Decentralization: Good results aren’t automatic

Pushing responsibility and taxing power down to regional governments and municipalities can increase efficiency and accountability. But to achieve these gains, the necessary social and institutional structures must be in place.

The idea of fiscal federalism and decentralization used to be the subject of footnotes. Now it is a hot topic in Washington and has seeped over the U.S. borders to become an international fad. One country after another is shifting government functions down to regions and municipalities. In the European Union the question is how to keep too much power from moving up to Brussels. In Russia the issue is how much can be safely moved down from Moscow. But a big part of the interest is nothing more than near-universal disenchantment with the role of the public sector and suspicion of central government. If it can’t be privatized, then localize it. Shift responsibility and taxing power to the region, state, province, or city.

Introducing choice

In countries such as Russia or Ethiopia, where ethnic, racial, cultural, or linguistic characteristics are concentrated regionally, there is a pure political argument for decentralization. But the proponents of decentralization tend to focus mostly on economics rather than politics. Local governments theoretically can accommodate different preferences better than a one-size-fits-all, centrally supplied basket of goods and services. This introduces choice in public services. In principle, people can move to a jurisdiction that provides more of what they want for the taxes they are willing to pay. Decentralization also opens the way to local experimentation in meeting public needs. And, above all, decentralization of responsibility brings local accountability. At least in theory, local officials have a greater stake in good government performance since they can be clearly identified by the voters and taxpayers as the architects of success or failure.*

All these are powerful arguments. But while the theoretical case for decentralization is relatively straightforward, the practical case may be less so. Fiscal decentralization has worked well in the United States, Indonesia, some European countries, and, perhaps, Malaysia. It has been less successful in other countries, including Argentina and Brazil. Experiences in those two countries and elsewhere indicate that good results are not automatic.

One cause for caution is that decentralization shifts power not only from central to local governments, but from central to local bureaucracies. Local governments are not necessarily staffed by competent, democratically elected officials who have the public interest in mind. Corruption is one problem. The local official who is a relative, friend, or former schoolmate is usually far more accessible than a cabinet or ministry official. At the same time, when educational standards are as low as they are in many African countries, the small national pool of talented and trained individuals that central governments can draw from is even smaller for local governments. They can’t offer the same career opportunities as the national government, let alone the same attractions as life in the capital. Even in more advanced areas there can be huge differences in quality among local public administrations. In Italy, for example, the administration in Emilia-Romagna is probably better than that in Rome, but the local bureaucracies in the south generally are very weak.

The big "ifs"

"If the constitutional or legal aspects are very clear and are enforced, if the local governments are given access to the necessary resources, if they have adequate public expenditure management systems in place so that they both monitor and control the pace and the allocation of spending, and if the local bureaucrats are of equal quality as the national bureaucrats, then decentralization can live up to its promise."

– Vito Tanzi*
The possibility of administrative weakness at the local level raises a serious question of local governments' ability to manage public expenditures. By definition, decentralization means that localities take over both responsibilities and the taxing power or financial resources needed to meet them. Good public expenditure management requires a minimum of good forecasts and adequate accounting systems to monitor and control cash flows. The skills required are scarce in many countries and hard to locate in the developing world. And the most basic statistical information often is unavailable. To have a good chance of success, then, decentralization should be accompanied by the establishment at local levels of at least the essential public expenditure management systems.

A leaner public sector? Some proponents argue that decentralized countries tend to have smaller public sectors as measured by the public sector share of gross domestic product. But the relationship between the size of the public sector and the degree of centralization is difficult to establish. Among industrial countries, for example, the presence or absence of a large, centrally funded welfare or social security scheme has more impact on the comparative share of GDP than whether the government is centralized, as in France, or is a federation, as in Australia. Furthermore, the true impact of the public sector on the economy includes quasi-fiscal activities and regulations. If fiscal decentralization increases the number of regulations, adding a local layer to the national one, the impact of government activity will be greater even if the total government share of GDP does not change.

The contract Decentralization may aggravate macroeconomic problems or, at best, make it more difficult for the central government to stimulate or stabilize an economy. Brazil, India, and Russia have encountered difficulties because they have assigned major tax bases to local governments, forcing the central government to make do with less efficient or unproductive sources of income. Sharing taxes also can lead to trouble. In Argentina the federal government, faced with a large deficit, cut spending through privatization, reduced its payrolls, and introduced major tax reforms that helped increase taxes relative to GDP. But 57% of the additional tax revenues had to be shared with the provincial governments. They immediately spent their windfall and expanded their civil services.

In a number of cases decentralization has created a situation in which local bureaucrats have been able to spend more than they raise, increase their debt, and then pass off the problem on the central government. As long as localities believe that the central government will have to bail them out, fiscal decentralization can lead to macroeconomic instability.

The solution is to base decentralization on a clear, comprehensive contract that spells out the obligations of local governments, assigns them adequate resources for meeting those obligations, and stipulates that under no circumstances will they receive additional resources from the national government. These conditions will force local governments to live within their means, allowing them to increase local spending only if their revenues permit.

The key is good planning: decentralization should mean devolving both spending responsibilities and revenue sources — and determining the magnitude of both simultaneously and in advance.

Despite the difficulties in implementation, the arguments for decentralization are sound and powerful. The process can and does live up to its promises. Properly implemented, it provides important economic and political benefits as local jurisdictions improve the efficiency and accountability of public spending.