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# **Fiscal Decentralisation in Transition Economies and Developing Countries**

(Work Sessions 12 and 24)

## **1. Introduction**

Fiscal decentralisation – the devolution of taxing and spending powers to lower levels of government – has become an important theme of governance in many transition economies and developing countries. Accordingly, the restructuring of governmental functions and finances of national and lower-level governments has entered the core of the development debate.

The transition country case presented Russian situation while those for developing countries examined Pakistan and Indonesia. There have been reforms in all three countries, which had previously been more centralised. These have led to a system of fiscal rearrangement that enhances democratic participation and improves the service delivery performance, responsiveness and accountability of the public sector.

## **2. The need for decentralisation**

It was advanced that in transitional countries the main motive for decentralisation is political (achieving democracy) rather than economic, while in developing countries the aim is to improve performance in public service delivery and promote macroeconomic stability. The chosen countries were

regarded as very important in the sense that they exposed major complications in undertaking reforms leading to fiscal decentralisation. However it was revealed that the need for fiscal decentralisation was different in each country and thus the pace was also dissimilar.

### **3. The search for the right balance**

There is a wide range of reasons for rethinking fiscal arrangements for transitional and developing countries, both external and internal to the countries concerned, and they may include things such as witnessing the success of such processes in other countries. While some reasons may be country specific some cut across many countries.

#### **3.1. Internal reasons**

- The downfall of centrally planned models, ushering in the end of collective ownership model and prompting a major change in governmental organisation and geographical boundaries (e.g. in Eastern Europe and the former Soviet Union).
- Highly centralised systems that were prevalent in many developing countries depended on command and control with little concern for citizen's preferences: these systems have eventually proved inadequate in public service delivery.
- Failure by national governments to ensure regional equity, economic union, central bank independence, a stable macroeconomic environment or local autonomy. However, political reforms have

empowered citizens who in turn demand greater accountability from their governments.

- Poor record of sub-national governments: they have followed “beggar-thy-neighbour” policies; sought “free rider-ship” from the centre with no accountability, and often undermined national unity in pursuit of narrow self-interest.
- Judicial systems in some countries which provide stimuli for change by giving a broader interpretation of basic rights, and requiring national and sub-national legislation to conform to the basic rights of the citizens.

### **3.2. External forces**

The emergence of a new “borderless” world economy is bringing challenges to constitutional federalism. The nation states’ responsibility for carrying out regulation of certain economic activities has been reduced as borders have become more permeable, and information technology has undermined the state’s power to control information flows. Nation states are now in dilemma as they are too small to tackle the large things in life and too large to address small things.

Because of the new trends in globalisation and regionalism, nation states are swiftly losing power in some traditional areas of control and regulation, for instance external trade, telecommunication, and financial transactions. Nation states are therefore experiencing diminished ability to control the flow of goods and services, ideas, and cultural products.

Nation states should move towards co-federalising and relinquishing responsibilities in some areas, such as technology, satellite communication, international financial transactions that need specialised institutions of global governance (e.g. World Trade Organization (WTO)). However, the new trends add to democracy deficits, as citizens do not have the opportunity for direct input in fundamental decision making by supra-national institutions.

#### **4. Experiences of fiscal decentralisation in transition economies and developing countries: the case of Russia, Indonesia and Pakistan**

The guiding principle in fiscal decentralisation is clarity regarding the respective roles in public service delivery: the so-called “assignment problem”. This should be based on subsidiarity principle as far possible, while assignment of spending responsibilities must be aligned to the responsibility for taxation or raising of funds. Matching between taxing and spending powers ensures better accountability, and reduces over-reliance on transfers.

The general goals of fiscal decentralisation programs are:

- To increase national allocative efficiency and regional government operational efficiency;
- To meet regional aspirations, improve overall fiscal structure, and mobilise regional and therefore national revenues;
- To enhance accountability, increase transparency, and expand constituent participation in decision making at the regional level;

- To mitigate fiscal disparities among regional governments, assure delivery of basic public services to citizens across the country, and promote government efficiency objectives;
- To improve the social welfare of the people.

## **5. Actual performance in fiscal decentralisation in Russia, Pakistan and Indonesia**

We had speakers from different areas of responsibility for the three countries.

They included public sector employees from central ministries and local governments, local bureaucrats, consultants and civil servants. The conference discussions revealed that there are commonalities as well as differences in fiscal decentralisation for developing and transitional countries.

The starting points were:

- The origin of the reform process;
- How extensively it has been instituted;
- The laws and regulations supporting it;
- The division of responsibility;
- Fiscal transfers.

## **6. Implementation of reforms in fiscal decentralisation**

From the cases presented it was revealed that in all the three countries, some progress in the reform of fiscal decentralisation has been made. All three countries have carried out a series of comprehensive reforms of their inter-

governmental fiscal relations. Core issues in fiscal decentralisation in these countries are offered below.

### **6.1. Division of responsibilities between different layers of government through legal and institutional structures**

In all the three countries there have been reforms in the legal and institutional structures to back up the fiscal reform process. While the legal and institutional structures have clarified the division of responsibilities to a certain extent they have also introduced their own difficulties.

- Difference of theory and practice: in Russia the political and administrative organisation is described as a unique blend of de jure federalist structure and de facto elements of confederation and of a unitary state. It is advanced that while in theory the division of responsibilities between the layers of government is clear, in practice this is not the case.
- Overlapping of responsibilities: in Indonesia the legal and institutional framework is based on Law no. 22 of 1999 on Regional Autonomy and Law No 25 of 1999 on Central Local Fiscal Balance. The two laws have resulted in overlapping legal authorities for two ministries.
- Lack of coordination: there are other technical problems caused by institutions, as they lack coordination and cooperation.
- Problem of interpretation: in the case of Pakistan reforms backed by law and comprehensive institutions have been created. The problem is that the legal framework has been difficult to interpret at the local level. Too many institutions have been created, both elected and non-

elected, which has resulted in implementation problems. In practice, the reform document has been difficult to follow, and some units have been created whose functions are not clearly spelt out.

- Formality and informality: there is considerable disparity between what is offered in laws and regulations and what is practiced. Russia for example, is described as having a contradiction between a highly centralised formal system and substantial informal sub-national autonomy. The highly centralised and often unfeasible nature of the formal system prevents effective delegation of financial responsibility to lower levels of government.
- Existing laws that contradict the law on decentralisation: these need to be revised and synchronised in order to be able to implement the law on decentralisation.

## **6.2. The relationship between the central and lower-level governments in fiscal matters**

From the presentation it was clear that the actual relationship between the national and sub-national governments has changed. For the three cases, the sub-national share of total national revenues and expenditure has increased. In Indonesia for instance, sub-national revenue as a percentage of total national revenue grew from 4.7% in 1989-90 to 6.1% in 1994-95, but dropped again in 2001 to 5.3%. Sub-national expenditure as a percentage of total national expenditure grew from 16.6% in 1989-90 to 23% in 1994-95, to 28% in 2001. In Russia, 90% of taxes are collected by the federal government, and 10% by regional or local governments (note that this figure was disputed by

the different speakers from Russia). In Pakistan 83% of taxes are collected at the federal level, and provincial governments depend to a large extent (90%) on transfers.

Because the federal or central governments are commandeering a large percentage of revenue resources, such as high yielding and buoyancy taxes, they have to transfer large amounts of revenue to lower levels of government.

In all three cases this creates a lot of problems in practice:

- Local governments are constrained to operate without resources, because transfers are incommensurate with the numerous responsibilities assigned to them;
- The transfers cause delays resulting in many problems, especially given that salaries depend on these transfers;
- The central government still determines the taxes that local governments are allowed to levy, and this has sometimes meant getting rid of certain taxes, leaving the local governments with no source of own resources (as in Pakistan);
- Bureaucracy has been a big problem in the transfer schemes;
- Transfer formulas exist, but the basis for actual transfers is not very clear. The basis for both horizontal and vertical formulas is muddled by lack of transparency and discretion;
- Because the local governments have been given many responsibilities without matching resources it has encouraged lower-level local governments to institute some regressive means of getting funds,



including levies, patriotism, special funds contributed by private companies etc;

- The transfers have encouraged “soft budget constraint” syndrome, as the lower levels of government do not collect the revenues, and thus problems of accountability still exist.

### **6.3. Equalisation in inter-governmental transfers**

In all three cases, the objective of regional equalisation was mentioned. This was based on the fact that the three countries are large with differing levels of revenue-raising capacities across the regions. Some regions possess natural resources with higher revenue-raising capacities, others do not. The motive for revenue sharing and transfers should thus encompass vertical and horizontal distributive equity.

In practice however some difficulties were cited.

- The bulk of shared revenues go to relatively few regional governments, while some regions in need of these funds are missed out.
- There is lack of transparency in the sharing of the revenues: some relatively wealthy regions get more.
- Where matching grants are targeted at offering incentives for efforts in tax collection, there is a contradiction of the regional balancing principle, since those with high revenue-raising capacities get more funds (this point was raised in relation to Russia). Similarly, Pakistan’s matching grant for resource mobilisation rewards relatively rich provinces for additional tax effort. It also calls into question the

credibility of federal commitment, as the federal government has not been able to meet its commitment arising from the grant program.

- The formulas are complicated, and the data needed to implement them are not readily available, which results in discretionary allocations.
- Regional balancing is also blamed for a reduction in local revenue-raising capacity efforts, and lack of motivation among local authorities to search for innovative ways of consolidating their revenue.

#### **6.4. Capacities in financial management**

The cases presented indicated different levels of financial management in such areas as financial planning, budgeting, accounting framework and standards, information and reporting requirements, audit arrangements etc.

Problems associated with this include:

- Inadequate capacity at local level, especially in cases where tax assignments are not clear, although if the system is clear, the inadequate local government capacity is not a significant problem;
- Problems in interpreting the complicated legal documents leading to “elite capture” of the process by those who can understand them;
- Inadequate capacities of many regional and local governments to implement projects or financial planning and budgeting;
- Problems encountered with the institution of local accountability and central spending requirements by many local authorities at a particular time has resulted in insufficient planning and procurement spending (as in Pakistan).

## **6.5. Increase in employment and regulations**

The cases discussed show that all the countries concerned have moved from highly centralised systems to decentralised ones. In the process of decentralisation there have emerged parallel administration/bureaucracies in the centre, at regional, and at local levels. In Pakistan for instance, the current reforms have increased a number of institutions (including many local councillors) with no clear responsibilities, all requiring privileges and office space.

The process has also necessitated an increase in regulations and has resulted in some complicated legalities. Central ministries regulate the local governments, sometimes two or more ministries' authorities overlap, and at the same time have their own regulations at regional and local levels. The decentralisation process has thus increased employment and regulation, a fact that has been pointed out by Tanzi (2000) among others.

In addition, in some countries such as Russia, fiscal decentralisation has been top-down rather than bottom-up, with no clearly instituted system for involving local people.

Indonesia's education and health grants use simple and objectively quantifiable indicators in allocation of funds, conditions for the continued eligibility of these grants emphasise objective standards of access to these services. Indonesian grants for public sector wages on the other hand, represent an example of not-so-thoughtful design as they introduce incentives for higher public employment at sub-national levels.

## **6.6. Involvement of other non-governmental players**

In the cases presented, the involvement of other players in fiscal decentralisation and reforms is shown to take place at different levels. In Russia, for example, it is claimed that Non-Governmental Organisations (NGOs) are still not well integrated into the reform system, while the private sector (especially organisations with large capital), plays a very large role at the sub-national level. Companies control resources in local areas and have even become governors. Private bodies have also been used to deliver certain services, and ways to incorporate them further in social service delivery at a local level are still being examined. In Pakistan, private sector participation in the provision of public services is more common.

Decentralisation has also led to more balanced gender participation, for example in Pakistan 33% of councillors are now women.

Donors have also had a big role to play in the reform process. Their presence has complicated the issue at times, for instance it was revealed that there are 32 donors in Russia and it was suggested that they undermine the fiscal decentralisation of Russia.

## **6.7. Cross-cutting issues**

While it was demonstrated that positive progress of reform in fiscal decentralisation has been noted in all the three cases. Wide-ranging conclusions were drawn.

The reform process in some countries has been described as too quick, eroding a country's institutional and administrative capacities. This is true for instance in Russia and in Pakistan. The rapid (shock therapy) process was

not accompanied by political reforms, and so devolution took place in a political vacuum and an absence of overall democracy. This also resulted in a lack of improvement in public service delivery. The recommendation was that reforms should be taken at a slower pace, based on local capacities to manage the process.

Lack of clear-cut allocation of responsibilities between the centre and lower levels of government has resulted in parallel administration and “elite capture”, while service delivery has not improved. In addition, regional redistribution has not succeeded due to lack of sufficient resources and unclear formulas. Lack of transparency in practice has exacerbated the problems. Some participants advanced that in transition and developing countries it is more important to ensure local participation than regional redistribution and equalisation.

Central control of significant levels of resources and reliance by lower levels of government on transfers has resulted in a “master-servant” relationship, leading to clientism, favouritism, soft budget constraint based on bailouts, financial irresponsibility, lack of encouragement for local-level initiatives as the centre is expected to deliver to lower levels etc.

On the other hand the centre has de-concentrated its activities to the lower levels without giving them sufficient financial autonomy. Management of the change has to be well monitored, with responsibilities matched to capacities in terms of human and financial resources. Institution building is necessary but so are information flows. If one wants to empower local government, money should not come from the top but should be sourced from local levels as much as possible. It is important to be careful and critical when comparing principles

with reality, and when discussing how to move from a point of free resources to one of “hard budget constraint”. Monitoring and overall control are very important in order to technically audit corruption. Transparency and dialogue with local government should be encouraged, but borrowing by local governments should not be allowed.

## **7. Conclusions and recommendations**

### **7.1. Conclusions**

From the discussions it was generally agreed that the aims when introducing local authority are the same in all countries. Such reforms bring power closer to the people, increase responsibility and therefore improve public services. They ensure local management of conflict, increased public services, introduction of a code of accountability, operating and execution, control of accounts etc. The three cases discussed showed that there is a need for reform in fiscal policy, and that fiscal decentralisation has been motivated by internal as well as external factors. The pace and achievement of reforms has been different in these countries, and in general reforms implemented too quickly generated more problems than they solved. Other constraints in the economies such as lack of legal clarity also complicated the process.

The discussions showed that there is considerable divergence between what is offered in theory and the practical realities, for instance the dual (formal and informal) system existing in Russia. Responsibilities are not clarified and centre still controls the lower levels of government through transfers or retention of greater authority in taxing. Capacities to implement the reforms have sometimes been insufficient, and duplication of responsibilities evident.

The process has in many cases been top-down, and the local citizens have not benefited from fiscal reforms.

## **7.2. Recommendations**

There should not be only one competency: it is necessary to empower lower levels of governance and for them to have their own revenue sources.

Governments at all levels must be made to face financial consequences of their decisions in order to ensure fiscal discipline. This is possible if the central government does not backstop local authorities and local debt.

The relations between different levels of government should be clearly defined, but a means of coordination should also be provided. Fiscal rules accompanied by “gatekeeper” inter-governmental councils/committees provide a useful framework for fiscal discipline and fiscal policy coordination. One principle rule is that civil servants should serve under elected politicians and information on hiring and firing should be readily available and transparent. Democracy should have strong institutions with checks and balance.

There should be some institutions that equalise the financial disparities between regions. Inter-governmental transfers in transition and developing countries undermine fiscal discipline and accountability, while at the same time building transfer dependencies that cause a gradual economic strangulation of fiscally disadvantaged regions. Properly designed inter-governmental transfers, on the other hand, can enhance fiscal harmonisation, competition for the supply of public goods, sub-national government accountability, and regional equity.

Change of management is tough but it needs political leadership, authority, and the opportunity to convince people. In addition, it should be introduced at the right pace. Societal norms and consensus on the roles of various levels of government, and limits on their authorities are vital for the success of decentralised decision making. In the absence of such norms and consensus, direct central controls do not work, and inter-governmental gaming leads to dysfunctional constitutions. It is necessary to adapt the general principle of decentralisation to specific condition of the country. The system should operate so that local people feel the system is working for them.

Established democracy should learn and revise all the time, constantly re-enforcing democratic principles. Periodic review of jurisdictional assignments is essential to realign responsibilities with altering economic and political realities. With globalisation and localisation, the direct role of national governments in stabilisation and macroeconomic control is likely to diminish over time, but their role in coordination and control is expected to increase as regimes and sub-national governments presuppose increased responsibilities in these areas. Constitutional and legal systems and institutions must agree to opportune modifications that allow adaptation to changing circumstances.

Decentralised fiscal systems in transition and developing countries offer a greater potential for improved macroeconomic governance, and therefore increased growth, than centralised ones. However, decentralised fiscal systems require greater clarity in the roles of the various players and centres of decision making, and transparency in rules that govern their interactions.

Decentralisation should also be a country-specific process, governed by local knowledge and history, and directed by local priorities. Sub-national



governments need to be given access to adequate resources to do the work assigned to them; but at the same time they must be accountable for what they achieve with their resources. Like many other public policy reforms, reform in fiscal policy must take into account the political constraints faced by policy makers, disparities in the strength of different regions and localities, and different interest groups. Other constraints such as economic development and financial intermediaries should also be taken into account.

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