.e. making a distinction between providing a service and producing it – it is the latter, not the former, that requires economies of scale).
- e) **Lack of capacity** at the local level, whether through lack of technical or managerial skills or low calibre of staff. This is often a serious issue, but tends to become self-fulfilling where it is used as the reason for not decentralising activities, since the result is that there is no incentive for skilled people to stay at the local level. The problem can be addressed (to some extent) by training and/or secondment of staff from higher tier(s) of government.
- f) **Lack of financial resources** at the local level, since local tax bases are small (particularly in rural areas). However, this is not a reason for not decentralising – rather, the intergovernmental fiscal system needs to be designed so that the distribution of functions between levels of government is matched by fiscal resource transfers (see chapter 6).
- g) **Increased fiduciary risks and corruption**: Since more resources are handled further from the centre, where financial controls are generally weaker, there are increased fiduciary risks. Corruption may also be more serious at the local level because of the proximity of officials and politicians to clients and contractors. However, the same proximity, to citizens and voters, may also help to increase accountability. There is

ongoing debate about whether decentralisation makes the problems of corruption better or worse, or just disperses the problem more widely (Fjeldstad, 2004).

- h) **Threats to macroeconomic management and stability:** Decentralisation may reduce the room for manoeuvre for national governments in managing the economy, and in extreme cases can be destabilising (Prud'homme, 1995; World Bank, 1997: 125; Tanzi, 2000). This can occur where large areas of taxation are assigned to, or shared with, local governments without matching increases in their functions, where local governments are free to borrow without proper limits or where they incur substantial budget deficits. These have been significant problems in a number of Latin American countries, and to a lesser extent in China, but in most other developing countries, the local government sector is too small or too highly controlled by the centre, or both, to have any serious impact on national economic management. Prudential rules about borrowing and deficits can largely obviate the problem. The perception that local government borrowing is generally irresponsible is changing, and countries such as India have started institutionalising borrowing from the private sector for municipal infrastructure financing (see chapter 4).
- i) **Domination by local elites** and traditional authority structures may be to the disadvantage or exclusion of the poor. It is argued (Manor, 1999) that local elites are generally less favourable to the poor than central government elites. However, whether the poor are more disadvantaged or excluded in a decentralised system than in a centralised one is still a matter of debate. Much depends on the local and national political processes, and the opportunities for the voice of and accountability to different groups, in the particular country.
- j) **Resistance from central government officials:** In practice, the main resistance to decentralisation is likely to come from central government politicians and civil servants, who perceive that their power is being eroded. Even when they officially endorse decentralisation, their actions may impede or undermine the process.

What is the evidence?

A number of recent studies have shed light on the effects of decentralisation.

Blair's (2000) study of democratic local governance in six countries showed that in most cases there had been benefits in terms of extending participation and accountability, but that there had been little impact on inequality or poverty. The impact on participation and accountability depended on the range of mechanisms adopted.

Crook and Manor's (1998) study of four countries (Karnataka in India, Bangladesh, Côte d'Ivoire and Ghana) found mixed results:

- Performance in terms of output of public services improved in most cases, but strongly only in Karnataka;

- Indicators of responsiveness and citizen satisfaction ranged from good in Karnataka to poor in Ghana;
- Certain poor groups may benefit from decentralisation but others are unlikely to;
- It is the combination of various factors (notably, political commitment, resources, popular participation and mechanisms of accountability) that account for whether or not decentralisation is effective.

In their cross-country analysis of studies of the impact of decentralisation on poverty-alleviation, Crook and Sverrisson (2001) found that:

- Decentralisation is unlikely to increase pro-poor performance except where this is driven by central (or state level) government (e.g. in West Bengal and in some Brazilian states);
- There is a common pattern of 'elite capture' of elected local governments, often encouraged from the centre;
- Accountability is critical: top-down, unaccountable decentralisation processes have not helped the poor (e.g. Ghana, Côte d'Ivoire, Bangladesh, Kenya, Nigeria and Mexico);
- Poverty reduction requires effective arrangements for allocating both financial and administrative resources that ensure the intended use of transferred resources and the capacity to implement programmes;
- Outcomes depend on the length of time which the decentralised system has been in operation (e.g. West Bengal compared to most other places);

Schneider's (2003) statistical study of 108 countries found:

- That deconcentrated governmental systems spend more on social services, while politically devolved governmental systems spend less on these;
- No correlation between fiscal decentralisation and pro-poor expenditure;
- That the interests of the poor are best served by a combination of political centralisation and administrative deconcentration.

By contrast, Von Braun and Grote's (2000) comparison of human development indicators with the extent of political decentralisation concludes that decentralisation can be beneficial to the poor under the right circumstances, and that it is political rather than administrative decentralisation that makes the greatest difference. This is because of the greater scope for the poor both to hold elected officials accountable and to influence public spending decisions when they are concentrated in certain jurisdictions.

Overall, the evidence on decentralisation is mixed and contested. In a number of countries (Indonesia, Philippines) problems arising from rapid and substantial decentralisa-

tion have led to calls for a degree of recentralisation. These may have the support of powerful interests. Nevertheless, there is a general point that can be made. Local services, on which the poor depend, have to be delivered 'out there', so that some form of decentralisation is necessary. What matters, then, is how the system is designed and the mechanisms that are incorporated to ensure 'voice' and accountability.

Forms and principles of decentralisation

In the literature and in common usage, terms are not always used precisely. Some use the term decentralisation to refer to any shift away from the centre, whether managerial/administrative (e.g. within a company or organisation), political, spatial or fiscal. Here we make a basic distinction between deconcentration and devolution.

- **Deconcentration** (sometimes also referred to as administrative or management decentralisation): responsibilities are assigned to agents of the central government.
- **Devolution** (also referred to as political decentralisation or democratic decentralisation): responsibilities and authority assigned to elected bodies with some degree of local autonomy.

Deconcentration is concerned mainly with the administrative rationale for decentralising and to some extent with the economic arguments, whereas devolution to elected local bodies is concerned with the political as well as the economic (and administrative) arguments.

The distinction is not always clear-cut. Deconcentrated units may well have considerable discretion about how to operate and may have resources under their control (e.g. local managers in the UK's National Health Service). Meanwhile, devolved local governments may be tightly controlled by the centre, with limited discretion over resource use. But the difference in principle is that the former are answerable only to their parent ministry or agency, whereas the latter are primarily answerable to the local electorate (although there will also be an upward accountability to central government).

In the past, some governments (e.g. Tanzania, Kenya) have used the term decentralisation to refer to a process of shifting power to deconcentrated agents of central government (e.g. district commissioners), while at the same time reducing the role of elected local governments.

Two further forms of decentralisation are often mentioned, although they do not really affect the basic distinction drawn here. One is delegation, where a government agency or a sub-national government carries out a particular function on behalf of central government in return for a payment. This can take place within either a deconcentrated or devolved system.

The other is fiscal decentralisation, which is the transfer of fiscal resources and decision-making power to the sub-national level, usually to an elected regional or local govern-

ment. However, fiscal decentralisation does not usually exist on its own: it requires devolution of decision-making power in order to be meaningful, while devolution of decision-making power requires fiscal decentralisation in order to be meaningful. Fiscal decentralisation will be discussed further below, as well as in subsequent chapters.

Requirements for effective decentralised (devolved) government: Decentralisation in the form of devolution requires a system of local government that has:

- Boundaries, powers and functions defined in law;
- A separate legal identity with perpetual succession, able to buy, sell and hold property, and with its own budget and bank account;
- An elected decision-making body, although some members may be appointed;
- Significant discretion over local expenditures;
- Some independent source(s) of finance over which it has some discretion in setting the level and using the receipts;
- Its own staff (although they may belong to a unified national cadre and some may be seconded from central government).

Relationships between deconcentrated and devolved authorities: In most systems, a key issue is the relationship between the devolved local governments and the deconcentrated agents of the state (such as prefects, district commissioners, collectors, intendente and the local offices of central ministries). This concerns:

- Territorial authority (who is ‘in charge’?)
- Division of functions (who does what?)
- Representation (who represents the local population?)
- Supervision and control (who supervises whom?).

In some countries, there are two parallel systems (e.g. prefect or district commissioner and commune or local government), often with considerable friction between the two. In other countries (e.g. Indonesia), the two are combined, so that a provincial governor is both the head of the provincial government and the representative of central government locally.

Fiscal decentralisation

Decentralisation – at least in the sense of devolution to elected local governments – requires fiscal decentralisation. Fiscal decentralisation is the assignment to sub-national or local governments of resources to finance the functions that have been assigned to them. This involves the assignment of both local own revenue sources and intergovernmental fiscal transfers.

Local own revenue sources include not only local taxes, but also revenues from charges and fees, from local owned enterprises and other miscellaneous income sources. These will be discussed in more detail in chapter 2. Intergovernmental fiscal transfers include shares of revenues from national taxes that are assigned to sub-national or local government, and grants, both conditional grants and general or block grants. These will be discussed in more detail in chapter 6.

Fiscal decentralisation involves the design of an overall intergovernmental fiscal system that achieves both vertical and horizontal balance:

- Vertical balance between the functions assigned to each level of government and the resources assigned;
- Horizontal balance between the expenditure needs and resource capacity of each unit at the same level (i.e. between local governments at the same level in a multi-tier system).

In most systems, the main revenue sources are assigned to central government, for good reasons of administrative practicality, economic efficiency and inter-regional equity. As a result, the local own revenue sources assigned to local government are often quite limited, and in rural areas may yield very little revenue indeed. Therefore, a system of intergovernmental transfers is essential in order to ensure that local governments can carry out the responsibilities assigned to them. The design of such systems will be discussed further in chapter 6.

Fiscal decentralisation also involves a set of rules about the use of financial resources at sub-national level, and systems for monitoring and enforcing those rules. These rules may relate to:

- The specification of local taxes, including the system of assessment;
- The scope for local governments to levy fees and charges for locally provided services;
- Regulations about the operations of local government-owned enterprises;
- Regulations about borrowing by local governments;
- Requirements regarding the execution of assigned functional responsibilities, including the level of discretion about the delivery of local services;
- Specification of the use of intergovernmental transfers;
- The form of the local expenditure plans and budgets, including approval of development plans and annual budgets;
- Systems of accounting and financial management;
- External audit of the accounts of local government.

Central government's ability to monitor and enforce these regulations is, however, often constrained by:

- Limited knowledge at the centre about what is actually happening at the local level;
- Lack of staff at the centre to monitor and control the activities of numerous local governments;
- Lack of skills at the centre to interpret the information available;
- Rent-seeking and corrupt behaviour of central officials charged with enforcing central controls;
- Manipulation of data provided to the centre by local governments;
- Central regulations that create perverse incentives on the part of local officials (e.g. actions that avoid the intended effect of the regulations).

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