



PFM Reforms: The lessons learnt -promises and tears

Session6: Managing Fiscal Decentralization

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Managing Fiscal Decentralization

Expectations, Risks and Lessons Learnt

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Outline

1. What to expect from fiscal decentralization
 - a. Why do countries decentralize?
 - b. Setting the Stage: International Experience with Fiscal Decentralization
 - c. What is the empirical evidence on the results of decentralization?
2. What are the associated risks to fiscal decentralization.
3. Equalisation: a missing element in decentralized systems in Asia.
4. What is needed for successful Fiscal Decentralization reforms?
5. Conclusion

Main Messages

1. Despite a general perception that decentralization has failed to deliver on its promise, empirical evidence is mixed, with more rigorous studies being considerably more positive.
2. International best practices (such as fiscal responsibility laws) offer options to address potential risks from decentralization.
3. Benefits from decentralization seem to be closely linked to efficient revenue assignments (lower transfer dependence).
4. Often, main obstacles to efficient decentralization come from unfinished reforms, lack of sustained political commitment and weak local accountability mechanisms.
5. Assessing the impact of decentralization policies takes time and usually no counterfactual is available. Results depend on type and extend of reform and country context.

What to expect from fiscal decentralization?

Alexis de Tocqueville's "Democracy in America"
(1835)

"Decentralization... increases the *opportunities for citizens to take interest in public affairs*... and it makes them get accustomed to using freedom..."

"...and from the accumulation of these local, active freedoms, is born the most efficient *counterweight against the claims of the central government*..."

**Decentralization is a political decision
first and foremost**

What to expect from fiscal decentralization?

Richard Musgrave's Theory of Public Finance (1959)

- ✓ Functions of the Public Sector: macroeconomic stabilization; income redistribution; and efficient allocation of resources
- ✓ The first two should be carried out by the central government, but *subnational governments can contribute to the efficient allocation of resources.*

What to expect from fiscal decentralization?

Wallace Oates' Fiscal Federalism (1972)

Decentralization theorem: each public service should be provided by the jurisdiction:

(1) having control over the minimum geographical area that would internalize benefits and costs of such provision,

(2) taking into account economies of scale, externalities, the heterogeneity of preferences and the potential benefits from competition among them.

What to expect from fiscal decentralization?

Multiple other contributions to the theory:

- ✓ Decentralization as a tool to control governmental power - Brennan and Buchanan (1980, 1982)
- ✓ Decentralization's role improving democratic decision making due to its proximity to voters and local preferences -Oates (1999).
- ✓ It can lead to improved productive efficiency (Martinez-Vazquez and McNabb 2003) and also greater accountability through local taxation (Bird 2000)

What to expect from fiscal decentralization?

In summary

Certain public activities could be *more efficiently performed* by subnational governments, matching *closer delivery to the preferences of the voters* and allowing citizens to exercise *democratic controls over government's behavior*.

1. Improved efficiency in the delivery of public services
2. Improved accountability of government agencies towards their constituents
3. Potential positive impact on economic growth (effect on TFP) and on reducing poverty and inequality.

Pillars of Fiscal Decentralization

- ✓ Expenditure Assignments
- ✓ Revenue Assignments
- ✓ System of Transfers
- ✓ Borrowing Powers

Setting the Stage: International Experience

- ✓ Decentralization and sub-national government reform have been prominent trends in Asia and globally for several decades
 - *With transition to democracy, decentralization may be the most important trend in governance In the last 50 years (Rodden 2006)*
- ✓ Role and expectations of sub-national governments have increased substantially in many countries in the region
- ✓ Sub-national governments face a range of great challenges that increase demands on them:
 - Global financial and economic crisis
 - Rapid urbanization and demographic changes
 - Global environmental challenges/climate change

Setting the Stage: International Experience

Estimated Sub-National Government Shares						
Country	Share of Total Public Expenditure (%)			Share of Total Public Revenue (%)		
	Subnational	Upper	Lower	Subnational	Upper	Lower
India	66	33	33	33	30	3
Pakistan	33	28	5	7	6.5	0.5
Bangladesh	15	5	10	2	1	1
China	70	20	50	40	15	25
Japan	60	20	40	40	20	20
Korea	45	15	30	25	10	15
Indonesia	35	7	28	8	5.5	2.5
Philippines	25	11	14	10	2.5	7.5
Viet Nam	45	30	15	35	25	10
Thailand	10	5	5	2	1	1
Cambodia	5	3	2	9	9	0

Source: Martinez-Vazquez 2011, and ADB 2013 with IMF GFS and Other National Data Sources

Setting the Stage: International Experience

Estimated Sub-national Government Shares of Total Public Expenditure and Revenue						
Country	Share of Total Public Expenditure (%)			Share of Total Public Revenue (%)		
	Sub-National	Upper Tier	Lower Tier	Sub-National	Upper Tier	Lower Tier
Australia	36	30	6	20	17	3
New Zealand	9	n.a	9	8	n.a	8

Setting the Stage: International Experience

	Local revenues as percentage of total public revenues	Local expenditures as percentage of total public expenditures
Africa	3.2 (3.6)	7.9 (6.8)
Asia		
South Asia	1.5 (0.9)	16.0 (0.9)
East Asia	20.0 (0.3)	40.0 (0.3)
South –East Asia	5.3 (0.8)	15.5 (0.6)
Eurasia	N.A.	26.5 (15.1)
Europe (2008)	13.0 (0.7)	23.9 (0.5)
Latin America	4.0 (4.5)	11.1 (7.3)
Middle East and Western Asia	N.A.	4.6 (1.7)
North America	17.8 (0.6)	26.8

Note: *South Asia*: India, Pakistan, Bangladesh; *East Asia*: China, Japan, Korea.; *South -East Asia*: Indonesia, Philippines, Vietnam, Thailand. Source: Martinez-Vazquez (2011)

Setting the Stage: International Experience

- ✓ Predominant view: Decentralization has failed to deliver its promise (Rondinelli et al (1983), Treisman (2007)).
- ✓ This assessment is challenged by the size and diversity of studies (Channa & Faguet 2012), (Martinez-Vazquez 2011):
 - ✓ Thin body of rigorous evidence (health in education decent.)
 - ✓ More work on technical efficiency than preference matching.
 - ✓ Higher quality empirical work is more optimistic on the results of decentralization.
- ✓ Other criticism: decentralization may lead to macroeconomic instability (Prud'homme 1995, Tanzi 1995), diversion of funds (Reinikka and Svensson 2004), or capture by local elites (Bardhan and Mookherjee 2000).



Empirical Evidence of Potential Benefits of Decentralization

1. Improved efficiency in public service delivery (Preference Matching and Technical Efficiency).
 - a. In OECD countries (2014), the composition of public spending is significantly different between centralized and decentralized countries (more spending on health care and social welfare).
 - b. Improved preference matching in Bolivia (Faguet 2012), Uganda (Akin et al 2005), Philippines (Schwartz et al 2002) and cross-country (Arze et al 2005), but no evidence in Indonesia (Skoufias et al 2011), or Pakistan (Hasnain 2008).
 - c. Decentralization may lead to improved education performance (OECD 2014) and health (lower IMR in China, Uchimura and Jutting (2009) and India, Asfaw et al (2007)).
 - d. Decentralization can improve service delivery outcomes such as infant mortality or student test scores (Channa and Faguet 2012).



Empirical Evidence of Potential Benefits of Decentralization

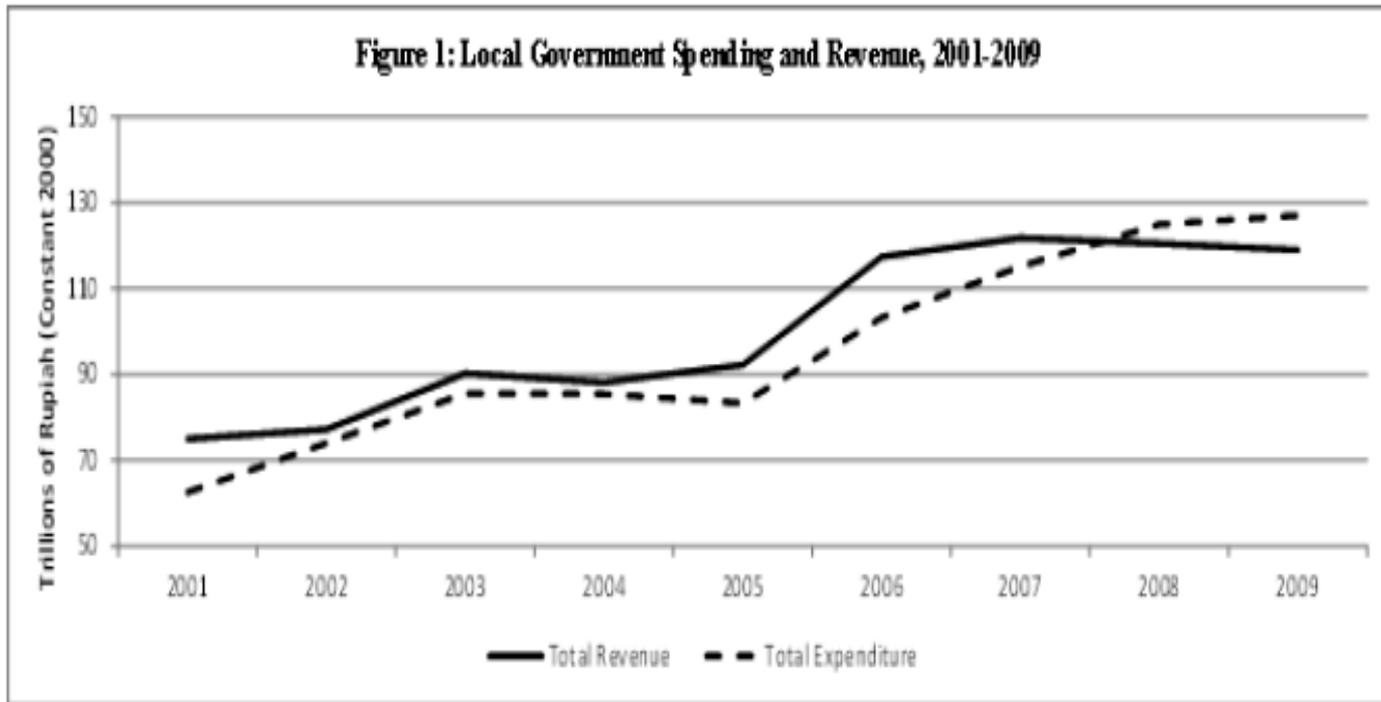
1. Improved efficiency in public service delivery (Preference Matching and Technical Efficiency).
 - a. Indonesia, Simatupang (2009) and Qibthiyyah (2008) note improved education outcomes after decentralization (overall and female literacy rates, years of schooling, and dropout rates).
 - b. Peña (2007) and Solé-Ollé and Esteller-Moré (2005): the proportion of successful students in Spain improved with decent.
 - c. Habibi et al. (2003): revenue decentralization leads to lower infant mortality in Argentina. Robalino, Picazo, and Voetberg (2001) and Khaleghian (2003) noted that expenditure decentralization was positively related to improved health outcomes in low- and middle-income countries.



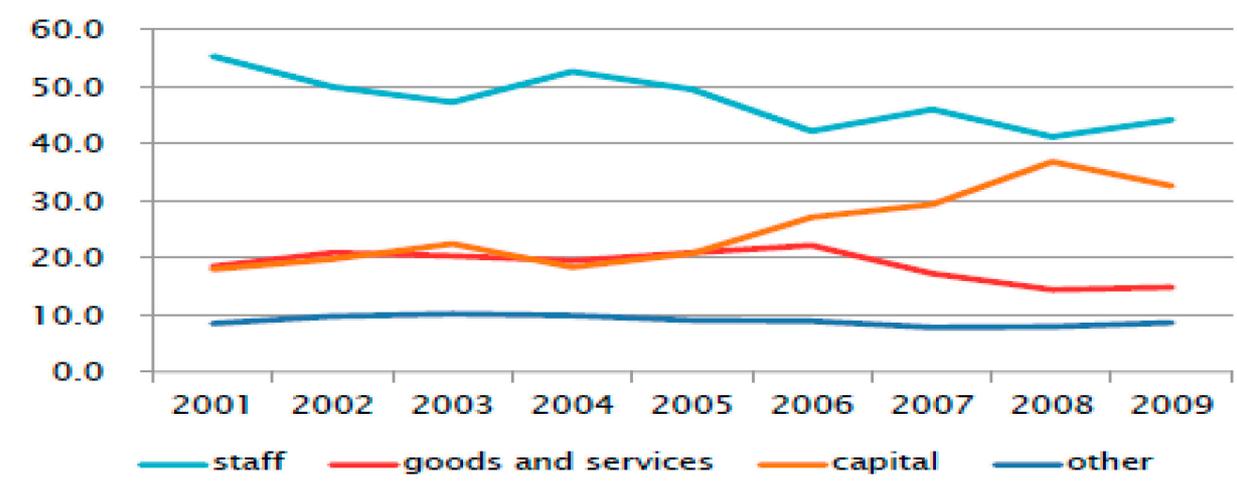
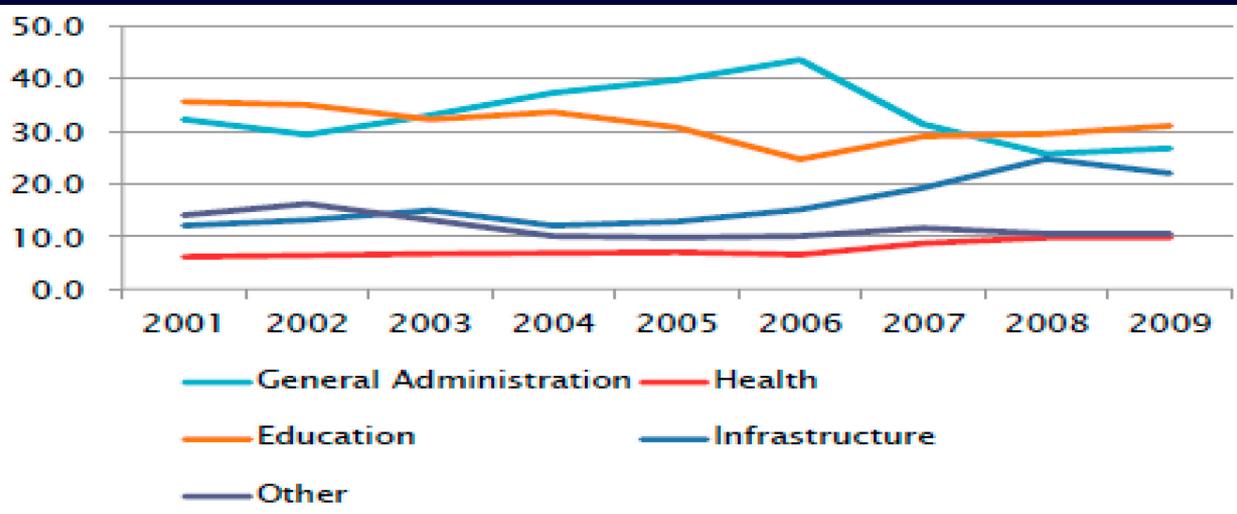
Empirical Evidence of Potential Benefits of Decentralization

1. Improved efficiency in public service delivery (Preference Matching and Technical Efficiency).
 - a. Santos (2005): decentralized participatory budgeting led to increased access to water and sewage services in Brasil.
 - b. In Korea, Wade (1998): more efficiency in decentralized irrigation systems as opposed to inefficient centralized systems in India.
 - c. World Bank (1994): infrastructure delivery in decentralized settings was of better quality and lower costs.

Indonesia: Local Government Spending (Lewis 2013)



Indonesia: Sector Distribution of Spending (Lewis 2013)



Indonesia: Local Government Performance

- ✓ Citizens' satisfaction with the quality of local public service (Lewis 2013):
 - 78%, 90%, and 85 % of respondents were satisfied with the quality local administration, health, and education services.
 - Only 7 % of households had ever complained about the quality of services; of those;
 - Less than 30 % of households indicated that they desired improved administrative and social services and were willing to pay for them.
- ✓ However:
 - Indonesian education performs in the lower middle range among Asian and other developing countries.
 - Immunization rates have increased rapidly but child nutrition has not improved.
 - District road length has increased but road quality has deteriorated.



Indonesia: Local Government Performance

- ✓ What can explain this dilemma? (Lewis 2013):
 - Sufficient finance in general, except for local infrastructure development.
 - Lack of subnational capacity is a severe constraint a limited number of places.
 - Perverse incentives in intergovernmental transfers don't seem to have harmful local fiscal, initial experience with performance grants is auspicious in terms of encouraging better service delivery.

- ✓ So then?:
 - Downward accountability in Indonesia is still weak.
 - It may be in large measure a function of insufficient citizen demand for higher service quality.
 - "If citizens are already reasonably satisfied with service delivery there would seem to be little reason for local governments to advance in service quality."



Empirical Evidence of Potential Benefits of Decentralization

2. Improved accountability of government agencies towards their constituents
 - a. improve the accountability and responsiveness of government so as to increase citizen voice
 - b. Reduce abuse of power from the central government
 - c. Improve political stability
 - d. Increase political competition

Assuming direct elections, multi-party systems and functioning electoral dynamics.

Empirical Evidence of Potential Benefits of Decentralization

2. Improved accountability of government agencies towards their constituents

- a. Cambodia's National Program for Sub-National Democratic Development (NP-SNDD) (2009). Its goal is to promote and sustain democratic development and local accountability.
- b. Philippines Local Government Code (1991): "...to provide for a more responsive and accountable local government"
- c. Indonesia Decentralization Law 1999: Aimed to prevent the disintegration of the state by granting local autonomy.
- d. Bolivia (2010): "...effective participation of citizens in decision making..."
- e. Peru (2011): "...to improve citizen participation in government..."

Empirical Evidence of Potential Benefits of Decentralization

2. Improved accountability of government agencies towards their constituents.

a. Political Competition

- ✓ Re-emergence of local identities in Indonesia, and fragmentation of political alliances.
- ✓ But also local elites may capture the electoral system (dynasties in Philippines)
- ✓ Decentralization is associated with lower levels of corruption for sufficiently high level of political competition (Albornoz & Cabrales 2013), and also Fisman and Gatti (2002) or Barenstein and de Mello (2001).
- ✓ Political competition may be lower in developing countries.

Empirical Evidence of Potential Benefits of Decentralization

2. Improved accountability of government agencies towards their constituents.

b. Public Accountability

- ✓ Increasing evidence that decentralization makes government more responsive to local needs, increased citizen satisfaction with services and better program targeting Alderman (2002), Faguet & Sanchez (2008).
- ✓ Hellman et al. (2003), Lewis (2013): improved satisfaction with service in Indonesia after decentralization. Meagher (2001): in Philippines after decentralization, improved matching of citizens' priorities.

Empirical Evidence of Potential Benefits of Decentralization

2. Improved accountability of government agencies towards their constituents.

b. Corruption

- ✓ Gurgur and Shah (2005), Arikian (2000), and Fisman and Gatti (2002): decentralization reduced the overall level of corruption
- ✓ In Colombia, Fiszbein (1997) found that competition for political offices reduced corruption at the local level.
- ✓ Kuncoro (2000) found that in Indonesia, administrative decentralization led to lower corruption as firms relocated to areas with lower bribes.

Empirical Evidence of Potential Benefits of Decentralization

3. Reducing poverty and facilitating economic growth.
 - ✓ Positive effect on poverty and HDI: Sepúlveda and Martínez-Vázquez (2010), Von Braun and Grote (2002) and Lindaman and Thurmaier (2002). Galasso and Ravallion (2001) noted that Bangladesh's food-for-education program became more pro-poor with decentralization.
 - ✓ Negative or no impact on poverty: West and Wong (1995) in the PRC, Ravallion (1998) in poor areas of Argentina; Azfar and Livingston (2002) in Uganda.

What are the associated risks to fiscal decentralization?

1. Macroeconomic Instability – Overspending (Prud'homme 1995, Tanzi 1995)

- ✓ In the absence of hard budget constraints, decentralization may lead to overspending (Prud'homme 1995, Tanzi 1995).
 - ✓ Expenditure and revenue decentralization lead to lower deficits (Neyapti 2010, Panel 16 years). Thorton (2009): No negative impact (OECD 19)
 - ✓ IMF 2012: ...spending decentralization improves the fiscal position of the general government unless high transfer dependency...

What are the associated risks to fiscal decentralization?

2. Macroeconomic Instability - Inflation

- ✓ No relationship with inflation levels - Treisman (2000); Rodden, Eskeland, and Litwack (2003)
- ✓ Martinez-Vazquez and McNabb (2006): Decentralization may help price stability in developed countries, impact is uncertain in developing economies.
 - ✓ But positive relationship in Pakistan (Iqbal & Nawaz 2010). Jalil et al (2010): Decentralization leads to a decrease in inflation rate. No correlation with fiscal deficit.
- ✓ Shah (2006): Decentralized countries perform better on macroeconomic management than centralized ones.

What are the associated risks to fiscal decentralization?

3. Macroeconomic Instability - Borrowing

- ✓ Excessive borrowing of SNAs behind 2001 crisis in Argentina; Brazil had two sub-national debt crisis in the 1980s, 57 out of 89 regional governments defaulted in Russia between 1998 and 2001.
- ✓ Colombia, South Africa had subnational debt crisis in the 1990s, current situation in China is a concern due to the country's specific political economy.
- ✓ A number of new instruments, including fiscal rules (Brazil, Colombia, Peru) and other debt management systems (traffic light system in Colombia) have dealt successfully with this risk.

What are the associated risks to fiscal decentralization?

3. Macroeconomic Instability - Borrowing

- ✓ In Philippines, subnational borrowing limited in practice to government financial institutions < 1% GDP.
 - ✓ Borrowing <4% of local gov revenues
 - ✓ Debt service < 1.5% of local gov revenues
- ✓ Indonesia presents similar regional debt levels, well below 1% of GDP.
- ✓ In Cambodia, no borrowing powers for SNAs.

What are the associated risks to fiscal decentralization?

4. Expansion of the State

- ✓ Incentives for local government fragmentation in Philippines and Indonesia.
 - ✓ Pemekaran – Led to a moratorium on new government formation.
 - ✓ Philippines – Conversion of municipalities into cities in search for higher transfers.
- ✓ Decentralization leads to larger civil service (Martinez-Vazquez and Yao 2006) but again, no evidence of overspending across the board.



What are the associated risks to fiscal decentralization?

5. Increase in Inequality?

- ✓ Decentralization of government expenditure can help achieve a more equal distribution of income (IMF 2014, Goerl & Seiferling) if sufficient revenue decent.
- ✓ Hill (2008): decentralization has not led to major changes in regional inequality in Indonesia or Philippines.
- ✓ But also, decentralization may lead to decreased leverage power of poorer areas (Rodríguez-Pose and Gill 2005, Besley and Ghatak 2003).

Equalisation: Pivot Element

- ✓ Comparable levels of service delivery with similar tax effort.
- ✓ Fiscal gap: Equalising the difference between expenditure needs and fiscal capacities.
- ✓ Provides incentives to revenue collection when fiscal capacity based on potential rather than actual.
- ✓ Need to combine both vertical and horizontal.

Source: GFS, IMF	Spending		Own-source revenue		Vertical Imbalance	
	Expenditure /gdp00	Expenditure /gdp10	Own Revenue/gdp00	Own Revenue/gdp10	Vertical Imbalance/gdp00	Vertical Imbalance/gdp10
China,P.R.	21.03	7.43	12.93	14.55	8.10	2.54
	2002	2004	2002	2011	2002	2004
India	12.30	11.60	1.11	7.63	11.19	3.97
	2000	2011	2000	2011	2000	2011
Indonesia	0.92	6.94	0.35	2.04	0.57	4.89
	1998	2012	1998	2012	1998	2012
Japan	13.98	16.02	8.02	8.42	5.96	7.59
	2005	2012	2005	2012	2005	2012
Korea, Republic of	13.73	11.07	8.86	6.26	4.87	4.80
	2006	2011	2006	2011	2006	2011
Mongolia	12.32	5.96	7.06	8.39	5.26	-2.44
	2001	2012	2001	2012	2001	2012
Thailand	0.94	2.46	1.23	1.67	-0.29	0.79
	2000	2012	2000	2012	2000	2012
Philippines	3.67	3.28	1.22	1.09	2.45	2.19
	2000	2010	2000	2010	2000	2010
Nepal	1.02	1.59	0.56	0.4900	0.46	1.1
	2003	2007	2003	2007	2003	2007

Equalisation: Pivot Element

- ✓ Although widespread agreement on the concept, limited implementation is due to:
 - ✓ Resistance from potential “losers”
 - ✓ Lack of understanding of measures of fiscal capacity.
 - ✓ Formulas for the transfer mechanisms inserted in law – difficult to change.
 - ✓ Only acceptable if applied to additional resources.
 - ✓ Indonesia: Pioneer country on equalisation.

What is needed for successful FD Reform?

- ✓ Political and social accountability mechanisms are key for effective fiscal decentralization.
- ✓ Successful reforms are helped by health fiscal conditions.
- ✓ Constitutional provisions may slow reform.
- ✓ Bundling of reforms is required to create reform constituencies.
- ✓ Momentum for reform builds slowly. Second generation reforms are a painful process (Indonesia, Philippines). Set the basics right.
- ✓ Careful sequence assists reforms, as well as asymmetric approaches.

What is needed for successful FD Reform?

- ✓ Bring out the “human face” of the reform.
- ✓ Sustained political leadership is required for full implementation.

Conclusions

1. Despite a general perception that decentralization has failed to deliver on its promise, empirical evidence is mixed, with more rigorous studies being considerably more positive.
2. International best practices (such as fiscal responsibility laws) offer options to address potential risks from decentralization.
3. Benefits from decentralization seem to be closely linked to efficient revenue assignments (lower transfer dependence).
4. Often, main obstacles to efficient decentralization come from unfinished reforms, lack of sustained political commitment and weak local accountability mechanisms.
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Thank you

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