

## **FISCAL DECENTRALIZATION FOR POVERTY REDUCTION IN ASIA: OPPORTUNITIES, CHALLENGES AND POLICY ISSUES**

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*The increasing popularity of decentralization has been due to political imperatives and the economic rationale of improving the efficiency of the allocation of resources and the responsiveness of policymaking to local needs and preferences. There are various forms of decentralization, but this paper is focused mainly on fiscal decentralization. The paper analyses the challenges and policy issues of decentralization with respect to experiences of countries in Asia. It examines the benefits and advantages of decentralization, as well as the various costs. The financial and human resources costs can be quite large, especially in the early phases of decentralization. It is essential to conduct a careful cost-benefit evaluation before making a decision on the process of fiscal decentralization. The paper concludes with some suggestions for measures and policy options that could maximize the benefits and minimize the risks of the fiscal decentralization process and make it conducive to poverty reduction.*

### **I. INTRODUCTION**

Decentralization transfers from higher to lower levels of government the power to design and implement certain policies; it sometimes entails establishing additional tiers of government. The popularity of decentralization has been due to political imperatives and the economic rationale of improving the efficiency of the allocation of resources and the responsiveness of policymaking.

Despite economic growth over time, poverty is still a major problem for many countries. The provision of basic social services, such as clean water, sanitation, education, health and housing, is far from satisfactory, and environmental

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deterioration and a lack of good governance have become serious problems. Within many countries, development across regions has not been uniform. Certain areas, especially those that are remote, have not yet benefited from the fruits of socio-economic development; underdeveloped and rural areas lack basic services. These disparities have prompted calls for improved resources for less developed areas. Moreover, the people want a greater say in how these resources are to be utilized for their development.

The idea that decentralization can help in solving problems, including poverty, has led many countries to incorporate such a strategy or strengthen their existing decentralization initiatives. As noted in the following section, some countries were able to achieve certain objectives through decentralization. At the same time, they faced many difficulties and challenges while implementing decentralization; occasionally, the results did not meet expectations.

The main objective of this paper is to analyse issues and challenges related to decentralization, particularly fiscal decentralization, in the light of the experiences of countries in the region. It is likely that all countries will eventually implement some kind of decentralization, varying in terms of the speed and intensity of the changes. The present paper suggests some measures and policy options for maximizing the benefits and minimizing the risks of the fiscal decentralization process and making it conducive to poverty reduction.

Decentralization is a multidimensional concept; the next section explains various forms of decentralization with illustrative examples from selected countries. Section III attempts to analyse in detail the opportunities, challenges and issues of fiscal decentralization. The concluding section outlines policy recommendations and suggestions for making fiscal decentralization successful, particularly for poverty reduction.

## **II. VARIOUS FORMS OF DECENTRALIZATION**

At least three types of decentralization can be identified: (a) administrative; (b) democratic (devolution); and (c) fiscal (Manor 1999). These forms of decentralization can take place simultaneously—quite often this is the case. Any particular form of decentralization can occur in isolation or in combination with another.

## Administrative decentralization

Administrative decentralization, occasionally referred to as deconcentration, deals with relocating officials at higher levels of government to a lower-level arena so that they perform their duties at local levels. Sometimes, government officials at the local level are authorized to perform certain tasks which were traditionally within the purview of officials posted in the central government. In other words, it is the delegation of authority from an administrative headquarters to a field office.

Administrative decentralization is carried out in some cases, especially those related to public dealings, to increase convenience for local people and ensure that certain tasks can be accomplished without delay. However, government officials working at the local level remain accountable to higher officials in the system. In this way, higher-level government does not give up any authority. To achieve a degree of genuine decentralization, it is important that local people are consulted in some way, especially when major decisions affecting them are being made. Governments in all countries of the region have been carrying out administrative decentralization when needed, keeping in view financial and other resource constraints.

## Devolution

Under devolution decentralization, also known as democratic or political decentralization, there is a transfer of power, resources and often tasks from higher- to lower-level governments within a political system. The lower-level governments are democratic in the sense that local people are involved in decision-making in some way. The best form of democratic decentralization is when lower-level governments are elected by secret ballots. However, consultations with community leaders and voluntary associations can help make decision-making more democratic. Lower-level governments perform their duties with participation of their communities; this increases the accountability of government institutions, thereby leading to improvements in the welfare of the people.

Major decentralization initiatives have been carried out by several countries, including India, Indonesia, Pakistan, the Philippines and Thailand.

In India, the *Constitution (Seventy-third Amendment) Act, 1992* installed panchayat raj as the country's third level of governance after the central and state governments (CIRDAP and FAO 2004). There are three tiers of local government in rural areas and each tier has its elected council, called panchayat, which are at the district, taluk (block) and village levels. The elected council at each level has seats reserved for women and socially marginalized sections of society. Local

governments are responsible for planning and implementing economic development and social justice schemes.

Indonesia is a vast country geographically, and has a large population characterized by linguistic and ethnic diversity. The country was under heavily centralized rule for decades. The Asian economic crisis contributed to the resignation of former President Soeharto in 1998 and a new Government was put in place. In response to growing pressure from the regions for greater political and legal autonomy and control over resources, two laws were enacted in 1999: Law 22/1999 on regional governance and Law 25/1999 on the fiscal balance between the central government and the regions.<sup>1</sup> These laws decentralized political and economic powers to democratically elected regional governments. Charged with new powers and responsibilities, regional governments obtained large quantities of funds, personnel and assets. Since the devolution of powers and responsibilities was to districts and cities, the provincial authority was considerably diminished. Under the new laws, provinces have no hierarchical authority over districts and most of their tasks are related to coordination.

In Pakistan, a three-tiered federated local government system comprising district (the top tier), tehsil (subdistrict) and union levels was set up in 2001 (CIRDAP and FAO 2004). Each tier has an elected council and head. An important feature of these councils is that marginalized social sections have been given adequate representation at each level of local government. More specifically, there are seats reserved for women, peasants, workers and minorities.

To improve governance, responsiveness and accountability, the district administration and police are accountable to the elected head of the district government. Then there are citizen community boards to motivate and involve the local community in local development and improved delivery of services. Supporting institutions for local governments are being established, but the process is slow. Moreover, capacity-building for the institutions has to be accelerated.

The local government system is an integral part of the provincial government. However, some representatives at the provincial level have expressed unhappiness that some of their powers have been transferred to local level governments. The Provincial Local Government Commission, which acts as an impartial arbiter, has been established to resolve any differences between provincial and local governments.

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<sup>1</sup> For more details on decentralization in Indonesia, see Turner and Podger (2003).

In the Philippines, after the fall of former President Ferdinand Marcos, the 1987 constitution embraced decentralization. Later, the 1991 Local Government Code consolidated all existing legislation on local government affairs, providing the legal framework for the decentralization programme (Reinoso 2004). This comprehensive legal framework includes provisions affecting: (a) the assignment of functions across different levels of government; (b) revenue sharing between the central and local governments; (c) the resource generation/utilization authorities of local governments; and (d) the participation of civil society in various aspects of local governance. A devolution master plan (1993-1998) was formulated to further implement the process of decentralization. The implementation of the decentralization policy has led to more integrated services delivery, focusing on local priorities in a more cost-effective way.

The 1997 constitution of Thailand also embraced decentralization. The legal framework was further elaborated in law and through parliamentary cabinet decisions. However, the implementation of the framework has been slow.

### **Fiscal decentralization**

In fiscal decentralization, higher levels in a system grant lower levels influence over budgets and financial decisions. There is a downward transfer of decisions on fiscal matters. Fiscal decentralization may accompany administrative decentralization only where government officials at the local level are accountable only to superiors at higher levels. True fiscal decentralization involves people at the local level in decision-making concerning fiscal matters.

China is a large unitary State with five levels of administration: in addition to the central Government, provinces, prefectures, counties and towns/townships each have administrative duties.<sup>2</sup> The lower levels form a strong system of local governments. The present intergovernmental fiscal system of the country has evolved over more than two decades, with a major fiscal reform in 1994. The effective decentralization of the 1980s and early 1990s was accompanied by economic growth and growing regional inequalities. At the same time, general government revenues declined along with the restructuring of the previously centrally planned economy.

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<sup>2</sup> For more details on fiscal decentralization in China, see Ahmad and others (2002).

China introduced the major fiscal reforms of 1994 to simplify the tax system and raise the ratio of revenue to gross domestic product. The fiscal reforms were also aimed at raising the proportion of central Government revenue, which had been falling as a share of total government revenue. Another major objective of fiscal reform was to make the intergovernmental fiscal system more stable by shifting from ad hoc, negotiated transfers to a rule-based tax assignment. The fiscal reforms attempted to recentralize tax collection and reform the tax-sharing system. It was agreed that the coastal provinces that generated much of the revenue would be given a lump-sum transfer to protect their pre-1994 income levels. A new equalization transfer scheme was expected to gradually replace the lump-sum transfer. Subnational governments are becoming more responsible for financing their expanding functions from their own revenue, both formal and informal. This gives them more autonomy, except in sectors with mandated service standards.

In India, fiscal decentralization between the central and state levels is quite significant. As noted above, the constitutional amendment of 1992 established a system of elected local governments. In general, states had to devolve powers to local governments concerning both the collection of revenue and the incurring of expenditures, but the implementation of decentralization varied across states. The Constitution of India provides for the establishment of an independent finance commission at the state level to review and make recommendations once every five years on the fiscal interrelationships between local governments and the state government. Fiscal decentralization at the local level has been slow in most states, evidenced by the fact that revenue collections by them are still small. In many states, local governments are used as agencies to implement the development schemes stipulated by the central and state governments.

In Pakistan, the decentralization initiative of 2001 has fiscal aspects also. Since local governments have been made responsible for many development and service delivery activities, some provision of resources has also been made. Local governments receive financial resources in the form of transfers from higher levels of local government, grants from the respective provincial governments, proceeds of taxes/charges levied at the local level, fines for offences under local government laws/rules, and proceeds from other sources of income.<sup>3</sup> Local governments are empowered to levy taxes/fees with the approval of the local council, subject to vetting by the provincial government. Provincial finance commissions have been established as institutional mechanisms for equitable revenue sharing between provincial and local governments. Local revenue mobilization has been insufficient for carrying out many development activities or providing basic services.

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<sup>3</sup> For further details on the sources of revenue of local governments, see CIRDAP and FAO (2004).

In Indonesia, regional government revenue comes from general allocation grants from central governments, regional taxes and other sources. As mentioned above, two laws were passed in 1999 to implement decentralization. Law 25/1999 introduced the sharing of oil and gas revenue among various levels of government (Ahmad and Mansoor 2002). With regard to onshore oil, 15 per cent of non-tax revenue is to be distributed to subnational governments in the following manner: (a) 3 per cent to the producing province; (b) 6 per cent to the producing district; and (c) 6 per cent (total) to the non-producing districts in the producing province. For onshore gas, the non-tax revenue to be shared is doubled to 30 per cent and distributed in the same way as non-tax revenue from onshore oil.

### **III. OPPORTUNITIES, CHALLENGES AND POLICY ISSUES**

Under a decentralized system of governance, there are multiple tiers of government. A clear legal system and institutional framework is needed for the smooth functioning of the system. The interlinkages and coordinating mechanisms also need to be clearly specified so that governments at all levels are able to work in unison for the welfare of citizens. A comprehensive approach to decentralization is needed to ensure effective decision-making at the local level (Shah and Thompson 2004). However, the focus of this paper, by design, is mainly on fiscal decentralization. In this section, the discussion will touch on, among other things, interlinkages among various levels of governments, institution-building for successful decentralization, and the process of decentralization.

#### **Participatory approach to development planning and implementation**

The literature on decentralization is full of descriptions of opportunities. Decentralization facilitates participatory planning and the implementation of development programmes. Even marginalized groups and the poor can be represented in local governments so that they can actively participate, help make decisions and lobby for their interests. For example, as noted above, in local governments in India and Pakistan, seats are reserved for women and marginalized groups (CIRDAP and FAO 2004). Programmes tend to be more successful when owned by the people of the area, leading to greater prosperity and poverty reduction. Provision of public goods can be tailored to local preferences. Causes of poverty may vary in different parts of the country, and decentralization can help better target responses. The proximity of policymakers to the target groups reduces the information and transaction costs of identifying the poor. This can help in designing potentially successful programmes aimed at poverty reduction. Central governments tend to be overloaded with jobs and responsibilities; local governments can shoulder

some of the responsibilities as they have more room to manoeuvre in tapping new revenue potential. Also, it is easier under a decentralized system to form public-private partnerships at the local level for efficient delivery of services.

In Asian countries that have implemented decentralization reforms, the more-democratic processes have boosted the chances of meaningful participation in development planning and implementation. There is some evidence of improved provision of basic services in Indonesia, Pakistan and the Philippines after decentralization was implemented in those countries (World Bank 2005 and ILO 2004).

While local governments operate within their own jurisdictions, there can be healthy competition among them, leading to innovative programmes for the provision of public services and other development schemes. By sharing experiences on best practices of local governments, the welfare of people across the country can be improved.

#### *Governance issues*

One of the main advantages of decentralization often put forward is that it helps to promote good governance by introducing accountability and responsiveness through the preferences of local people. Government officials become accountable to people mainly through their locally elected representatives. The expected benefits of decentralization are based on the assumption that local accountability mechanisms are effective and that all information is available to citizens so that they can demand good governance. However, it is possible (especially when people are less educated and substantial financial resources are needed to contest local government elections) that local elites may capture the local government and divert resources for their personal gain and/or their own group (Jütting 2004). This is the case in many rural areas of Pakistan, where distribution of land is highly unequal—landlords with large landholdings usually dominate local governments. Under such circumstances, corruption may become more widespread and as a result fewer resources may be left for the benefit of the poor.

Decentralization as such may not guarantee that the poor will gain access to basic services; what matters is good governance. However, over time, regular democratic elections of local governments will help people to elect better representatives who will work to improve the quality of life in their jurisdictions. As mentioned above, special quotas for women and marginalized groups can be established in local governments. Institutions such as civil society organizations, which can regularly monitor the provision of basic services to the poor and voice their concerns, can contribute to good governance at the local level. In addition to



bottom-up approaches, some monitoring and oversight by the central government may be needed for good governance. Moreover, rules should replace discretionary approaches at all levels of government.

Local governments should be required to enhance access to information on their activities, particularly with regard to the provision of services for the poor. The free press and media can play a major role in building awareness of the successes and failures of local government. Surveys by communities on access to and the quality of basic services and wide publicity of such surveys by the media can spur local governments to make improvements. In Bangalore, India, citizen ratings of public services were compiled in a community report card and the results were widely disseminated by the media; this led to an improvement of those services (White and Smoke 2005). In sum, a multi-pronged strategy should be used to strengthen the accountability of local governments to citizens.

### **Financial and other costs of decentralization**

Decentralization also imposes several costs. When decentralization is being introduced for the first time or it is a major initiative, the initial capital costs, in terms of building infrastructure, are huge. The recruitment of staff for supporting institutions to run the local government involves capital as well as recurrent costs. Quite often, developing countries are short of trained and skilled professional staff to run the businesses of government. Therefore, there are costs to train staff and build the capacity of local governments. Given the limited pool of human resources, there can be competition between central and local governments for qualified staff; a lack of trained staff can adversely impact the performance of all governments.

The transferring of functions from central to local governments may require the relocation of staff. The number of staff involved can be huge, as was the case with Indonesia. Almost 2.4 million personnel were transferred from central to local governments (Turner and Podger 2003). Such transfers can entail problems. Some staff working in major cities may not wish to move to smaller cities or places that lack social services. At the same time, local governments may not be interested in accepting staff previously employed by the central government. They may be more interested in employing their own people.

Successful decentralization requires a clear delineation of the functions and responsibilities of the various levels of government. Still, there is always a need to coordinate the activities of the various levels. Such coordination costs can be large during the initial stages of decentralization.

*Impact on fiscal instability*

Another cost of decentralization can be its possible adverse impact on fiscal stability. Fiscal decisions under decentralization are made by various layers of government. These fiscal decisions, if made too independently, can lead to fiscal instability and increase budget deficit. It is well recognized that macroeconomic stability promotes savings and investment, which in turn promote economic growth and poverty reduction. At the same time, the poor suffer more from the rapidly rising prices during periods of macroeconomic instability.

Maintaining macroeconomic stability is a major responsibility, and it is argued that this task can best be accomplished at the level of central government. Fiscal decentralization can make it more difficult to fulfil that responsibility. More specifically, the critics of fiscal decentralization argue that local governments tend to run fiscal deficits and that central governments can end up covering those gaps between revenue and expenditures. At the same time, central governments lose flexibility when they have to share their resources with local governments in a strictly defined manner, which can hamper efforts to deal with any macroeconomic instability. Moreover, when subnational governments have the power to borrow on the open market, they can accumulate huge debts. Domestic public debt is becoming a major problem in many countries.

One major assumption underlying the above arguments against fiscal decentralization is non-cooperative behaviour on the part of lower tiers of government. In theory, effective coordination mechanisms can be put in place to minimize the adverse outcomes of fiscal instability. However, given the difficulties in implementing these coordination mechanisms, the desired results may not be produced.

As shown, empirical evidence on the consequences of decentralization on macroeconomic stability is mixed. This, however, demonstrates that fiscal decentralization is not inherently destabilizing. When decentralization is supported by institutions which promote intergovernmental cooperation and arrangements that mandate and provide incentives for responsible local government fiscal behaviour, there is less risk of macroeconomic instability.

**Generating resources for redistribution and poverty reduction**

One can argue that a highly decentralized system could create impediments to redistribution and poverty reduction efforts. The central government is usually in a better position to implement redistribution policies. Its fiscal policies cover the whole country and revenues generated from rich regions of the country can be

used to provide infrastructure and basic services in poor parts of the country. The existence of externalities also supports a larger role for central government in redistribution and poverty reduction (Rao undated). For example, the benefits of poverty reduction programmes may spill over from one jurisdiction to another. Such externalities do not pose any problem for central government, as the entire country is its jurisdiction. Local governments can face the problem of a shifting of the tax base. In other words, if a local government imposes heavy taxes for redistributive purposes, taxpayers can move to other parts of the country where local taxes are low. Therefore, a local government may not be able to achieve its desired objective.

While the role of local government in generating revenue for redistribution may be limited, local governments have certain advantages in designing and implementing poverty reduction programmes. As discussed earlier, because of their close proximity to the poor, local governments can design poverty reduction programmes according to actual needs.

In sum, central governments should have a greater role in mobilizing resources for redistribution and poverty reduction. A major share of these resources can be passed on to local governments to achieve better results in terms of the delivery of goods and services to the poor.

### **Clear and well-defined allocation of expenditure and revenue**

#### *Expenditure*

One widespread problem in Asia-Pacific countries where decentralization has been carried out is the overlap of functions and responsibilities of various levels of government. When governments at different levels are responsible for providing the same services, it becomes difficult to assign credit or blame to any particular level. Under such circumstances, there is no incentive for any government to improve the services. Moreover, a lack of effective accountability can lead to a deterioration of services. Therefore, it is important that expenditure assignments to local governments are defined clearly and precisely. This is also needed for proper revenue allocation. Imprecise expenditure assignments will result in poorly defined corresponding revenues. The assignment of expenditure under a decentralization framework is a dynamic issue. Effective processes and coordination mechanisms are essential for minimizing overlap.

As noted above, demand for public services can vary across a country. Decentralization provides a mechanism to meet the specific needs of each local area; certain functions can be assigned to local governments. However, while allocating functions, efficiency concerns should be considered. Certain capital-

intensive services, such as electric utilities and transportation systems, exhibit economies of scale in production and are more suited for provision by the central government.

The provision of some services, such as water and roads, can generate inter-jurisdictional externalities in terms of both costs and benefits. For example, a road built in a particular local jurisdiction can be used by people living in other jurisdictions while travelling to and from other parts of the country. Under such circumstances, efficient resource allocation requires that the service provision area be drawn in such a way that externalities are internalized. While it is possible to define an area for the efficient provision of a particular service (taking into account economies of scale and externalities), this may not correspond to the boundaries of existing political jurisdiction. Not only does changing boundaries of jurisdiction involve substantial costs, it is almost impossible to define a single optimal area for the provision of various public services. Therefore, certain services are better provided or regulated by central government.

Local governments should be assigned tasks which they can accomplish at a lesser cost than other levels of government could. Moreover, they should have the capacity to undertake the functions. If many functions are assigned to local governments without giving due consideration to their capacities, decentralization will result in failure. It is better to decentralize functions in a gradual manner so that local governments can better cope with their responsibilities.

### *Revenue*

To perform their functions fully, local governments need sufficient revenue. This revenue can come from various sources. The discussion here is limited to taxes, fees and user charges. A number of factors should be considered while assigning taxes to local governments; for example, the taxes should be easy to implement. Administrative and compliance costs can be minimized by avoiding the assignment of complex taxes to local governments. Taxes with mobile bases should be avoided by local governments—there is not much use in imposing such taxes when the base can move to a jurisdiction with no or lower tax. Taxes with economies of scale in collection can be handed over to the central government and tax proceeds can be distributed among local governments. Taxes assigned to local governments should be buoyant, to reduce dependence on central government resources. Such taxes would represent greater revenue with the expansion of the economy.

A tax burden that can be exported to residents of other jurisdictions should not be assigned to local governments. For example, a substantial local tax should not be imposed on the output of a manufacturing factory in a jurisdiction if most of output of the factory is consumed by residents of other jurisdictions. Taxing the output forces the residents of one jurisdiction to bear the economic burden of taxes imposed by another jurisdiction. Under these circumstances, a tax on consumption rather than on output would be better. If the tax on output is to be maintained, it is better that such a tax should be levied by the central government.

Local governments should have at least some autonomy in levying their taxes so that they can modify their tax bases and rates; this fosters efficient resource allocation and accountability. When local governments feel that certain expenditures are essential for the welfare of their constituents, they should have the ability to finance those expenditures at the margin through additional taxation. Local governments cannot be held accountable for the provision of services if they cannot modify tax rates.

It is important that revenue yields should be stable and predictable over time. In some countries (for example, Indonesia), local governments get a share of revenue from natural resources such as oil and gas. Due to the fluctuation in prices, revenue from natural resources cannot remain stable. This can adversely affect the sustained provision of public services by local governments. Therefore, ways must be found to save revenue during times of high prices for utilization during times of price downswings.

The benefits of taxes, in terms of provision of services, should be clear and visible to the residents of the jurisdiction. Where possible, user charges can be levied for certain services. However, basic public services, especially for the poor, should be funded from revenue from progressive taxes.

### **Intergovernmental transfers as a source of revenue**

Intergovernmental transfers are required when revenues and expenditures of governments at various levels do not match. Usually the revenue of local governments falls short of their expenditure, creating a vertical imbalance. The varying fiscal capacity of different jurisdictions to raise revenue is known as horizontal imbalance. Therefore, even with identical tax rates, different jurisdictions may not be able to provide the same level of public services. Another aspect of this horizontal imbalance is that the costs per unit of providing public services can also vary among jurisdictions. The central government can deal with these vertical and horizontal imbalances by sharing revenue or tax bases with local governments.

In the latter case, local governments can apply a surcharge on a central government tax.

The central government can also design a system of grants. In principle, general equalization grants can be designed to deal with horizontal imbalance. In practice, it is extremely difficult to work out the level of grants for different jurisdictions that would ensure that all are able to provide the same level of public services at a given tax rate. Therefore, when developing countries in Asia and the Pacific distribute general equalization grants, it is not strictly on the basis of tackling horizontal imbalances. However, central governments do provide various types of grants to local governments. The level of these grants can be determined through negotiations between the governments. However, this introduces arbitrariness and uncertainty and is not conducive to adopting a medium-term fiscal strategy or planning expenditures. Formula-based grants are better, given that they are more transparent and objective; they also reduce the transaction costs to the recipient.

Grants can be of two types: unconditional and conditional. Unconditional grants can be provided to close a vertical imbalance or redistribute revenue. However, one argument against grants is that they discourage subnational governments from cultivating their own revenue sources. To tackle this problem, conditional grants can be linked to the revenue efforts of subnational governments. A matching grant formula can be designed in which the matching rate varies inversely with local fiscal capacity. These types of grants become incentives for subnational governments to generate their own revenue. Another form of conditional grant is the specific purpose grant, which is employed to promote the use of specified services that are considered important. For example, with regard to direct anti-poverty interventions, specific purpose grants can be provided for self-employment and wage employment schemes (Rao undated).

Using various forms of grants to achieve different objectives can complicate the intergovernmental fiscal system. It can also produce unintended results—poorer areas can even end up with relatively fewer resources. Therefore, any intergovernmental transfer system should be kept simple and transparent. There should be some flexibility in determining the size of the transfer pools, so that during an economic crisis situation the central government has the fiscal power required to meet the macroeconomic challenges (Smoke 2001).

## **Access to borrowing**

Borrowing is an option when subnational governments are unable to finance their expenditure obligations from their own revenue and grants from central government.<sup>4</sup> Infrastructure projects, including the building of schools and hospitals, usually require large investments; the benefits are spread over future generations. On equity grounds, it is better that future generations should also share the costs of such investments. This is possible through borrowing, which creates repayment liabilities for future generations. Borrowing also works as a useful tool when revenue and expenditure flows of a subnational government are not synchronized. A subnational government can borrow against its expected revenues in the latter part of the year and repay the loan when revenues are realized.

Subnational governments can borrow from government financial institutions, sometimes established especially for this purpose. Such loans can be subsidized. Public financial institutions are controlled by the central government, which can practice political favouritism in extending loans. As some of those loans might otherwise be considered unadvisable, repayment can become a serious problem.

Subnational governments can also approach the private capital market for funds. The use of this channel entails the development of a market-based relationship between lenders and subnational governments. A well-designed regulatory framework, including standardized accounting procedures for subnational governments, disclosure of subnational government liabilities and repayment capacity, is essential. To curb excessive borrowing by subnational governments and avoid default on loans repayment, limits on the borrowing ability can be imposed. As discussed earlier, the central government is responsible for macroeconomic stabilization; therefore, it should have the power to limit borrowing by subnational governments and thus retain control of public debt.

In the case of self-financing projects, where costs can be recovered from service users, private borrowing through loans or bonds is the most efficient way to mobilize resources (Smoke 2001). If the costs cannot be recovered, but the projects are considered important for the welfare of people, projects could be subsidized through grants from central governments. Poorer jurisdictions that might not be able to borrow could be provided more grants than the richer jurisdictions. This linking of borrowing and grants can serve both equity and efficiency objectives.

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<sup>4</sup> Subnational governments in many developing countries usually finance their investment expenditure from their revenues and grants from central government. However, some decentralized governments, particularly of states/provinces and large cities, are able to borrow in some countries.

## **The decentralization process**

### *Sequencing of decentralization measures*

Any design of decentralization measures must follow a proper sequence if it is to be successful. Before embarking on a major decentralization, it is important to determine the role of the public sector in the provision of goods and services. Once this role is determined, the functions and responsibilities of various levels of government can be decided.

When designing fiscal decentralization, first the responsibilities of subnational governments, keeping in view their capacities, should be decided in order to determine their expenditure requirements. The next step is to identify the subnational government's own sources of revenue. Intergovernmental transfers and grants can be worked out to fill the revenue-expenditure gap.

Due to political pressure, the focus of fiscal decentralization initiatives is usually on the revenue side, and clear assignment of expenditure is neglected. This is misguided; the assignment of expenditure should be the priority. A lack of clear assignment of expenditure can adversely affect the provision of public services. For example, the major decentralization reforms in Indonesia focused more on revenue than expenditure assignments. The laws on revenue and expenditure were prepared quite independently, and financing was assured before the effective devolution of responsibilities (Ahmad and Mansoor 2002). This tendency of many countries to deal with various elements of fiscal decentralization as separate and independent can result in imbalances among expenditure responsibilities, sources of revenues and transfer programmes.

### *Major fiscal data requirements*

Fiscal decentralization introduces significant complexity to the fiscal system of a country. As a result, fiscal data requirements become enormous. Both the central and subnational governments must devote resources and develop capacity to collect and compile such data. Such databases must be maintained and monitored regularly in order to facilitate efficient decision-making with regard to intergovernmental transfers. This can pose serious challenges, particularly for subnational governments.

The complexity of the task is reflected in the detailed records of revenue and expenditure that are required. Local governments must maintain data on their own revenue as well as on transfers or grants from the central government. While unconditional grants pose fewer problems, conditional grants require detailed records



of how they were spent. The central government also has to compile data on revenue if those are to be shared with subnational governments. Similarly, it will need good fiscal data to work out equalization grants and other transfers. Local governments occasionally implement projects on behalf of the central government. It can be very difficult for local governments to maintain data on various categories of expenditure that are financed through several different sources.

### *Capacity-building*

Decentralization for poverty reduction requires local governments to provide certain basic services to the poor of their jurisdiction and raise finances from various sources. Therefore, local governments must have the required institutional, technical and managerial capacity. Without such capacity, decentralization cannot succeed; in fact, it can be counterproductive (Jütting 2004). With regard to the detailed fiscal data required, the capacity of officials (from both local and central governments) to collect the required data and maintain databases must be developed.

During the early phases of decentralization reform, the central government can lend trained officials to local governments to facilitate the transition. This approach was adopted in Indonesia. Operational capacity can also be borrowed from the private sector and civil society. In the long run, the training of local government officials is a must if operational capacity is to be augmented.

The central government can also play a major role in developing capacities of local governments through training programmes. In India, the National Institute of Rural Development has developed a training needs assessment and a programme for building the capacity of functionaries (both elected representatives and civil servants) in local governments. The training covers many areas, including the mobilization and management of resources. The managerial capacity to plan and implement development projects, including the provision of basic services, is essential for the success of decentralization. Training in accounting and auditing can help promote the efficient utilization of resources, accountability and good governance.

Some experiences of countries in the region suggest that greater success can be achieved by focusing on a few key areas rather than trying to accomplish too much simultaneously. Therefore, decentralization can be phased in gradually, so that responsibilities can be assigned to local government as their capacities develop.

#### **IV. POLICY CONCLUSIONS AND RECOMMENDATIONS**

The benefits of fiscal decentralization are well known: it allows participatory planning and implementation of development programmes. Fiscal decentralization is usually expected to have a strong and positive impact on poverty reduction through increased efficiency, better targeting of services and greater responsiveness to local needs. However, there are issues of governance, such as when elites dominate local governments; in such cases, decentralization may not have the desired positive impact. Therefore, issues of governance need to be addressed through a multipronged strategy, including the involvement of civil society, enhanced access to information, participation of free media and some oversight by the central government.

Decentralization also entails various costs. Financial and human resources costs can be quite large, especially in the early phases of decentralization. A careful cost-benefit evaluation must be made before making a decision on the process of fiscal decentralization.

When fiscal decisions under decentralization are made independently by various layers of government, fiscal stability can be threatened. The resulting budget deficits and macroeconomic instability can have adverse impacts on economic growth and poverty reduction. The central government is considered to be in a better position to deal with the problem of fiscal instability. Therefore, to facilitate the success of decentralization and minimize the possibility of fiscal instability, the central government should have the power and flexibility, especially during an economic crisis, to implement measures to contain the budget deficits of various levels of government. Equally important is the level of cooperation among the various levels of governments.

The central government is usually considered to be in a better position to implement redistribution policies because its fiscal policies cover the whole country. The central government can have a greater role in mobilizing revenue, and a major share of these resources can be passed on to local governments for expenditure to achieve better results in terms of the delivery of goods and services to the poor. However, certain capital-intensive services, such as electric utilities and transportation systems, exhibit economies of scale in production. In view of efficiency concerns, they are more suited for provision by the central government. The tasks assigned to local governments should be clear and precise as well as in line with their capacity. Imprecise expenditure assignments can result in poorly defined corresponding revenue.

Revenue for local governments can come from various sources. Local taxes should be easy to implement, and taxes with mobile bases should be avoided. Moreover, taxes with economies of scale in collection are more suitable for collection by the central government; such proceeds can be distributed among local governments. It is important that local governments should have at least some autonomy in levying their taxes, so that they can modify their tax base and rates. This will help increase the efficiency of resource allocation and the accountability of local governments. Moreover, revenue yields should be stable and predictable over time. While user charges can be levied for certain services, basic public services, especially for the poor, should be funded through revenue from progressive taxes.

Intergovernmental transfers are usually a major source of revenue for local governments. These transfers can take various forms. The central government can share revenue or tax bases with local governments. It can also design a system of grants. While the level of grants can be determined through negotiations between the governments, this introduces arbitrariness and uncertainty and is not conducive to adopting a medium-term fiscal strategy or planning expenditure. Formula-based grants are better, given that they are more transparent and objective; they also reduce the transaction costs to the recipient.

Unconditional grants can be provided for redistribution purposes. Conditional grants can be linked to the revenue efforts of subnational governments in order to encourage subnational governments to generate their own revenue. Specific purpose grants promote the use of specified services which are considered important. For example, in direct anti-poverty interventions, specific purpose grants can be provided for self-employment and wage employment schemes.

The intergovernmental transfer system should be kept simple and transparent. There should be some flexibility in determining the size of the transfer pool, so that during an economic crisis the central government has the fiscal power required to meet the macroeconomic challenges.

Borrowing from the public and private sectors is another way for subnational governments to finance their expenditure obligations. Loans from government financial institutions can be subsidized. For self-financing projects, where costs can be recovered from the users of services, private borrowing through loans or bonds is the most efficient way to mobilize resources. A well-designed regulatory framework should be in place for borrowing from capital markets. Moreover, to curb excessive borrowing by subnational governments and avoid defaults on loan repayments, limits on the borrowing ability of subnational governments can be

imposed. This is important for controlling public debt and achieving macroeconomic stability.

Any design of decentralization measures must follow a proper sequence if it is to be successful. To begin with, the responsibilities of subnational governments, keeping in view their capacities, should be decided in order to determine their expenditure requirements; then, sources of revenues should be identified and allocated. Due to political pressure, fiscal decentralization initiatives usually focus on revenue, and clear assignment of expenditure is neglected. This can adversely affect the provision of public services.

If decentralization is to be successful, local governments must have the institutional, technical and managerial capacity to perform their tasks of raising revenue and providing public services efficiently. Moreover, vast amounts of detailed fiscal data are required in operating a fiscally decentralized system. The capacity of both local and central government functionaries to perform their tasks, including collecting the required data and maintaining databases, must be developed. Training in accounting and auditing is important to facilitate more efficient provision of public services and minimize the misuse of resources. The central government can play a leading role in developing the capacities of local governments through training programmes. At the same time, decentralization can be phased in gradually so that responsibilities can be assigned to local government as their capacities develop.

In most countries of the region, poverty reduction is not the sole reason for decentralization. However, the institutions established through decentralization can lead to improved delivery of services to the poor, participatory planning and the implementation of development activities and programmes designed to benefit the poor, opportunities for the poor to articulate their needs and preferences, and improved governance at the local level, all of which can help in poverty reduction. Since the institutions and framework of decentralization are conducive to poverty reduction, they should be strengthened, thereby facilitating the design and implementation of pro-poor policies. The capacity of those running the institutions should be developed. The idea that decentralization, if implemented appropriately, can play a major role in poverty reduction should be promoted. More research should be done to further explore and enhance linkages between decentralization and poverty reduction.

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