Fiscal Decentralization: Lessons from East Asia (and Elsewhere)

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1. Introduction

This paper originated in a recent review of work on decentralization by the World Bank in the East Asia and Pacific Region (Bird, 2002). To a considerable extent, however, it also draws upon related earlier work that I have done in other parts of the world.1 An alternative title for the paper might thus be “Fiscal Decentralization: What Have We Learned, and What Do We Need to Learn?” Whatever its title, the aim of the paper is simply to set out a few lessons that I derive both from the considerable experience we have now had with various varieties of decentralization in many countries around the world, including those in East Asia, and also from the important scholarly work that has been done on different aspects of decentralization in recent years.2

There are two ways that one might undertake such an exercise. The first way would be to set out what might be called the “rules of good practice” that may be derived from experience to date. What substantive lessons emerge that may help those engaged in the dark art of designing and analyzing decentralization? In Section 2 of the paper I follow this path, summarizing briefly the answers to this question that I have recently developed elsewhere at more length.

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1 See, for example, Bird (1986), Bird, Ebel, and Wallich (1995), Litvack, Ahmad and Bird (1998), Bird and Vaillancourt (1998), and Bird and Stauffer (2001).
2 For a useful recent survey of much of the relevant literature, see International Conference (2002), especially Theme III (Assignment of Responsibilities and Fiscal Federalism).
In the balance of the paper, however, I follow an alternative path to possible enlightenment. Stepping back from substantive questions like how to design better transfer systems, I have instead tried to position myself well above the trenches of decentralization policy and to consider not only the varieties of decentralization experiences we can observe in East Asia (and elsewhere) but also the broader context within which such experiences must be understood. Based on this “Bird’s eye” view, in Section 3 of the paper I suggest that most major decentralization experiences around the world share two fundamental characteristics -- they are complex and they take time.

These characteristics of decentralization suggest two main lessons, as developed further in Section 4. First, decentralization is fundamentally political in nature. Second, to be useful and effective, analysis and implementation of decentralization should focus on the process, and not just the product. These lessons are obviously very general indeed, but they lead me to argue that there are several important analytical and factual questions that have often proved critical in determining the success (or not) of particular decentralization efforts but that do not yet appear to have been adequately taken into account in the design and analysis of decentralization. A brief Section 5 concludes.

2. What Have We Learned About the “Rules” for Good Decentralization?

As I have recently argued in more detail elsewhere, we have learned a lot in recent years about how to do “good” decentralization. Others might state some of the following points differently, and some will differ with respect to one point or another, but on the whole I suspect that few analysts with substantial experience in the field are likely

3 This section largely follows Bird (2000) and Bird and Smart (2002). Some of the key points are developed in more detail in such other papers as Bird (1993, 2000a). The papers cited of course make extensive use of, and reference to, work by many others who have written on these subjects but providing a more detailed --and hence less self-referential -- bibliography is not the purpose of the present paper.
to take much exception to the following version of the rules of best (or at least good) practice with respect to fiscal decentralization.\footnote{For many purposes it is useful to distinguish fiscal, administrative, political, and economic decentralization, but I focus here only on fiscal matters.}

First, expenditure assignment should be clear. There should be no unfunded mandates. Subnational governments should both be able to reduce expenditures if they wish to do so and also to raise them -- provided they fund such additions from their own resources. Subnational budgets should not require prior central approval, but there should be uniform budgetary and financial reporting systems for all levels of government, the results of which are subject to external audit and are publicly reported in a comprehensive, comprehensible, and comparable way.

Second, subnational governments (like all governments) should finance their activities through user charges whenever feasible. They should also be able to impose (or to choose not to impose) and to set rates for taxes that fall largely on local residents, such as residential property taxes. Larger intermediate and regional governments with broader expenditure responsibilities should also be permitted to set tax rates impacting on their residents, for example, through surcharges on the national personal income tax.\footnote{Much interest has been expressed recently in possible subnational VATs: this question is discussed extensively in e.g. Bird and Gendron (2001).} When subnational governments are permitted to impose taxes on businesses, as a rule their rate discretion should be subject to both a floor (to reduce inefficient competition) and a ceiling (to reduce tax exporting). The critical feature on the revenue side is that subnational governments should have clear political accountability for the tax rates that they impose and that they should be able, in general, to impose such taxes only on those to whom they are politically accountable.

Third, subnational governments should in principle be able to borrow at market rates for capital projects. In some circumstances, such borrowing, particularly by smaller entities, may be from a public sector institution, but in no circumstances should there be
any possibility of “bail-out.” Should a subnational government get into difficulty in servicing its debt, specific “work-out” arrangements should be available, but in all cases there should be no subsidization. Those who make the decisions (or who choose those who make the decisions) should bear the consequences.\(^6\)

Fourth, intergovernmental transfers are usually needed, for several purposes. Depending upon how highly interregional equity (however defined) is valued in a particular country, for example, a general equalization transfer may be desired to enable regions with different capacities to provide roughly similar levels of services. Such transfers should generally be unconditional, based on a formula that incorporates measures of both need and, especially, capacity, and subject to adjustment to changing circumstances at periodic intervals. Depending upon local circumstances and the value placed on “national standards,” there may also be a case for a general per capita (“capitation”) grant, perhaps with a variable matching component, to enable subnational governments to provide certain services, such as education and health, at relatively uniform levels. In this case, such grants may, if desired, be conditioned on the expenditures being made, and may also be subject to some performance monitoring by the central government. Finally, there may also be some capital grants to supplement (or in some cases replace) borrowing as a source of finance for infrastructure -- for instance to the extent such infrastructure is required to achieve some national policy objective (e.g., a road network). Ideally, such capital grants should be awarded only when the recipients can satisfy technical conditions sufficient to assure the money is properly spent, and they should also be subject to close monitoring.

Finally, central governments need to have a coherent decentralization strategy. They should also provide key “framework” laws for subnational governments (e.g. to ensure uniform financial reporting). In addition, central governments must themselves abide by the rules of the intergovernmental game. They must, for example, refrain from giving discretionary transfers or making arbitrary cuts in transfers, as well as from

\(^6\) For extensive discussion of such questions, see Rodden, Eskeland, and Litvack (forthcoming).
imposing unfunded mandates and bailing out subnational governments in trouble. In addition, considerable attention needs to be paid to creating an appropriate institutional framework for intergovernmental interaction with respect to building consensus, improving capacity, and improving information and analysis.

In total, the first four sets of “rules” discussed above -- those dealing with expenditures, taxes, transfers, and borrowing -- are intended to ensure that subnational governments face a “hard budget constraint” at the margin, so that they are as economically, politically, and administratively accountable for their actions as possible. Theory tells us, and experience suggests, that only when such a constraint exists is decentralization -- implicitly understood throughout this section (see Section 3 below) to mean the effective devolution of decision-making authority to subnational governments -- likely to produce economically beneficial results in the sense of improving social welfare.

The fifth set of “rules” listed above -- those relating to the institutional setting -- are intended to ensure both that the central government is similarly as constrained as possible to accommodate citizen preferences and also that information flows as freely as possible within the governmental system as a whole. Although the literature has so far paid less attention to such institutional issues than to the substantive matters dealt with in the other rules suggested above, I suggest in the balance of this paper that, in most circumstances, “institutions rule” in determining the outcome of decentralization.

To illustrate, it is exceptionally difficult to find that many -- indeed, sometimes any! -- of the “essential” substantive conditions for good decentralization listed above are actually to be found in most developing and transitional countries. One reason for the yawning gap between such prescriptions and the reality found on the ground is, I suggest, that we need to do much more to understand the nature and importance of the institutional framework of decentralization. In the balance of this paper I attempt to begin this task.
3. Two Key Characteristics of Decentralization

As noted in Section 1, two key characteristics of decentralization are that it is complicated and that it takes time. Because decentralization is complex, any particular decentralization experience (or proposal) needs to be very clearly defined and carefully analyzed if its nature and implications are to be understood. Because decentralization is time-consuming, it needs to be analyzed as a process, not simply a product. To make the critical importance of these perhaps banal observations more understandable, and perhaps more persuasive, I shall discuss each of these two key characteristics a little more fully.

Decentralization is Complicated

What does “decentralization” mean? The very diverse experience of recent decades around the world tells us that the only possible answer to this question is one familiar to those who have read Alice in Wonderland. “Decentralization” means whatever the person using it wants to mean. Moreover, whatever one may mean by “decentralization,” its meaning may be interpreted quite differently by others. There are many reasons why countries decentralize, many ways in which they can do so, and many different attributes of any decentralization program or projects.

In East and Southeast Asia, for example, in the countries in which decentralization has been an especially important issue – in Indonesia, the Philippines, and China – in every case the reason is largely political. On the other hand, where decentralization is a real but less significant issue – in Vietnam, Thailand, and even more so Cambodia and Laos – it appears to be driven mainly by concern about regional disparities. Moreover, the main reform priorities vary from country to country, and even from time to time within each country:

- In China, for example, the first priority in the early 1990s was to centralize revenues in order to get control over the national fiscal pie. Increasingly, the priority appears now to be to “rebalance” the pattern of regional growth and to
cope with the political problems that arise from increasingly diverse local circumstances.

- Similarly, in Indonesia, in the early 1990s the priority was a controlled “downshifting” of some central functions, at least partly in line with efficiency concerns. More recently, however, decentralization has become much more politically driven, responding largely to perceived and actual separatist pressures.

- In the Philippines, where the institutional structure has been more stable over the last decade than in Indonesia, the problem continues to be how to “fine tune” transfers, local taxes, and public expenditure management and accounting systems in order to get the right services to the right people in the right way – a task complicated, as always, by the differing perceptions about what is “right” that are held by different groups.

- In Thailand, although decentralization seems driven by some of the same concerns as in the Philippines, the setting differs in that most of the intergovernmental institutions existing in the Philippines – they may not always work well, but at least they exist – have to be created, largely from scratch.

- Finally, in Vietnam, and even more so in Cambodia and Laos, the central priority appears to be to find ways to deal with service provision in poor rural areas, in part to deal with poverty issues but perhaps also in part to slow down the pace of migration to urban areas.

All these aspects of the problem need to be carefully sorted out and understood in each country before one can either assess any particular decentralization effort as successful or not or appraise its worth from any normative perspective. Who wants decentralization, why they want it, what exactly is done by whom, when, and how – many such context-specific factors need to be taken into account before one can meaningfully analyze or appraise any decentralization program. Moreover, even when
some particular form of decentralization seems well-defined and understood, different relevant actors in the process may have different rationales for supporting or opposing it, may face very different incentives with respect to its implementation, and may have very different interpretations of its degree of success. These issues are not simple.

Decentralization may come from above or below. If it comes from above – that is, if the central government initiates decentralization – it may do so for macroeconomic reasons (to “downshift” a deficit), for political reasons (to “offload” a potentially explosive issue), and perhaps even occasionally for economic reasons (to improve the efficiency of service delivery). On the other hand, the initiative for decentralization may come from below – perhaps again for economic reasons (to satisfy local preferences more efficiently) or perhaps for political reasons (particularly in ethnically, linguistically, or religiously fragmented countries). The regions seeking more resources and more autonomy may be small, or large. They may be frontier or border regions. They may be resource-rich or resource-poor. The rationales and motivations for decentralization may thus differ substantially from country to country and from time to time in the same country, and may even differ for different actors in the same country at the same time.

There are perhaps as many forms of decentralization as there are reasons for it. Nonetheless, the varieties of decentralization can usefully be categorized in several ways. With respect to the nature of decentralization, for instance, the most common “top-down” form of decentralization is probably simple administrative decentralization -- for example, moving from a centralized to a decentralized (regional) administrative structure. Local people may perhaps be better served by such a decentralized structure, but they almost never have any greater influence on what is done as a result of such reorganization. Administrative decentralization (or regionalization) of central functions is sometimes called “deconcentration” to distinguish it from “true” decentralization.

A second common form of decentralization – also “top-down” in nature – is what is sometimes called “delegation.” While there are many variations of delegation with respect to the relative division of responsibility and of authority and who pays how much
for what, the common element distinguishing this approach is that subnational
governments are in effect acting as agents of the central government. Subnational
governments may be responsible for a certain public sector activity. They may have
considerable leeway both in what they do and how they do it. Ultimately, however, they
are acting on behalf of the central government and in pursuit of its policy objectives and
are hence subject to its will in critical respects. As in any principal-agent relationship, of
course, in practice there are usually important asymmetries of information and difficulties
in monitoring the behavior of agents and ensuring their accountability to the principal
(the central government).

Finally, the third type of decentralization – sometimes called “devolution” (or
“true” decentralization) – is when full responsibility and authority for an activity is
devolved to subnational governments. Such devolution may or may not be accompanied
by resources (in the form of transfers, or additional taxing power), but in any case
subnational governments are in principle no longer responsible to the central government
for what they do with the funds, but instead solely (at least in democratic settings) to their
own constituents.\footnote{The link between democratization and decentralization has been much discussed in recent years,
especially in the context of Latin America (e.g. Fukusuka and Hausman, 1998), but this important issue
cannot be further considered here. What should perhaps be noted, however, is that no one seems to have
considered the implications (possibilities, limitations, nature) of decentralization in such dictatorial settings
as those interestingly set out in Wintrobe (1998).}

Further, devolution (or, for that matter, delegation) on the administrative side may
be complete – in that subnational governments are fully responsible for all aspects of the
activity concerned — or only partial, in the sense that the central government maintains
some role in terms of policy, regulation, or finance, though not in terms of actual
implementation. Similarly, with respect to both devolution and delegation the central
government may transfer sufficient funds (in one way or another) to pay for all, or part,
or none of the transferred function. Even if the central government pays for all of a
devolved function, however, it still has no say on what is done, since full authority rests
with the subnational government (at least for some part of the function). If the central government pays for a devolved function, how much it pays may depend upon either such general characteristics of the subnational government as its relative access to resources or its “needs” (somehow assessed), or it may simply be discretionary.

If the central government pays for none of a transferred function, but still requires the subnational government to carry out the activity (at a specified level), this is what is called an “unfunded mandate” and is, as already mentioned in Section 2, always a bad idea. Equally bad from an efficiency perspective is the opposite case, in which a subnational government can spend as much as it wants in whatever way it wants, with the bill being picked up entirely by the central government. Matching authority and responsibility is the core of good decentralization policy. Mismatches such as those just mentioned are recipes for disaster.

Of course, in the modern world governments do many different things. Each public sector activity may conceivably be decentralized in a different way and to a different degree. Education, for example, might be organized locally, with local governments expected (say) to provide school maintenance but with everything else essentially being decided by a regional office of the central ministry. This is a form of deconcentration, coupled with an unfunded mandate (for school maintenance). In contrast, health services may be provided directly by local (and/or regional) bodies that are partly funded nationally, with the precise nature of the services provided, the professional qualifications of service deliverers, and so on being essentially determined and regulated by national policy. This is a form of delegation. Finally, all matters relating to local roads – if there are any, where they are, how well they are built, how well they are maintained, and how they are paid for – may be devolved entirely to the local level.

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8 In contrast, even if the central government pays for none of a delegated function, it may maintain full control if it wishes because it has the authority to do so.
Some activities may be devolved or delegated to regional general-purpose governments, some to local general-purpose governments, some to special-purpose bodies or autonomous agencies with different territorial coverage, and some to one or more of the foregoing bodies with the right to contract the actual provision of the service in question out to private providers in whole or in part. Moreover, different approaches to the same problem may be taken in different parts of the same country – perhaps for reasons of efficiency or equity (to achieve the same objective when local circumstances are different), perhaps for reasons of politics (as “squeaking wheels” – those areas which have the most credible threat of separatism or whatever – get the most grease).

Every possibility mentioned above, and many more that have not been mentioned, may be found somewhere in the world today – indeed, sometimes within the same country at the same time. The underlying complexity of decentralization is to some extent unavoidable: it reflects both the complexity of what the public sector does and the complexity of most countries. In such circumstances, to say that “decentralization” is “good” or “bad,” or to say that “it” should be done in one way or another, is to say nothing. One must thus be extremely precise in determining exactly what is being discussed before pronouncing judgment. Clear understanding of the complexity of decentralization is critical to good analysis.

Decentralization Takes Time

Decentralization takes place in the real world, and in the real world change takes time, and time moves in one direction. What exists today is largely explained by what existed the day before yesterday and by what happened yesterday. What will exist tomorrow is similarly going to be explained largely by what now exists and is now going on. Those who would change the complex institutional structure sketched above must therefore not only understand its complexity in detail, but also have a good understanding of how, over time, it came to be the way it is. They must then be prepared to spend considerable time and effort if they wish to make any substantial changes in the
prevailing situation. The juggernaut of public sector institutional structure is not easily turned from its course in any country.

Indeed, what may be called “institutional inertia” is perhaps the most underrated factor in public policy analysis in general. Things work the way they do for reasons, and unless these reasons are clearly understood, and the underlying incentives to which actors are responding are credibly and permanently altered, outcomes are unlikely to change much. Moreover, it is not enough simply to persuade those now in power that change would be in their own interests – though this too may of course be exceedingly difficult to accomplish, since few at the top of any power structure see much virtue in giving up some of their power.

In addition to persuading the rulers one must also ensure that change is in the interests of those on the ground who actually manage and administer public sector activities. Most experienced policy advisers have had the disconcerting experience of successfully persuading – often after great and prolonged effort -- some Minister or government to change a policy, of seeing a new law or edict enacted and perhaps even a new organizational structure created, and then returning ten or twenty years later to find that the same old things are still being done in the same old ways.

The Philippines, for example, has long had a tradition of relatively strong local government, in part perhaps reflecting the long and strong influence of US dominance and policy, as well as more indigenous factors. Although the recent strong interest in decentralization has been driven by a major reform in 1991, that reform itself was the result of decades of discussion of regional and local issues and policies. All too often, when such reforms are evaluated, institutional changes that a country has never managed to achieve in centuries are presented as an absolute imperative for success, and success is confidently anticipated within a relatively short time frame. Centralized education systems supported by strong teacher organizations, but producing little “education,” do not suddenly become effective decentralized student-centered community-responsive systems. Water systems that have long been inadequately funded and poorly maintained
do not turn into “first world” systems in a few short years. Such miracles are unlikely to occur even if the policy environment is macro-economically sound and the central government is exceptionally (and persistently) keen. Even the best consideration of theoretical issues and good practices cannot replace a thorough understanding of the specific details of how a country’s public sector institutional heritage may affect the nature and pace of decentralization.

Institutional inertia is a strong and pervasive factor everywhere. Unless those who control, those who administer, and also – at least in democracies (in theory, and, one hope, to some extent also in practice) -- those who are served by an activity are all persuaded of the need for change, change is unlikely to occur or, if it does, to persist. Consider a few of the conventional rules for good decentralization listed in Section 2 above. Take the case of user charges, for example. Breathes there an economist with analytical soul so dead who has not on some occasion urged on some government the virtues of good user charges (marginal cost pricing, in effect)? But one looks in vain around the world -- including the developed world, incidentally – for evidence that the near-universal expert advocacy of user charges has had any significant effect. Nowhere, for example, is urban transit properly priced. Indeed, almost nowhere do well-designed user charges exist for many government services that could and should be priced. Why?

At least two reasons come readily to mind. First, it is seldom, if ever, in the interest of public sector managers to set proper prices unless they have control over the resulting revenues – and, for other good reasons, it is seldom desirable (or at least desired by those in power) that they have such control. A common efficiency argument for pricing is that it will restrict demand to those willing to pay the marginal cost of providing the service. Ignoring distributional aspects, what this means for the usual under-priced public service is obviously that less will be demanded when the service is properly priced. How will officials whose remuneration usually depends to some extent upon the size of the organization with which they are associated view this outcome?
Second, the consuming public usually views user charges as a “revenue grab” in the sense that they are expected to pay more for no more service. All too often, they are right to do so. A common reason for urging higher public sector fees and charges, for example, is because service levels have deteriorated. The economic logic of such pricing may be sound, but the political feasibility of persuading those who have been getting less and less service that they should now pay more, on the promise that they will get more service in the future seems dubious. Would you buy such an argument from a public sector that has let you down in the past?

Undoubtedly, there are exceptions to this pessimistic characterization, but if neither managers nor customers see anything to gain, and both groups have something to lose by imposing good user charges, should we be surprised that such charges are seldom found? Much more time, effort, and detailed planning and marketing than is usually devoted to such matters seems needed to bring about changes not only in such attitudes but, more fundamentally, in the deep-seated institutional incentives and structures that underlie them.

Similarly, why are subnational governments so seldom given the flexibility to set significant tax rates that is required to establish the hard budget constraint that both theory and experience tell us is critical to good decentralization policy? Why is the fiscal transparency that is so obviously desirable and necessary for both democracy and efficient government so seldom found in practice? Lamenting such obvious failures of reality to accord with analytical precepts is as futile as attacking local governments for not making more efforts to tax their own people when they have more attractive, and less painful, options such as seeking more funds from the central government or foreign donors. To make headway with such problems one must understand in much more depth the political and institutional factors shaping outcomes.

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9 Incidentally, it may be worth noting that buying consent by such bribery may backfire, given the human propensity to rationalize behavior that violates one’s beliefs without changing those beliefs. A large enough grant may induce any government to change any policy. But the fundamental forces that resulted in that policy in the first place will be untouched, and (absent further, and perhaps larger, bribes) they will almost certainly over time reassert themselves and restore the pre-bribe situation.
The problems may be universal, but the solutions – if there are any – are inevitably local in nature. Moreover, even if a satisfactory solution is found to a current problem in some specific setting, it is unlikely to remain satisfactory for long. Decentralization not only has a past that must be understood but also a future that must be anticipated. The past has to be understood if changes in existing institutions are to be successfully introduced. The future has to be anticipated because it may well differ in ways that will require further changes in policies if desired policy outcomes are to be maintained in the face of changing circumstances. Of course, it is never really possible to anticipate the future. It may alter in ways we cannot envisage. The only way we have to deal with the future is to try to put into place institutions and incentives that encourage people to use their problem-solving capacities rather than permitting them to hide their heads in the comforting sand of existing practices.\(^{10}\)

Some objectives, of course, may not be attainable in some countries no matter how well public sector institutions are structured. If the underlying social structure is such, for example, that those who are excluded from society’s bounty are also excluded from political decision-making, poverty alleviation is not likely to be a major policy objective. If those who rule really do not want to make the lives of the less fortunate better off, no matter how carefully and decentralization or other policies are designed to achieve this goal, it is not likely to be attained to any significant degree. Similarly, the gender issue in many countries is a matter of social structure. Clever project design may sometimes be able indirectly to benefit disfavored target groups, but it is unlikely much can be done along these lines without calling forth strong resistance from the existing social and power structure. Reform has its limits in all countries.

Decentralization is a process, not a product, and it is a process that must, in the nature of things, evolve and adapt over time if it is to be sustained. Sustainability is thus as important a criterion with respect to decentralization policy as it is with respect to

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\(^{10}\) As mentioned in Section 4 below, this is an important reason for favoring “competitive” governments.
macroeconomic policy, although it is both less quantifiable and less easy to conceptualize. Nonetheless, a central aim of good decentralization policy should be to put into place sufficient institutional flexibility and problem-solving capacity to cope with at least the near future. In the next section, I make a few suggestions on how this formidable task may be approached.

4. Lessons from Experience in East Asia (and Elsewhere)

The two key characteristics associated with decentralization in the preceding section suggest two general lessons that can be derived from the extensive experiences we have now had with a variety of decentralization efforts not just in East and Southeast Asia but in virtually every region of the world. The first lesson in effect combines the two characteristics discussed in Section 3. It is simply that decentralization is always and inevitably a political process. The second lesson follows directly from the first. To understand decentralization, policy analysts need to think it through very carefully, and in particular they need to be very clear about what decentralization does not and cannot do. In this section, I attempt to make these very general statements a bit more concrete and meaningful. First, however, I shall summarize some observations suggested by a recent examination of experience to date with decentralization efforts in several countries in East and Southeast Asia.\(^\text{11}\)

Some Observations from East Asian Experience

A first observation is that perhaps too much attention has been paid to the lack of decentralized administrative and managerial capacity as a constraint on what can be done. Concern about this problem seems pervasive. Efforts to improve matters in this respect are common. Success is seldom reported. Hardly ever does it seem to be adequately recognized that this problem is inextricably linked to the resolution of such

\(^{11}\) Detailed documentation of most of the points made may be found in Bird (2002).
broader institutional design issues as the extent of “true” decentralization (as defined in Section 3).
If locally-responsible political institutions with adequate capacity to raise funds and with a clear mandate to do something, do not do it adequately, then the full cost is borne by those who pay and it is, in principle, up to them to fix matters.

Of course, externalities, both technological and fiscal, may in reality often make matters less simple than this, but this is surely the right starting point. It is simply not good enough to view local capacity deficiencies as some kind of “engineering” problem – a gap to be bridged by better training and techniques such as better management information systems. On the contrary, such problems are deeply embedded in both the institutional heritage and the basic political and fiscal structure and are most unlikely to go away unless and until these more fundamental matters are dealt with appropriately. Shortages in administrative, managerial, and technical “capacity” do not constitute a “gap” that must be filled as a prior condition to decentralization. They are better seen as problems that will, perhaps after some difficult moments, solve themselves if the right institutional structures are put into place. Sir Arthur Lewis (1967) long ago made this argument, and much the same inference can be drawn from the discussion of “supply-driven” vs. “demand-driven” investment policy in Hirshman (1958). Supply may not create its own demand; but demand may well, in time, draw forth supply.

Much the same may to some extent be said of the common criticism of the deficient intergovernmental administrative and managerial authority arrangements currently in place in most developing and transitional countries. Undoubtedly, many such countries suffer from such problems. Most discussion of such problems, however, at least in the Asian countries examined seems to focus on the need for improved “horizontal” cooperation, between governments at the same level so that e.g. they can learn from each other, see “best practices” at work, and the like. Not nearly enough attention seems to be paid to “vertical” issues although these issues are often more critical in determining outcomes.
Of course, it is often noted that the upper-level government should support lower-level governments, e.g. through training. What is much more important, however, is to ensure that authority and responsibility are properly matched. If a subnational government fails, it should be its responsibility (no bail-outs). If it succeeds, the rewards and kudos should go to it (no central takeovers e.g. of successful local taxes). If these conditions exist, such governments will (if they wish to do so) be able to buy the services and people they need and to use them at least as sensibly as most central governments do. If these conditions do not exist, then even if subnational governments get such inputs for free, they are unlikely to use them efficiently.

Another matter to which not enough attention seems to have been paid is the importance in most decentralized systems of developing a more “consensual” decision process, in which all relevant levels of government partake. Often, the center cannot direct without local implementation and implicit consent, and the local level cannot act without central finance and consent. Critical to the success of such interlocked systems is the creation and maintenance of forums in which all relevant public sector stakeholders have a voice and in which, however painful and time-consuming the process may be, sufficient consent can be achieved to enable effective action. Recent literature has justifiably paid considerable attention to the importance of incorporating “stakeholders” into the decision process. However, it is curious that so little attention seems to have paid to what seems to be the even more pressing need to get on board those who are supposed to implement the policies thus agreed – the “public sector stakeholders.”

Equally surprising, despite the wide experience of the World Bank (and other organizations) with a variety of decentralization activities in many countries, no systematic way of getting such feedback and feeding it back into the policy development and implementation system seems to have been developed in any country. Although much attention has been paid to accountability in recent years, the accountability considered has been almost entirely “accountability up” – to the funding level or the presumed policy-making level through improved monitoring – and not “accountability down” – to the citizen-voter-taxpayer-residents, in whose interests everything is
presumably being done. One reason for the relative neglect of “downward” accountability (through formal local government institutions) may be because there has been perhaps too much attention to institutions “beyond the government” – variously called “participatory democracy,” “civil society,” or non-government organizations (NGOs).

The common emphasis in on community involvement as the key to project success in rural areas, for example, is surely correct. Unfortunately, no one seem to link such policies to the equally common emphasis on the inadequacy of local political and governmental institutions. Just as a good “policy framework” is a good indicator of likely project success nationally, so a good “community-involved local government” serves the same function in a decentralized context. The question is whether constantly emphasizing the need to bypass formal political institutions in order to see what people “really” want is a good way to build up such government…or to ensure that it will not be built up. Not enough attention seems to be paid to this critical issue.

Another curious feature of much discussion of decentralization is that there seems to be an implicit, and never questioned, aim of, so to speak, “keeping them down on the farm” – or at least close by in some rural industry rather than letting them follow the market to the bright lights of the overcrowded big city. ¹² No doubt there is much to be said for creating income-generating activities in the backward areas, but there is little or now serious discussion of the pros and cons of migration – admittedly a highly politicized question in countries such as China and Indonesia -- in the decentralization discussion in any country. It is curious to see so much emphasis on e.g. improving rural infrastructure and jobs and so little discussion of the alternative of moving the people to existing jobs and infrastructure – perhaps because so little of the latter is properly priced that it already over-utilized – although the latter issue seems almost never to be mentioned.
In practice, what decentralization means, if it means anything in general, is that things are now done in a more decentralized way and also that funds now flow differently than before. It is critical to understanding either side of this proposition that the two sides be put together. Yet almost never do fiscal decentralization studies – even good ones – discuss adequately what local governments do with the money although they sometimes, especially in recent years, discuss how they should do it (public expenditure management and all that). Similarly, even good studies of sector policy with respect to e.g. education or health seldom discuss how either the wide differences between different regional and local governments most countries or the changing context of the intergovernmental fiscal system may affect sectoral performance. I do not see how one can study something like education in a decentralized system without paying close attention to the way in which the intergovernmental fiscal system as a whole functions and affects what is done in the sector. Yet it seems to be done all the time.

Finally, how do we know when decentralization succeeds? A decentralized water plant gets built, a year late but within budget. The project is administered successfully (as judged by outside experts in such things), the necessary engineers, accountants, and so on are trained and put in place, and the water flows to the desired people in the desired quantity. People, including poor people, are happier and healthier as a result. It has all been done at a technically acceptable and economically efficient level. Five years later, however, while the plant still runs, water quality is now variable because the entity can no longer pay competitive salaries. A water line has been built to service a new civil service housing estate, but at the same time one of the main lines into a poor area has deteriorated badly owing to lack of maintenance. Every year the entity has to beg the central government for enough money to keep going. Is this a successful project?

Whether a project is efficiently run, or sustainable, is a difficult question. My subjective view, based on almost no real evidence, is that the efficiency of many decentralized activities is unlikely to be too high, essentially because they have all too

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12 A different approach might be to apply some aspects of the emerging theory of “competitive
often been “plugged into” a fundamentally unchanged institutional structure. Many experts in different substantive areas seem to agree since they so often suggest that the particular activity with which they are concerned should somehow be removed (e.g. through an autonomous self-financing corporation) -- or at least insulated (e.g. through earmarked and highly conditional transfers) -- from the generally messy and inefficient public sector. No one seems ever to note the inconsistency between “insulating” sector X or activity Q, while at the same time developing an efficacious, efficient, and sustainable public sector in general -- “good governance,” if you will. At the project level, for example, “institutional development” seems often to be interpreted as creating a good project implementation unit and training people. How either of these worthy activities can produce much lasting benefit outside of the context of creating a good civil service more generally, let alone the possible damage that any success achieved in carving out a specific activity may do to the prospects of ever achieving this broader goal, seems never to be considered.

Decentralization is a Political Process

Building in part on some of these observations, I now return to the two big issues raised in Section 3 -- politics and time. What has recently been called the standard TOM (Tiebout-Oates-Musgrave) model of fiscal decentralization (International Conference, 2002) has on the whole served economists well. This standard approach provides both a normative rationale for decentralization and some clear guidelines upon which to base policy prescriptions intended to achieve “good” decentralization -- essentially those set out in Section 2 above. As mentioned in Section 3, however, one of the most striking features of the actual decentralization in most countries is how widely it departs from the prescriptions of this model. Standard public economics does not suffice to explain much of the real world of decentralization. Although such analysis is useful, it does not, and

13 Nor for that matter do standard “public choice” approaches to multi-government relations, whether in terms of Leviathan or rent-seeking, although they too, like the TOM model, offer some illuminating
cannot, do all that is necessary to understand the inherently political process of decentralization.

In Section 3, I noted that decentralization can often be characterized as being either “top-down” or “bottom-up.” Actually, sustainable decentralization probably has to be both at once. Central government needs to have a coherent decentralization strategy – to know what it is doing, why it is doing it, and how it intends to do it.\textsuperscript{14} It also needs to understand and accept that decentralized functions will not be carried out in the same way as they would if they were centralized.\textsuperscript{15} As emphasized earlier, authority and responsibility need to be decentralized as a matching set. If the central government gives up authority with respect to some activity, it must also reject responsibility. Citizens unhappy with e.g. the performance of their local government in maintaining the roads cannot run to the capital city for relief. If they do, they must not be heard. Similarly, subnational governments need to be willing and able to accept more responsibility. They cannot simply ask for more money and more authority without at the same time accepting more responsibility. Some subnational governments may be much more willing and able to act independently than others. If so, the central government -- and for than matter, other, less keen subnational governments – must be willing to accept asymmetrical arrangements, if such preferences are to be satisfied.

As mentioned earlier, a surprising omission in much of the recent discussion of decentralization is the general failure to recognize the uneven settlement patterns that characterize most countries. Many people in most countries live in very large cities, which are often growing quickly. Many others live in small remote rural settlements, which are often not growing at all. Development, some may say, takes place largely by going along with both these trends, so that in time the non-growing places end up with fewer and fewer people and the growing ones with more and more. Others may deplore insights with respect to decentralization: see for example the overview in Inman and Rubenfeld (1999). This subject is not further discussed here, however.

\textsuperscript{14} See Bahl (1999), who also sets out some other sensible rules on how to implement decentralization policy successfully.

\textsuperscript{15} Indeed, if they were, there would be no case at all for any form of decentralization.
such migration as socially and politically disruptive. In some instances – for example when, as is usual, the city is a “distorted price system” (Thompson, 1968) so that migrants are unduly subsidized – it may also be economically wasteful.

Whether one loves it or hates it, however, urban-rural migration is a central fact of life in developing countries. It is thus something that should be taken into account much more than seems to be usual in designing fiscal decentralization policy. For example, if increased flows of transfers to a poor region keep people in the region who would otherwise have moved to more prosperous regions is this result good, or bad? Although there is of course an extensive theoretical and empirical literature bearing on this question in the developed countries, the question has seldom raised and, to the best of my knowledge, never analyzed in detail in the context of most discussions of fiscal decentralization in developing countries. It should be.

For example, Bahl and Linn (1992) in their massive treatise on the urban fiscal problems of developing countries in effect suggest that the best form of government for metropolitan areas is a centralized one. They make a good case, but, if they are right, is there then ever any case for decentralization? When might “sub-central” government units make sense in a metropolitan context? The detailed design and structure of regional, metropolitan, and community governments, like the optimal balance between special and general purpose governments and the design of intergovernmental institutions in general, are all matters that have seldom if ever been adequately discussed by economists or factored into their analysis. Yet such issues are clearly central to the design and implementation of decentralization policy.

Metropolitan area public finance problems, and their links to metropolitan governance issues, thus need to be discussed much more carefully and systematically than has generally been the case in most studies of fiscal decentralization in developing and transition countries.\textsuperscript{16} Much the same can be said of the problems of small and

\textsuperscript{16} For a useful first look at this question, see Slack (2001).
remote rural settlements. Should two goatherds living on top of a remote mountain be provided exactly the same level of public services as someone living in the middle of the capital city? The implicit answer in most discussion of such issues in the decentralization context appears to be “Yes.” This seems wrong in budget-constrained countries that wish to raise the national standard of living, but then what is the level of “tolerable inequality”? Who decides the answer to this question, and how? What about such other “special cases” as areas rich in natural resources but poor in the necessities of decent existence? Such problems invariably arise in the course of any serious decentralization analysis, yet little has so far been done to discuss them systematically, let alone think through the modalities of possibly acceptable “asymmetrical” treatment.

More generally, as discussed earlier, many other aspects of institutional design in a multi-level government setting may equally repay closer examination. For example, almost no attention has been paid to the possible role of special-purpose subnational governments in providing certain services. Under what circumstances might such “special districts” be preferable to such alternatives as general-purpose governments or public corporations? How should such districts, if created, be structured in order to balance performance efficiency and political representation, that is, to ensure that the right things are done in the right way? How can general local (or regional) governments best interact with such special districts? If “earmarking” (assigning certain revenues to certain expenditures) makes sense for such districts, when might it also make sense for general government? What are the best ways to structure “mid-level” general governments, that is, those in between the central and the local government levels? Should such intermediate governments be directly elected, indirectly elected, or appointed from above? Should they perform separate and distinct functions from local governments? Should they have a tutelary role with respect to local governments and act as intermediaries between them and the central government?

17 Kitchen and Slack (2001) offer some interesting thoughts on these problems.
Some degree of conflict remains inevitable in any decentralization situation. One government’s undesired “mandate” is another’s “essential objective.” One’s limits of tolerance may fall short of another’s minimum conditions. Limits will be tested; bargains will be struck; compromises must be reached. Such is the nature of government and politics always and everywhere. There is nothing unique about decentralization in this respect. What needs more attention than it seems to have received, however, is the question of exactly what can be done – what needs to be done – in order to facilitate the working out of acceptable compromises and hence make any serious decentralization initiative viable and sustainable. While such institution-building exercises have as yet received little attention, at least from economists concerned with decentralization issues, five areas that may perhaps repay further exploration in this respect may be suggested. Some of the following discussion may seem unduly idealistic in the circumstances of most developing and transition countries. Nonetheless, further exploration of such ideas is needed if we want to design and implement decentralization programs more successfully in the future than has generally been the case in the past.

First, an essential part of any significant decentralization initiative must be to establish and maintain what may be called “consensus-building” institutions. As Neumann and Robinson (2001) illustrate for Canada, an appropriate network of intergovernmental institutions is critical to the successful operation of decentralized federal states. Although just what is needed -- and, more importantly, what will work – in this respect obviously varies greatly from country to country, depending upon circumstances and upon the degree of decentralization desired, much more attention to the detailed structure and functions of intergovernmental bodies, whether political (forums of mayors or governors) or administrative (interdepartmental committees) seems needed. Such institutions may function across governments at the same level (horizontal) or across levels of government (vertical). But however they function, their existence in some form or other seems essential to the long-term viability of any significant

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18 Bird and Stauffer (2001) contains some discussion of the asymmetry issue, but mainly with respect to geographically clustered ethnic and linguistically distinct minorities.
Secondly, although one function of such intergovernmental institutions is of course to facilitate and encourage the exchange of information, the need for better information extends well beyond ensuring the smooth working of government(s). Information is essential to ensure not only that governments work well but also that they do the right things, that is, what their ultimate constituents, the public, want. “Feedback loops” thus need to be established not only among governments (as stressed in the previous paragraph) but also from the public to the various government actors, and vice versa. People should know what their governments are doing, who is paying for it, and who is benefiting from it. Central governments should know what local governments are doing, and local governments should know what central government is doing not only with them but with others. Subnational governments should also know what other local governments are doing. Even more importantly, local citizens should know not only what their governments (central and local) are doing for them but also what is going on elsewhere. Only thus – as discussed briefly below -- can the inherently competitive nature of decentralized government be channeled to productive ends.

Thirdly, while it is easy to say that everyone should have more and better information, such talk is cheap. As noted in Section 3, the volume of pleas for fiscal transparency in recent years is matched only by its continuing absence in most countries. Better “monitoring,” whether by the public – for example, through surveys or in other ways – or by higher-level governments through new and better management information systems (MIS), seems unlikely to produce much in the way of improved policy outcomes unless an adequate incentive structure is put into place so that subnational governments can both produce and use such information productively. Few are willing to spend time and effort producing information solely for the benefit of others. There must be something in the information produced that is of direct interest and benefit to the information provider if the information provided is to be worth much. More attention
needs to be paid to designing information systems for decentralized activities that will be implemented enthusiastically and in their own interests by those concerned.

Fourthly, although I noted earlier that in some instances undue attention to non-governmental organizations (NGOs) may undesirably attract attention away from the more important task of strengthening formal governmental institutions, NGOs may indeed have an essential positive role to play in decentralization. Not nearly enough attention seems to have been played to the critical role that NGOs might play in ensuring effective decentralization policy. That role can be both to educate – discovering and publicizing “best practices” (nationally and regionally) – as well as to influence – by analyzing critically governmental policy initiatives and outcomes. Government is sometimes defined as a monopoly (e.g. of politically legitimate power). Too often, however, government also has a monopoly of information about what it does, or does not do. One of the main advantages of decentralization is precisely that it breaks this monopoly. But it does so only to a limited extent, especially if transparency is limited to official circles. The virtue and value of going further and actively encouraging and developing non-governmental “think tanks” to analyze and comment on public policy issues, not least decentralization, have been seriously underestimated in most countries.

Finally, an issue that warrants much closer examination than it has so far received is the case for more competition between governments. Often the only context in which one hears the term “competitive governments” is when such competition – usually with respect to tax bases – is deplored as apparently inexorably driving everyone down to some dread “lowest common denominator.” The contrary position, however, has been taken by Albert Breton (1996), who argues strongly that governmental competition, both horizontal and vertical, is essential not only to restrain the Leviathan tendencies of governments at all levels but also to foster efficiency and especially innovative problem-solving in the public sector. As I have suggested elsewhere (Bird, 2000b), there seems
much in Breton’s hypothesis that warrants closer examination with respect to fiscal decentralization in developing and transition countries.\textsuperscript{19}

**Even the Best Decentralization Cannot do It All**

Sometimes fiscal decentralization seems to be evaluated primarily from the perspective of regional “balance.” Others seem to consider the merits or demerits of decentralization proposals largely in terms of how they affect such goals as poverty alleviation. Still others focus instead on the extent to which the result is more equal provision of public services in regions with different resource bases. As I have argued elsewhere, in reality only the last of these three perspectives is consistent with the canonical model of fiscal decentralization.

If the principal concern of policy is poverty alleviation, for example, not only are measures related directly to that objective bound to be superior to attempts to twist fiscal decentralization in this direction, but doing so may undermine the extent to which the feasible political and economic objectives of decentralization are themselves achieved (Bird and Rodriguez, 1999). Similarly, if the principal concern of policy is “regional balance” – whatever that singularly nebulous term may be understood to mean (Bird and Tarasov, 2002) – fiscal decentralization is almost inevitably going to look somewhat perverse. Giving subnational governments increased control over tax bases, for example, although an essential component of a sound decentralization policy (Section 2), inevitably gives more to those that already have most.

It is thus important to understand clearly what is beyond the reach, and perhaps fundamentally contradictory to, even the best-designed and implemented decentralization policy. Overloading decentralization with objectives such as those just mentioned is virtually always inimical to good decentralization policy. Transfer designs that, for example, require recipient governments to spend X percent of the funds received on the

\textsuperscript{19} A related, but quite distinct, question is the possible application of some variants of tournament theory
bottom quintile of the income distribution, or that direct disproportionate amounts of scarce central resources to the least productive parts of the economy, are unlikely to be either efficient or sensible. Overly “targeting” transfers, like earmarking locally-raised revenues to centrally-determined uses, is contrary to the central aim and intention of fiscal decentralization.

If the central government wants to raise and spend funds in a certain way, it can do so. What it should not do, however, is to force other governments to spend their funds – including funds they may receive from unconditional transfers -- in ways that the central government determines, whether by earmarking, mandating, setting local salaries, or in other ways. Policies such as these, which are all too common in many countries, in effect incur the cost and complexity of decentralization with no offsetting benefits. Similarly, whether “regional balance” is a meaningful or worthwhile target or not – and I am skeptical that it ever is in economic terms, although no doubt obeisance to this goal is often important politically – it does not, and should not, have much to do with the appropriate design of intergovernmental fiscal transfers.20

In many countries, however, the existing system of intergovernmental fiscal relations is difficult to comprehend and analyze precisely because these and other policy objectives are inextricably entangled with the design of various components of the system, notably transfers.21 It is of course true that in the end it is relevant to consider all effects of all policies in assessing government action. As Albert Hirschman (1967) once said, there is no such thing in public policy analysis as a “side effect:” there are only effects. Nonetheless, experience suggests that it is critical in designing policy at some level to follow Tinbergen (1963) and relate each policy instrument primarily to the achievement of a single policy goal. The only way our limited minds seem able to cope with the complexity of the world is to split it into manageable components such as the one-on-one instrument-objective relationship just suggested.

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20 For an example, see Bird and Chen (1998) for a discussion of the Chinese case.
In effect, the suggested approach is first to determine the objectives of policy – in itself by no means an easy task with respect to decentralization, as Section 3 suggests – and then to work out the best way to design the instrument and achieve the objective. Once everything has been thought through clearly in as simple terms as possible, one can then think about how to repackage the various instruments and objectives so that they may both be more saleable in the political context and, more directly relevant to the analyst, sufficiently aggregative to be employed in an efficient and effective fashion.\(^\text{22}\)

5. Conclusion

The preceding discussion may be viewed by some as little more than a string of generalities – either so obvious as to be not worth saying or so unsupported by detailed and rigorous analysis as to amount to little more than a string of unwarranted assertions. Those who hold strong prior beliefs with respect to, say, the best way to decentralize this or that or on the desirability or undesirability of such decentralization are perhaps most likely to dismiss this discussion in such terms. My own view, however, is that the apparent willingness of many to act on such largely untested beliefs, and the inevitably incomplete and partial knowledge on which such beliefs are invariably founded, is a principal reason why so many decentralization projects have come to grief around the world. In a way the main point of this whole paper is that, since no one’s knowledge can ever be complete, the most important key to success in decentralization policy is to ensure both that the process incorporates as much information as possible and that the actors in the process have as equal access to such information (and as equal incentives and abilities to make use of it) as possible.

\(^{21}\) See World Bank (1996) for a Colombian example.

\(^{22}\) The “policy philosophy” sketched here, which is broadly derived from seminal work by Simon, Lindblom, and others, is developed a bit more fully in Bird (1992), chap. 2, and sources cited there.
To put this argument another way, what is done and what should be done can and should really only be decided by those who do it and are affected by it. In the end, the only way we know to ensure that the outcomes of a process are beneficial is to get the decision-making process right. Scholars and policy analysts need not cast up their hands in despair at this pronouncement, however. They should not make the decisions, but they can and should do much both to clarify the nature of the critical policy choices to be made and to ensure that the needed information is generated and fed into the policy process in an understandable and relevant way.

Decentralization is not simply a matter of working out the details of how to achieve some agreed objective in a particular context. Rather, it is an inherently political process of formulating and evolving public policy in changing circumstances in a variety of very different settings. The process is what ultimately determines whether a country gets the decentralization it wants, and deserves. Even the best analysis cannot substitute for a sound process. At its best, however, good analysis can both help persuade those who decide that a better process for deciding is needed and also supply good and relevant information for those making policy decisions. Economists (and other social scientists) are not philosopher-kings: they should not make policy decisions, nor should they replace those who do. But they can help to widen the decision horizon of those who do and to ensure, as much as possible, that all relevant factors are taken properly into account. This is no small matter. To perform this role adequately with respect to decentralization, however, more attention needs to be paid to many institutional issues, such as those discussed in this paper.

The main lesson that we have learned about decentralization is the obvious one that it is a many-faceted essentially political activity that takes many forms and is worked out over time in many different ways in different settings. The general rules about how to do what economists would recognize as a “good” decentralization set out in Section 2 above are, I think, generally valid if that is what a country wants to do. But, as argued in Sections 3 and 4, countries often want to do many other things in addition to, or instead of, an economically sensible decentralization package. In order to understand
decentralization as we find it in the real world, we thus have to extend our tool kit and our knowledge considerably, for example along some of the lines sketched above. More, and more relevant, theorizing, more empirical work in a wider variety of institutional settings, and, by no means least, much more careful and comparative institutional analysis – all these are needed if we are to get a better grip on what is really going on when “decentralization” is in the air in a particular country at a particular time. We have learned much both from experience in East Asia and elsewhere and more generally from the extensive analytical work done to date. But there is, I think, still much, much more to be learned about decentralization.

References


Robert Inman and Daniel Rubinfeld (1999)


