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## WHEN DOES DECENTRALIZATION DELIVER? “THE DILEMMA OF DESIGN”



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Decentralization since early 1990s has become one of the buzzwords of the development paradigms. Among all ingredients of decentralization, the fiscal component of it has a special significance. Not surprisingly the literature unanimously recognizes that it is the regulation of intergovernmental relationships in the fiscal arena that can strike the right balance among different objectives of each level and resolve tensions between them. Thus, the fiscal decentralization is in vogue. The trend that began in 90s has only gained momentum at the turn of the century. Yet the outcome of adopting similar policies has not been uniform across the globe. Some have succeeded, some are stumbling and some others have failed. In fact, the success of decentralization depends on its design. The paper looks into various questions associated with the dilemma of designing decentralization instruments for the success of fiscal decentralization. These include the question of designing the right mix of policies, the questions of sequencing and synchronization, the question of pace and that of balancing the contrasting forces of centralization and decentralization. The paper offers the insight to the policymakers that while designing fiscal decentralization they should not try to replicate any 'ideal type' solution. Though the ideal types can be powerful analytical tools, yet they do not lead to solutions for specific situations. Real world fiscal arrangements rarely follow the idealized model; they are loaded with historical developments and political *ad hoc* solutions. It is simply not realistic to start from *tabula rasa*. The paper emphasizes that there is no "one size fits all" type answer to decentralization question. All systems will have to work out their own style of going about decentralization and restructuring of intergovernmental relations depending on the context and conditions peculiar to their own situation. The paper also argues that any attempt towards fiscal decentralization must be firmly grounded in the basic principles of fiscal federalism, irrespective of the fact whether the country in question is an officially declared federal state or not. Thus while implementing decentralization policies, the need is to 'bring the federal back in'.

There is a world wide trend toward increasing transfer of power, resources and responsibilities to the subnational levels of government. Both federal and unitary countries, whether industrialized or developing are moving toward more fiscal decentralization. This trend towards greater fiscal decentralization that began in 1980's with many developing countries embarking on the path to devolve more functions to the local jurisdictions, gained momentum during 90's. Paul Smoke (2001) asserts that during the 1990s, fiscal decentralization and local government reform have become among the most widespread trends in development. This trend, according to Ter-Minassian (1997), is evident not only in federal countries but also in many unitary countries including some that have a long tradition of centralist government. Political developments in Latin America, Asia and Africa point toward a trend en route for increasing decentralization. The trend is visible in post communist Central and Eastern Europe (CEE). The trend can also be observed even in essentially centralized countries such as Jordan and Morocco. Countries like India, Mexico and Pakistan are also trying to improve upon their fiscal federal arrangements to make them more responsive and efficient. Certain studies have shown that out of the 75 developing and transition countries with populations greater than 5 million, 63 have embarked on some form of fiscal decentralization

(Helmsing, 1999, Robert D.Ebel, 2001). In fact addressing the challenge of devising best achievable array of assignment of functions and responsibilities is, in words of Richard Bird (1993) "...a question at the centre of policy debate in countries around the world." In order to address the dilemma of design **section I** sets the context by highlighting the cases of decentralization failure, thus underpinning the relevance and gravity of the said dilemma. This naturally leads to the question of ensuring success that is taken up in the **section II**. This section deals with many popular questions relating to design and pace for ensuring success of decentralization policies. The paper reviews the existing literature (**subsections A to E**) and highlights that there is no single right strategy or design that could be projected as "success mantra" for all countries. However while customizing decentralization to strike their own chord; the policy makers must not lose sight of the basic principles of fiscal federalism (**as highlighted in the conclusion**).

### I. Decentralization Failure:

There is an ample evidence to prove that an overenthusiastic and imbalanced approach to fiscal decentralization can produce a market-distorting effect (as against market preserving). This has happened in case of Brazil and Argentina. **Brazil** is an example of an unbalanced federal system where states and municipalities have won. They dominate the union and compete among themselves in a disorganized and predatory fashion. Experience of **Argentina** shows that perversely structured systems of intergovernmental finance can destabilize public sector and economy as a whole. The World Development Report 1999/2000 (Chap 5) has arrived at certain observations in this regard: (a) Decentralization if improperly pursued can lower the quality of public services as in **Latin America and Russia**. (Chap 5, end note 13). (b) A poorly handled decentralization can threaten macroeconomic stability (Chap 5, endnote 26). (c) Fiscal decentralization reduces the central government's control over public resources thus hampering a government's ability to respond to economic shocks. The government of **Philippines** for example, is required to share nearly half of its internal tax revenues with subnational governments, limiting its ability to adjust budget in response to shocks. (Ch.5 p 111).

Further there are many studies that conclude that under *certain circumstances* fiscal decentralization may produce the results exactly opposite to what pro-decentralization literature may assert. For instance: (a) Spillovers, common pool problems and problems from soft budget constraints result in efficiency losses associated with decentralization (Inman and Rubinfeld 1997, Sanguinetti 1994, Rodden 2000, Stein 1998, Wildasin 1997 and Willis, Garman and Haggard 1998). (b) Davoodi and Zou have found in their studies that fiscal decentralization is associated with slower economic growth. (Davoodi and Zou, 1998; Xie, Zou and Davoodi, 1999) (c) In some studies local Governments were found to be more corrupt & decentralization in certain studies has been shown to be leading directly to greater state capture (Goldsmith, 1999, Bardhan and Mookherjee, 2000). (d) It has also been argued that there is no significant relationship between fiscal decentralization and public sector size (Oates, 1985; Nelson, 1986). Thus the assertion that it limits the size of public sector is not true.

What is more serious is that if 'decentralization' aspect is stretched to its extreme it can even encourage and incite separatist tendencies as is happening in **Italy**. Wallace E. Oates (1999), have stated that in Italy the movement toward decentralization has gone so far as to encompass a serious proposal for the separation of the nation into two independent countries (p1120).

In past also the experience has shown the limits of a 'largely' decentralized distribution of powers in terms of inducing and maintaining federal cohesion. Most unique experiment was that of **West Indies**, which assigned very few powers to the federal government, so much so that there was a significant lack of financial resources even to make those trim powers effective that were entrusted to the federation. Within a short time it became obvious that the sense of community shared by the islands was not sufficient to hold the federation together. This was exacerbated by the relative paucity of powers to generate support for the federal government. Following the succession of Jamaica and then Trinidad, the "salt water federation" was officially dissolved by the British Government in 1962, only five years after its foundation in 1957. Another instance is of **Bosnia Herzegovina**. The country adopted federalist structure under Dayton Peace Agreement. But the agreement seriously compromised some basic principles of "fiscal federalism" and powers of the state with respect to subcentral units were highly curtailed. The state now faces the challenge of carrying out even its minimal responsibilities, since it relies on transfers from the entities. Moreover, since central government has little resources and power to offset regional imbalances, large inequalities are likely to develop among and within the entities (as economic conditions differ substantially across the country) (Fox and Wallich 1997). It is in such context that Prud'homme (1995) warned against potential dangers of decentralization and Vito Tanzi(1996) challenged the role of decentralization as a means to foster growth and development. Some authors have even argued that in post Soviet context, greater centralization is in fact required (Polishchuk, 2000, Stoner Weiss, 2001). Thus the recent literature on centralization-decentralization debate tilts in favour of the argument that in case of developing and transition economies existence of strong center (political centralization) at least in short run is required. In a short-term perspective and under the strong pressure of both radical and "over the night" systematic economic and political reforms, sometimes even accompanied by state transition, decentralization need not necessarily be a prerequisite for good governance. According to Luiz de Mello and Matias Barenstein (2001), "Because improvements in governance take time to mature, fiscal decentralization should *not* be used as a catalyst for improving governance"

In fact the policy oriented research has clearly demonstrated that the tendency in public policy discussion to distinguish between economic objectives on the one hand, and political and constitutional objectives on the other, is inappropriate. Real world fiscal arrangements rarely

follow the idealized model; they are loaded with historical developments and political *ad hoc* solutions. It is simply not realistic to start from *tabula rasa*. In any case, economic fundamentals are not the only logic of good governance. Though the ideal types can be powerful analytical tools, yet they do not lead to solutions for specific situations.

## II. The Question of Ensuring Success:

The above description shows two things. Firstly, it shows that the decentralization is now a political reality world-wide (though it varies greatly in form within and among countries) and secondly that there are cases when decentralization fails to deliver. Implication of the first is that the debate on whether decentralization is good or bad has lost its relevance. Implication of the second point is that the debate now has shifted to the problem of designing instruments and ensuring conditions for success of decentralization.

In recent decentralization literature it has been emphasized that decentralization *in itself* is neither good nor bad (IBRD, 2000; 107). The implementation of similar decentralization policies in different countries may produce different outcomes depending on the specificities of the country in question, such as the strength of existing institutions and legacies of centralization. The World Development Report (1999, pp 107-124) asserts that the question today is not whether decentralization is good or bad, the more important question is whether it is successful or not. It says that successful decentralization improves the efficiency and responsiveness of the public sector while accommodating potentially explosive political forces whereas unsuccessful decentralization threatens economic and political stability and disrupts the delivery of the public services. The report argues that the success of decentralization depends on its design.

It is generally argued that decentralization of government *in terms of devolution*, can improve governance by fostering *accountability, participation, and transparency*. But devolution in itself does not guarantee better governance. Indeed, ineffective or improper devolution creates more problems than it solves. Therefore, it is vital that decentralization instruments are carefully crafted keeping in view the specific context of the country in question. The idea here is to reinforce the importance of effective planning and design in undertaking decentralization.

### A. Striking the Right Mix of Policy Instruments:

At least seven components of designing decentralization are crucial for its success. The aim is to create institutions which provide disincentives for citizens to free-ride or for decision-makers at various levels of government to either overgraze the fiscal

commons or evade responsibility for citizens whose needs place disproportionate burdens on public expenditure: 1. Finance should follow function: Revenue raising authority must be linked, at the margin to the service provision responsibilities. 2. Informed public opinion: There should be local access to right information to enable the local community to develop meaningful public opinion and decide priorities. 3. Mechanisms for making local priorities known must be put in place. 4. Credible incentives for people to participate: Writers on institutional economics have long observed that people's willingness to participate varies according to their perception of how much impact such participation will have (Hirschman, 1970; North, 1990; Ostrom and others 1993). 5. Adherence to local priorities: There should be compelling incentives for politicians to be responsive and accountable. 6. Appropriate incentives for sub national governments to maintain fiscal responsibility: It is argued that destabilization effects of decentralization arose mainly from inappropriate incentives than any problem inherent in decentralization (Spahn 1997) including soft budget constraints. 7. Designing instruments of decentralization to support political objectives: The instruments of decentralization at the disposal of a policy maker are: (i) Legal institutional framework. (ii) Structure of service delivery responsibilities. (iii) Allocation of various taxes among different levels of the government. (iv) Intergovernmental transfers (v) Central government controls and constraints upon sub national borrowing (vi) Local government election rules.

Decentralization is a mixture of administrative, fiscal and political functions and relationships. In design of decentralization all three must be included. However, applying these principles in practice is a complicated task. This is because different decentralization instruments (taken independently) will produce different consequences for different objectives (such as economic efficiency, macroeconomic stability, income redistribution and political efficiency) under different circumstances. The 'right mix of the policy instruments' has to be shaped while taking into account specific circumstances of the country concerned. It is thus not possible to propose a 'decentralization model' that would fit all the countries. To quote Prud'Homme(2001), " They (policy makers) are like a composer writing a symphony for a number of instruments; the quality of the

symphony will depend upon the melody written for each instrument and also upon the combination of the many melodic lines.”

### **B. The Question of Synchronization and Sequencing:**

Burki and others (1999) have argued ‘Decentralization often takes place amid political and economic turmoil...Even where decentralization happens in less dramatic context, questions of strategy and timing still arise....There is clearly no blueprint for decentralization....(but) the most consistent lesson of recent decentralization experience is the need to *synchronize* the elements of reform.’

Decentralization is a mixture of administrative, fiscal and political functions and relationships. In the design of decentralization systems all three must be included. [Cohen and Peterson 1999, Schneider 2003, Manor 1997]. Schneider makes the distinction between these three dimensions. “Fiscal decentralization refers to how much of the money collected and spent by government goes through non-central government entities. Administrative decentralization refers to how much autonomy non-central government entities have relative to central control. Finally, political decentralization refers to the degree to which non-central government entities satisfy the political functions of governance, such as representation”. He further states that there is a range of possible ways in which these dimensions could interact. One possible pattern is that increasing decentralization in one dimension leads to an increase in decentralization in other dimension. A second pattern is that increasing decentralization in one dimension leads to a decrease in decentralization in another dimension. With three dimensions there are six combinations. For example changes in fiscal decentralization can be either positively or negatively related to changes in administrative or political decentralization. The interaction could be more complex; in which decentralization along two dimensions augments or offsets decentralization along the third. Alternatively, decentralization along one dimension might augment decentralization along another, but this relation might not work in reverse. These possibilities are however, difficult to test statistically.

Thus it is not surprising that attempts to find causal relation have produced mixed, inconclusive or at best conditional results. Kent Eaton (2003) in his study evaluates a hypothesis that, ‘it is the democratic election of sub-national officials in particular that unleashes powerful and ultimately irresistible pressures from below for greater fiscal decentralization. In this view, fiscal authority follows elections’. The question asked is whether political decentralization has caused fiscal decentralization? According to the research presented by the author, elections for sub-national offices in the

20th century quite consistently led to fiscal decentralization in Argentina and Brazil, but *not* in Chile and Uruguay. Schneider (2003) speculates, “Fiscal decentralization might generate greater administrative decentralization. This would occur if local units used increased resources for a power grab and asserted administrative autonomy from the centre. Alternatively, fiscal decentralization might lead to less administrative decentralization. This would occur if central governments systematically tried to counteract any release of resources with an increase in bureaucratic or regulatory controls”.

Thus the issue of matching fiscal, political and administrative arrangements to achieve the optimal mix is a difficult but important design issue. Such policy synchronization is difficult because each service and even each function within a service will differ with regard to appropriate form of decentralization. Thus the challenge of designing decentralization has been linked to a soufflé where all ingredients must be present in the right amounts and prepared in the right way to achieve success (Parker, 1995).

Another related aspect of designing decentralization is that of proper sequencing. Though it is widely accepted that both political and fiscal decentralization are complementary to each other for overall success of the programme<sup>1</sup> but the question is of sequencing. The question is sometimes posed as to whether fiscal decentralization should precede or follow political decentralization? There are scholarly works justifying both sides of the argument. Jamie Boex (2001) asserts, “An important precondition of fiscal decentralization is political decentralization.” (p.3). He argues that fiscal decentralization is the “assignment of fiscal decision making power and management responsibilities to lower levels of the government. This definition implicitly assumes that subnational governments have a certain degree of fiscal discretion and are accountable to their regional constituents. Nothing but political decentralization provide local governments with real decision making power, which is neither provided by deconcentration nor delegation as subnational governments in such forms of decentralization (predominantly administrative ) continue to be accountable to the center, as opposed to being responsive to the local populace that they serve” (p3). Wildasin (1995) also puts political conditions for success of fiscal decentralization. He argues that the presumption that fiscal decentralization is conducive to allocative efficiency “depend critically on the decision making mechanism of lower level government and on the constraints on local decision makers, for example the ease with which households and firms can escape or enter localities in response to their fiscal attractiveness or lack thereof. If “exit” is constrained and there are no effective

channels for “voice”, there is no particular presumption in support of the view that fiscal decentralization enhances allocative efficiency”. He argues that enhancing the responsiveness of local institutions, either by democratizing them or by making them more competitive is a task that warrants explicit consideration in the developing country context. *But adds* in a footnote (fn2) that the example of the competitive firm shows that democratization (political decentralization) is not always crucial for allocative efficiency. Democratic political reform may be important for the success of some types of fiscal decentralization but not necessarily for all.

On the other side of the spectrum lies the sweeping argument that bringing political decentralization prior to fiscal decentralization is like putting the cart before the horse. Bardhan and Mookherjee (1998) argue that if local accountability is limited (which is best ensured by devolving fiscal authority<sup>2</sup>), political decentralization will lead to local capture. Political decentralization may therefore simply transfer power from national to local elites. In this respect, it has often been argued that the institutional foundations for *fiscal federalism, such as revenue-sharing arrangements and expenditure rules, should be in place before political decentralization and political liberalization begins*. As Burki and others (1999) have argued, “The political impetus behind decentralization prompts central governments to make political concessions hastily. But granting local elections is a step that can be taken rapidly. What is difficult is the working through new regulatory relations between central and subnational governments and working out a system of tax assignment, intergovernmental transfers and transfer of central government assets” (p33).

In the case of Russia according to World Bank Development Report 1999-2000, the fact that political decentralization preceded fiscal decentralization, may also have had an adverse effect on macro instability. The report says “... sometimes in the process of decentralization cart is put before the horse i.e. political decentralization is brought first. It happens also because political impetus behind decentralization prompts central governments to make concessions hastily. Further, granting local elections is a step that can be taken rapidly. But making decentralization a success requires taking a number of

slow and difficult steps that create new regulatory relationships between central and subcentral governments, transfers assets and staff to local levels and replace annual budgetary transfers with a system of tax assignment and intergovernmental transfers. *The recent history of decentralization illustrates the dangers of not sequencing appropriately*. Thus World Bank Report offers the policy direction "Put expenditure and revenue rules in place before political liberalization". (World Bank Report 1999-2000). Olivier Blanchard and Andrei Shleifer's (2000) analysis also suggest that federalism in Russia has failed precisely because of political decentralization. "There is no question that carefully designed tax and other fiscal policies can raise *the share of revenues from additional growth going to local governments* in Russia. Nevertheless, given the low level of political centralization, such fiscal measures may not be enough to induce local governments to foster growth". (p10).

The diversity in above studies is indicative of the imperative call for revisiting the propositions regarding mutual interactions of political and fiscal decentralization in context of globalization. To refer to another trend in the literature mention could be made of a recent paper by Geoffrey Garrett and Jonathan Rodden (2001). They show that globalization have had a different impact on political and fiscal decentralization. The authors thus contrast the likely effects of globalization on political and fiscal authority. Globalization, they argue, "may strengthen the credibility of regional autonomy movements and put pressure on central governments to cede policy control to local officials. But it may also encourage regions that choose to stay within countries to push for fiscal arrangements that better mitigate market risk for citizens within their borders. It may be a combination of *political decentralization and fiscal centralization* that best achieves these objectives. It is somewhat surprising that these conjectures have not made it into the literature until now". Thus their recipe for sequencing and design is exactly opposite to that proposed by Olivier Blanchard and Andrei Shleifer's (2000) and the World Bank (1999) which combines fiscal decentralization with political centralization.

Though in light of the above a clear-cut statement regarding the strategy or sequencing of decentralization (in terms of fiscal first or political first) becomes difficult to highlight yet to touch the bottom line it can be said that political decentralization and fiscal decentralization are two separate dimensions and can exist independently in absence of the other. As Scottish devolution shows, for example, substantial political decentralization might take place without fiscal decentralization."

[Geoffrey Garrett and Jonathan Rodden (2001)] *and vice versa*.

The foregoing discussion implies that there is no "one size fits all" type answer to decentralization question. All systems will have to work out their own style of going about decentralization and restructuring of intergovernmental relations depending on the context and conditions peculiar to their own situation.

### C. The Question of Pace: Incremental or Big Bang

Another aspect related to policy design is the concern regarding the pace of the decentralization process. There are arguments favoring "incremental decentralization" as well as "big bang decentralization". Those who support slow, incremental or partial decentralization draw attention toward probable downside risks of decentralization. Most significant among all is the concern with decline in service delivery on account of 'capture by local elites' and low technical capabilities of local government. It is feared that (a) the possibility is always there that the locally elected officials will spend the money in their own interest rather than interest of their constituents and (b) what is gained in better information (as the argument goes in favour of decentralization) may be lost in lower technical competence/capacity and in lack of economies of scale. In addition to this the suggestion to keep the pace slow also come on the basis of deeply entrenched historical basis that centralization legacy creates to the disadvantage of ongoing process of decentralization. Thus Prud'Homme advises, "A century of centralization cannot (and should not) be overruled overnight.... (Decentralization) will remain on agenda for many years" ( Prud'Homme,2001) . Concerns with the risks associated with decentralization have in fact prompted some Latin American and Caribbean countries to favour slow, incremental and piecemeal decentralization. Programs geared to strengthening subnational government technical capacity have been implemented in every country in the region. Incremental approach has also taken the form of micro monitored earmarking (for instance, in Mexican approach to sector decentralization). Econometric results reported in a World bank Report [Shahid Javed Burki, Guillermo E. Perry, and William R. Dillinger, 1999] suggest that fast decentralization normally leads to higher overall public expenditures and serious problems in macroeconomic management.

On the other hand arguments such as bureaucratic resistance and interests and attitudes of powerful stakeholders (which could be seen as the outcome of centralization legacy) have been used to argue for exactly opposite approach to decentralization i.e. the big bang approach. The proponents of big bang approach draw attention towards the constraints imposed

by anti decentralization coalitions which, it is expressed, can only be overcome if a political breakthrough is made by large scale decentralization rather than by moderate decentralization. It is feared that policy reform of any sort will be confronted by vested interests such as central bureaucrats and local governments aiming to protect their privileges, which could install such a reform or call for a major setback (Rodrik 1996). Alternatively, different political groups that are affected by different policy reforms may form a coalition to halt these reforms altogether ( Wei, 1997). Taking such concerns as justifications, Motohiro Sato (2002) suggests, "In reality therefore, economic reform plan must be accompanied by proper tactics to overcome political oppositions from stakeholders within and outside of a central government". The author shows that how (against intuition) large scale decentralization may turn out to be more successful in forming a political majority of pro decentralization and thus overcoming the political constraint. It is pointed out that a small scale reform will always remain constrained by a coalition of rent seeker governments and thus a theoretical model is provided to prove the case for "big push" or "big bang" approach for decentralization.

Keeping in view the above arguments the bottom line statement one can arrive at is the assertion that pace (along with design, sequencing and proper mix) should be "optimal" because each approach has its own costs and benefits. Optimal pace is more than highly cautious approach of gradualism which fails to replace even the most inefficient institutions. It is on the other hand less enthusiastic than the shock therapy designed to replace the old institutions all at once. Thus it aims at the best of both worlds. The optimality however, must be ascertained on case by case basis in accordance with the specificities and peculiarities of the country in question. Peng Lian and Shang-Jin Wei (1998) study the economics and political economy of optimal scale of reforms. The authors argue that if agents in the economy are heterogeneous in terms of their subjective discount rates, the politically-determined reform speed may be lower in a democracy than in an economy with a benevolent dictator.

Prud'Homme(2001) observes that each country must find its own model that best fits its tradition, geography, economy, income level, social structure and political choices. Lessons in theory and study of international experience

can be useful for defining such a model for a particular country.

#### **(D) The Question of Optimum Degree: Centralization- Decentralization Continuum**

The impression that one gathers from the literature survey and analytical observation of the various cases in point is that one reason as to why decentralization in certain cases is producing unintended consequences is probably that policy makers, while being *driven by political pressures*, fail to diagnose as to what ails their polities and economies and thereby, ignore the prospects of grounding the program in deeper appreciation of applying and adjusting *principles* of federal organization to their county specific context.

Oates (1972) compares the alternatives of a *centralized and decentralized* government in terms of their ability to deliver the three tasks identified for the public sector by Musgrave (stabilization, redistribution and allocation). He argues that both the options of centralized and decentralized government have relative advantages and disadvantages, so the optimal system would be one that combines the strengths of both while avoiding their weaknesses: "a *federal organization* of government meets this need." (Oates 1972, chapter 1, p14).

In fact the idea of balancing the contrasting forces of centralization and decentralization is central to the concept of federalism. These two movements are at work in European Union. The notion of fiscal federalism as predominantly centralizing (unifying) force led to the emergence of an integrated European Union<sup>3</sup> in November 1993. The Maastricht Treaty of Nov. 1993 conferred important new powers on the European Parliament including co-decision making on legislation. This creation and evolution of a new top level of government in Europe in context of European Monetary Integration has significant spatial consequences in which national factors are gradually losing relevance with vanishing of old borders and redistribution of roles at nation and regional levels. The biggest riddle according to Inman and Rubinfeld (1992) is "the future of the national governments of the member states". However, on the other hand, the 'subsidiarity principle' was also formally adopted as a quasi-constitutional rule through Article 3b of the Maastricht-Treaty—which stipulates that the powers of EU institutions be limited to those functions that cannot be adequately performed by member states. More recently, while on the one hand the notion that monetary policy be centralized has gained acceptance among the Europeans, the idea to centralize fiscal policy in the European Union (EU) has generally been rejected. Thus there are contrasting forces

of centralization and decentralization at work.

All this has generated a lot of rethinking on implications of economic integration within European Union for the fiscal structure of EU specifically and on the concept of fiscal federalism more generally. The contradictions emerging from the working of contrasting forces, some leading toward greater centralization and others toward greater decentralization which are at the heart of fiscal federalism have become more pronounced than ever in the context of new global economic order. This phenomenon is not restricted to EU but is also to be seen in those countries which are moving toward market economy after failure of centralized planning, in context of 'globalization'.

The dilemma of balancing the contrasting forces of centralization and decentralization that is inherent to the very dynamics of federalism, is more pronounced in the developing and transition countries, the nations that are on one hand trying to stabilize their economies while on the other "... trying to invest more decision making power in populations that have long been disenfranchised" (Bahl, 1995) thus ideally trying to "combine the advantages of magnitude and littleness of nations" (Tocqueville, 1945) and in consequence getting confronted with the predicament of resolving the trade off between autonomy and efficiency signifying a movement toward decentralization and centralization respectively.

Most of the studies on the 'centralization versus decentralization issue' tilt heavily in favour of decentralization. The arguments to support this stand are quite familiar. It is acknowledged that decentralization, besides giving many other advantages may also avoid noted inefficiencies of centralized decision-making such as:

- (a) Central officials may often lack detailed information about local tastes (Hayek 1948).
- (b) Decision-making by a centralized legislature may permit a narrow majority of regions to expropriate the others, or generate norms of reciprocity that result in overspending (Besley and Coate 2000; Weingast 1979).
- (c) Central government's ability to insure regions against exogenous shocks, increasing welfare, will create moral hazard for the regions (Persson and Tabellini 1996).

More recent literature however, suggests that decentralization, unless carried out under the aegis of a reasonably strong centre, is doomed to fail. A weak center is prone to get manipulated by the strong coalitions and interest groups. There is overwhelming consensus that most of the problems associated with decentralization can be solved by central government intervention and regulatory powers entrusted in it (Cumberland 1981,

Gordon 1983, Rivlin 1992, Wildasin 1989). While comparing a case of strong centre with weak, Blanchard and Andrei Shleifer (2000), argue that fiscal decentralization has been successful in China because centre in China is strong enough to restrain destructive behavior of local interests and withstand unhealthy local demands. On the other hand the process in Russia is, at best, just wavering, all because of weak centre. They show in their study that decentralization in developing and transitional countries can lead to capture of local governments. In such cases the authors argue, strong administrative control of local by central authorities is important for efficient economic decentralization. Thus for decentralization to be successful one of the conditions (among others) is that it must be balanced with provision of a strong central government with ability and willingness to resist unhealthy demands from lower levels of the government. This argument endorse Riker's (1964) suggestion that centralization does matter for federalism to be effective. To move even earlier one can quote none else than de Tocqueville, he writes, "From my perspective, I cannot imagine a nation that could survive and especially prosper without strong government centralization." (Oeuvres Completes, Vol I, 1, p. 87). In 1836 after living for several months in Switzerland he wrote "I have developed such an utter disdain for the federal constitution of Switzerland, that I would unequivocally term it a league and not a federation. A government of that nature is certainly the weakest, the most impotent, the clumsiest and the least capable of leading its people anywhere except to anarchy that one could imagine. I am also struck by the lack of any *vie politique* in its population. The Kingdom of England is a hundred times more republican than this republic." (Oeuvres Completes, Vol. XV, 1, p. 70-71).

Various studies show that fiscal decentralization may lead to allocative inefficiencies, as well as poor accountability and governance, if expenditures and revenue mobilization functions are not *properly assigned* across the different levels of the government (Hommes, 1995; World Bank, 1999 and Fukasaku and demello, 1999). Hommes (1995) sees decentralization as "essentially a political problem" representing, in Latin America for example, a stark departure from centuries of centralism. The success of decentralization may depend upon

the existence at the local level of a civic cultural tradition—informal civic institutions, such as solidarity, cooperatives, etc. With a lack of local governmental experience and riddled with patronage, local governments in Latin America tend to be captive of the elites and political barons. Thus, for Hommes, an irony of fiscal decentralization may be the need for more central government controls to protect against this danger. Hommes notes that the seeming paradox of decentralization is that it demands of the central government more ‘sophisticated political control’. Ultimately, however, effective decentralization requires the relinquishing of some central control. In fact the governance literature can help in exploring the kind of ‘sophisticated control’ that is being considered more relevant than ever in the current scenario.

This new role of the Center will not be identical to the older one where central government played strong-control and commanding role. As governments restructure, role of centre should be that of “stewardship”. Peter Block argues that principles of stewardship bring a new understanding of accountability to each act of governance. (Peter Block 1993, p. 27). In this concept, which is quite popular in literature of management and organization in United States, trust and service and accountability are emphasized. Central level of government will perform tasks such as “oversight and technical assistance to subnational governments, macroeconomic coordination, social safety nets, skill enhancement for international competitiveness, social and environmental policy through international agreements” (Shah, 2004). The task ahead to ensure this is to strengthen national level institutions. A real test of the strength of the institution is the ability to successfully meld two goals: central authority and subcentral or decentralized engagement and empowerment to ensure good democratic governance.

The foregoing discussion demonstrates that decentralization shall not be considered as an alternative to centralization. Both are needed. “The complementary roles of national and subnational actors should be determined by analyzing the most effective ways and means of achieving a desired objective. For example, a national road system should be designed with both local input and national coordination. Foreign policy should be a national function based on the views of the citizenry. Solid waste management should primarily be dealt with through local mechanisms. And so forth. In designing a decentralization strategy it is imperative that such an analysis be done.” (UNDP, 1998). The new literature on political economy of fiscal federalism, goes far beyond the earlier issues of centralization and decentralization. Now the case is for the center to assume sophisticated styles of remaining ‘in

charge’ (stewardship/ leadership) and constructing such support structures, processes and national institutions which create enabling environment<sup>4</sup> (in which subnational autonomy is tolerated and treasured), build local capacity and provide appropriate incentives for the subnational governments to behave responsibly while allowing center to perform its new role in changed political and economic conditions. The best design for decentralization, in the last analysis however, will vary according to circumstances and situations.

#### Conclusion:

The paper has argued that ‘designing decentralization’ is a very specific issue and is to be worked out differently in different contexts. In addition there are certain dimensions of the political economy of fiscal federalism<sup>5</sup> “in particular country-specific context” that must not be ignored. It is also clear that an improper attempt at fiscal decentralization in fact, could be a disaster-prone strategy while the “proper” distribution of tax authority and expenditure responsibility is an extremely complex issue. The problem in many cases according to Prud’homme is not what to decentralize (or whether a service should be provided by a central, regional or local government ) but, rather *how* to organize the joint production (shared rule) of the service by various levels (Prud’homme, 1995) The riddle can be solved only if a comprehensive view of the political economy of fiscal federalism is considered instead of a narrow approach to fiscal decentralization.

Since success of decentralization depends on its design, an overall improvement in the political, fiscal and administrative institutions of decentralization is a precondition before embarking on the path of decentralization. “But decentralization is often implemented haphazardly. Decision makers do not always fully control the pace and genesis of the decentralization process.” (WB1999). Thus what is required is that decentralization as it is understood and pursued in recent times must not be detached from broader and constantly expanding perspective on fiscal federalism, the intellectual lineage of which can only offer a framework for successful decentralization.

The conceptual framework of fiscal decentralization is well established in fiscal federalism literature, drawing largely on the contributions by Stigler, Samuelson, Musgrave, Oates, and Brennan and Buchanan the understanding of which is further expanding with the emerging second generation theory of fiscal federalism with important contributions from Inman and Rubinfelds , Weingast and others.. The central logic is that the core issues of growth and poverty (the justification offered for economic reforms across the globe after failure of the earlier paradigms) cannot be addressed without

addressing efficiency—‘supplying services up to the point at which, at the margin, the welfare benefit to society matches its cost’.

Though the conceptual framework of fiscal decentralization is well established in fiscal federalism literature yet there is no set of prescribed rules for fiscal decentralization. Roy Bhal, however on the basis of best practices in fiscal federalism delineates twelve rules for fiscal decentralization which are well grounded in the theory of fiscal federalism. These are: Roy Bahl’s XII Rules for Fiscal Decentralization: 1. Fiscal decentralization should be viewed as a comprehensive system. 2. Finance follows function. 3. There must be a strong central ability to monitor and evaluate decentralization 4. One intergovernmental system does not fit the urban and rural sector. 5. Fiscal decentralization requires significant local government taxing power. 6. Central government must keep the fiscal decentralization rules that it makes. 7.Keep it simple 8. The design of intergovernmental transfer system must match the objectives of decentralization reform. 9. Fiscal decentralization should consider all the three levels of government. 10. Impose a hard budget constraint. 11. Recognize that Intergovernmental systems are always in transition, plan for this. 12. There must be a champion for fiscal decentralization. (Meaning that one must defeat very strong centralization arguments.

Thus, to proceed with fiscal decentralization while detaching it from federal dimensions and political economy considerations inherent in fiscal federalism is no doubt dangerous. At this point it needs to be asserted that while bringing about fiscal decentralization in any country (whether unitary or federal, developing, transitional or industrialized); the principles of political economy of fiscal federalism should not be lost sight of. The term fiscal federalism according to Nieo Gromrindijk (2002 p1) “is often wrongfully associated with the theory of fiscal decentralization within federal states only”. It is applicable even to non federal states (having no formal federal constitutional/institutional arrangement) also in the sense that they encompass different levels of government which have de facto decision making authority. David King (1984) thus highlights that the *ideas of fiscal federalism are applicable to a range of structures of government, including unitary states*. While drawing attention to this aspect Jamie Boex (2001) stresses that

“fiscal decentralization is relevant to all countries, regardless whether they are unitary countries, federal countries or confederations”. Though the manner in which the principle will be applied will differ in each case as the unitary and federal governments provide different opportunities for fiscal decentralization due to divergence in their respective political and legislative context. However, it must be reasserted that to regain the dynamic stability inherent in fiscal federalism, there is a need to “put federal back into fiscal federalism” (Michael Keen, 1998) which is notable in decentralization literature only by its absence and which has been identified as one cause behind ‘decentralization failure’. It must be added here that “adherence to the principles of federalism or getting the rules of the game right is a necessary but not a sufficient condition for success of decentralized decision making. Complementary formal and informal institutions are needed to ensure that all players in the game adhere to agreed upon set of ground rules and deviant behavior is properly dealt with. This will need:

- Institutions and Processes of Intergovernmental Coordination.
- Institutional Arrangements for Fiscal Relations
- Institutions of Accountability.” (Shah, 2004 p 31-34)

#### End Notes:

1. As William Dillinger and Stewen B. Webb (1999) put it, “it is difficult to imagine what the restoration of democracy would have been like without substantial political decentralization—federalism—and some concomitant form of fiscal decentralization”. Dillinger, William and Stewen B. Webb (1999) *Fiscal Management in Federal democracies: Argentina and Brazil*, World Bank Working paper No : 2121 (Washington May 1999).

2. Importance of accountability lies in the fact that it clearly demarcates who is responsible for what. But accountability is not enough. Those who are accountable must also have the authority to deliver results. This means not merely the legal authority to make decisions, but also the financial (and human) resources to carry them out. This in fact is the common theme that runs through the six chapters of the World Bank study entitled *Beyond the Center: Decentralizing the State* by Burki Shahid Javed, Guillermo E. Perry, and William R. Dillinger. (1999).

3. The European Economic Community came into existence in 1957 and was the result of a sustained effort to create a sense of common European purpose. The first six Member States were Belgium, France, Germany, Italy, Luxembourg and the Netherlands. Other Member States subsequently. The European Union was established in November, 1993 on the entry into force of the Treaty on the European Union (The Maastricht Treaty).

This Treaty conferred important new powers on the European Parliament including co-decision making on legislation.

4. ‘Enabling environment’ means institutions of citizen participation and accountability. Anwar Shah adds the notion of – “authorizing environment” which in his words, “represents the institutional mechanisms to translate constitutional mission to concrete objectives and actions. These include societal norms, formal and informal rules, procedures and organizations dealing with participation, consultation, policy making and accountability. Legislative coordination and oversight bodies are important elements of authorizing environment. These institutions ensure that public sector is solely focused on citizen aspirations.” (Shah, 2004, p6).

5. The political economy of a fiscal federation in which spending is decentralized and taxation is not (as in the Scottish case) is very different from one in which taxation is decentralized as well (as in the US). Further political economy of fiscal federalism in a developing country attempting to decentralize is different from a developed country on account of the unintended consequences that relatively less developed institutions of accountability, governance and capacity in developing countries might have on decentralization policies

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