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The Seven Traps of Decentralization Policy

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Abstract. Since Mid 1980s, a number of governments in developing countries initialized an ambitious decentralization policy and other policies to strengthen local governments. Nevertheless, after more or less 25 years of their implementations, the initial enthusiasm decreases. The experience in some countries shows that reform policy can trigger many new political, fiscal, and administration problems.The article shortly describes seven major problems and potential traps lurking in decentralization policy, consisting: policy trap, coordination trap, fiscal trap, debt trap, capturing trap, inequality trap, and capacity trap. The evidence presented in this article has shown that decentralization can be part of a strategy to improve the capability and effectiveness of the state. It encompasses mechanisms that increase openness and transparency, strengthen incentives forparticipation in public affairs, and where appropriate, bring government closer to the people and to the communities it is meant to serve.

Keywords: *decentralization, reform, public policy*

Since the mid-1980s, a great number of governments in developing countries have embarked on ambitious decentralization policies and policies for strengthening local government. As an essential part of public sector modernization, initial expectations were high: decentralization and strengthening local governments was intended to bring about a variety of improvements, particularly in terms of political integration and participation, and the provision of public services (Pollitt, 2005).

However, after some 25 years of implementing decentralization policies, initial enthusiasm has waned. In many cases, decentralization that occurred did not result from a carefully designed sequence of reforms, but occurred in politically volatile environments where levels of trust were low and policymakers responded largely ad-hoc and unsystematically to the emerging demands from citizens, local interest groups and donors (cf. Smoke et al. 2006).

While decentralization has, indeed, brought about a variety of improvements around the world, most prominently in primary and secondary education (Hansen, 1997; Faguet and Sánchez, 2008), the overall outcome of decentralization appears to be mixed. Experience in some countries suggests that reform policies can lead to a variety of new political, fiscal and administrative problems.This article will briefly examine *seven major problems* and *potential traps* lurking in decentralization policy.

At this point it would be appropriate to stress, even at the risk of some repetition, that decentralization, despite a wide range of technical issues and tools, is essentially part of a highly, and sometimes volatile, political process. Decentralization embraces a variety of stakeholders, primarily within the public sector, and is aimed at recomposing and rebalancing the interests between these actors and ultimately their relationships with their citizens. In practice, rebalancing interests means bargaining that will eventually redefine command over public resources, both in revenues and expenditures (cf. Treisman, 1999; Eaton et al, 2010).

With respect toany government defining its decentralization policy, it is of intrinsic importance to know and critically analyzewho wants what and why in this environment. It is particularly important to be aware of the critical role played by certain stakeholders who are in a position to influence reforms throughout the implementation process. Unfortunately, this also holds for assessing different interests within the government itself (Tidemand, 2010). While a Ministry of Municipal Affairs, social policy think tanks, and municipal associations may be strong supporters of decentralization, other bodies may have the authority to blockor delay reform. Finance ministries, for example, are predominantly concerned with controlling overall public finance (and rightly so), thus contributing to fiscal health and macroeconomic stability. Consequently, allowing for new revenue and expenditure authorities at subnational level may be perceived as jeopardizing this very function. Sector ministries, such as in education, health and transport, may not wish to share their power and resources with subnational entities they regard incapable of executing public tasks.

In some cases, governments in developing countries have simply been interested in providing new options

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for political participation and integration instead of critically and financially evaluating the different options for improving public service delivery. In other cases, governments promised the creation of new territorial units providing internal 'autonomy' but became trapped in endless political battles with and among local interest groups. Such a pattern seems clear in Ecuador in the late 1990s, for example(Frank, 2007).

From this perspective, policy makers should be aware of political uncertainties and be prepared to provide a policy framework that is gradual in nature, which has been (i) thoroughly discussed with key stakeholders, and (ii) focuses on a medium-term strategy of implementation, including cost estimates. "Bush fire innovations" in decentralization may be politically rewarding for some – and for some time – but are fiscally or administratively unsustainable in the long term.

Most decentralization policies are accompanied by some delicate uncertainty about who does what in a more decentralized environment, i.e. which level of government carries out what function, for what share of public resources, and how such delegation of functions should take place over time.This may lead to endless political debates and a stand still for quite some time (cf. Smoke, 2003; Bahland Martinez-Vazquez, 2006).

Again, we may wish to better understand the rivalry and the political economy of such reforms. While local government son the one hand may try to push hard for a higher share of public resources, they are not necessarily interested in assuming more functions.Moreover, they may not be interested in thorough public sector reform initiatives within their respective jurisdictions either. On the other hand, regional or local representations of sector ministries may not be willing to lose their influence, share resources, and coordinate policies and investments with the local administrations (cf. Fuhr, 1994; Eaton et al, 2010).

Experience suggests that successful decentralization may be short-lived or difficult to replicate unless effective rules for intergovernmental collaboration are put into place. Macroeconomic management, for example, is still a core function of central government. In education, higher levels of government may be needed to prevent fragmentation and to minimize differences in the quality of education in different communities (Welsh and McGill, 1999). In the health sector, the appropriate allocation of responsibilities across levels of government is rarely clear-cut. Improving immunization programs, tuberculosis surveillance and vaccine storage all requirestrong effective management athigher levels of government. In addition, localities may not provide the right framework for policy formulation and implementation (Berman and Bossert, 2000).

Consequently, the impetus should not be to rigidly push functions down to communities and municipalities, artificially separating levels of government, but finding the right balance between the roles of different governmental levels to ensure that high-quality services are provided in a timely and cost-effectivemanner.

The overall objective of decentralization is to delegate functions to the level of government that can most effectively administer them, and to provide the necessary financial resources, usually in a combination of transfers, revenue-sharing and matching grants mechanisms with the central government, together witha set of authorities to raise revenues locally (Ferrazzi and Rohdewohld, 2009). Part of this debate islinked to the European discussion on'subsidiarity' - a normative concept in which the lowest level of government is selected to perform services, unless a higher level can demonstrate doing so more efficiently or more effectively.

Since the decentralization process results in an increase inthe number of actors and budgetary accounts, the countries embarking on decentralization that are already facing budgetary and inflationary pressures are confronted with additional challenges and risks.

Intergovernmental fiscal relations mainly affect the macroeconomic conditions through three major channels: the assignment and sharing of tax bases and expenditures; the matching of tax and expenditure decisions; and the regulation of sub national borrowing levels. Each channel provides a specific set of incentives for government decision makers (Boadway and Shah, 2009).

Serious macroeconomic imbalances can occur if major tax bases are inappropriately assigned. For example, in India during the 1990s important tax bases were assigned to subnational governments, while the central government with its growing public debt and pension liabilities, had but a small and inefficient tax base consisting mainly of income, foreign trade, and excise taxes. The sharing of major tax bases also has the potential to reduce the magnitude of deficit reduction at the central government level. This happened in Argentina in the early 1990s when tax reform led to increased tax revenues that had to be shared with provincial governments. The provincial governments essentially took a free ride on the tax-raising efforts of the central government and used the extra revenue to expand their civil service. The overall result was rapid subnational expenditure expansion that contributed significantly to Argentina's economic and fiscal crisis in the early 2000s (Dillinger and Webb, 1999a).

Expenditures with national benefits and costs – national public goods – are typically the responsibility of the central government. These include the costs of economic stabilization and redistribution. But some local expenditures may affect income distribution, such as residential zoning regulations and the provision of health and housing subsidies in developing countries. Since the benefits of local public expenditures tend to be concentrated in the jurisdiction of subnational government andthe costs are spread across the nation, subnational governments have a greaterincentive to spend beyond their means and to shift the financing costs to other governments.

In many countries (particularly in Latin America) democratization has resulted in an increase in the amount of resources under subnational control and the degree of local autonomy in their use, such that local governments in Latin America today often account for almost half of total public spending. Although decentralization has shifted resources downward, there has been no corresponding clarification and expansion of local responsibilities - for example, Colombia in the 1990s (Echavarría et al, 2002). Subnational governments were often not willing to assume new tasks and were not required to perform specific functions, nor were they prohibited from performing functions already performed by other levels of government. As a result, local governments used much of their wind fall to increase staff levels and launch questionable new infrastructure projects (Dillinger and Webb, 1999b).

Thus, as a means of achieving its objectives, fiscal decentralization must be accompanied by a corresponding decentralization of expenditure responsibilities, the institutional capacities of state and municipal governmentsneed to be improved, and the federal government must impose hard budget constraintson its fiscal and financial relationships with sub national governments.

Borrowing by local governments can contribute to macroeconomic instability when the central government fails to impose hard budget constraints and when there is a lack of effective mechanisms to monitor debt obligations, particularly when multiple lenders are involved (cf. Schwarcz, 2002).

There is also the problem of asymmetric information between borrowers (subnational governments) and lenders (central government and international capital markets). In China, for example, provincial governments were prohibited by law from running budget deficits and from financing them through borrowing. But in the early 1990s, all but uncontrolled borrowing by state enterprises at the subnational level (making deals with provincial governments) contributed to economic overheating, putting overall stability at risk. In the late 1990s, Brazilian stateshad accumulated a national debt exceeding US$100 billion, close to the levels of total federal and central bank debt. In 2009, subnational debt still accounted for some 30 percent of total public sector net debt in Brazil, and the debt of Indian states forsome 27 percent of GDP (Canuto and Liu, 2010).

Unless the growth of debt can be curtailed, the federal government will have to reduce its own spending, raise taxes, or resort to inflationary financing to cover subnational indebtedness.Therefore, since the early 2000s, 'fiscal responsibility pacts' between national and sub national governments have been enacted in many countries as a mechanism for monitoring and remedying accumulating fiscal and debt problems (Liu and Webb, 2011).

Economic and financial distortions may also arise from the ability of subnational governments to exploit weaknesses at the center. In the absence of agreed intergovernmental rules, local units may benefit from sources of income (rents) that have not been formally allocated to themunder an appropriate fiscal decentralization scheme.

During the 1990s, for example, the development of self-government at the local level in Poland saw many local authorities beginning to act like pressure groups, with a propensity to extract more benefits from the government for their local clienteles. As a consequence, inequalities have risen among jurisdictions, leading to new forms of social conflict (World Bank, 1992).

In Pakistan (during the late 1990s) decentralization was accompanied by the subtle politicization of intergovernmental relationships. Provincial governments, which have expanded their roles in the provision of education and other local public services since the 1960s, have increasingly adopted an intrusive, centralist behavior towards municipal governments. Instead of being encouraged to assume new tasks and responsibilities, municipal governments were being denied opportunities to succeed, while Pakistan's intermediate level of government were benefiting from a half way approach to decentralization (cf. Cheema et al, 2003).

A much more serious – and more general – problem is the lack of local accountability and the constraints to citizen participation. Local elites can capture the benefits of decentralization and easily use newly assigned revenue and expenditure authorities for their own purposes. Thus, the likelihood of corruption practices, biased spending, misallocation of resources, and collusion with suppliers increasing in quality and quantity is even higher (cf. for a more detailed reflection Bardhan and Mookherjee, 2002). The case of Aceh, Indonesia illustrates this point clearly. In 2006, local government in Aceh received revenues five times higher than before decentralization in 1999. Moreover, there was a massive inflow of other public resources including the US$ 8 billion tsunami reconstruction funds. Local government institutions, however, lacked the capacity to effectively manage and spend these resources. With little political competition, corruption became widespread. Government expenditure continued to neglect the rural poor and focused attention instead on urban centers, where resources were captured by politically well-connected elites (Barron and Clark, 2006).

National equality in living standards and access to public services is an over arching goal in many countries – at times, even a constitutional mandate, like in Germany. Centralization allows the national government greater discretion incountering regional income disparities by managing regional differences in levels of public service provision and taxation. Under decentralization, however, equal outcomes can no longer be guaranteed, or at least, may be difficult to achieve. And relatively powerful and wealthier local governments and regions may disproportionately benefit from being given greater taxing and spending powers.

In India, for example, per capita incomes in one of its richer states, Haryana, is almost five times greater compared to one of its poorer states, Bihar. In China, provincial disparities in per capita incomes have been steadily increasing in the last two decades. Per capita income (in 2010 PPP) in one of the richer provinces, Guangdong, is now four times greater than that in one of the poorest provinces, Guizhou. Most provinces on the eastern and southern coast, such as Hainan, Fujian, Jiangsu and Liaoning have done much better in terms of income growth than the western, interior provinces, largely because of their central location,good transportation and communication links,and their proximity to Hong Kong. These natural advantages have been reinforced by official policies that favor coastal provinces, including many tax incentives to foreign investors locating in the special economic zones near the coast, large allocations of credit (pro ratato population) through China's government-directed banking system, and registration requirements that actively discourage the poor from migrating to the booming cities on the coast.

European experiences indicate, however, that decentralization *per se* does not necessarily lead to higher (or lower) levels of income inequality. The impact of decentralization on the distribution of income may be largely determined by the internal structures of inequality within regions. Poor regions, therefore, may not always prefer centralization to decentralization and rich regions may not always opt for decentralization (Beramendi, 2003).

Decentralization policies often run into difficulties because the organizational and institutional capacities and performance at subnational levels are still too weak. Given historical circumstances, there is great need to upgrade human resources and financial management along with the quality of local service provision, as well aspromote the joint participation of citizens and the private sector in the formulation of adequate local development strategies. Without such improvements, it appears unlikely that local governments can assume their new responsibilities and new tasks effectively and efficiently (Wunsch, 2001; World Bank, 2005).

In the real world, however, decentralization policiescannot wait until such a process is completed. Instead, the delegation of functions needs to get started while capacity is still being developed 'on the run'.

In light ofthe previously mentioned pitfalls of decentralization, probably the most important objective in capacity developmentis to ensure that additional financial resources are managed soundly. This is partly, but not exclusively, a technical and training issue. In most cases, better fiscal management and transparency of local policy making has resulted not from financial management tools alone, but from upgrading citizen voice and choice options, and through better accountability (cf. contributions in Cheema and Rondinelli, 2007).

Similar to our arguments related to the capturing trap where public office is contested and people can participate and decide on representatives at different levels of government, the number of political choices citizens can make also increases, thus stimulating competition between governments. Local participation can also mean greater confidence in and acceptance of policy decisions by constituents. In many countries, citizen participation has played a crucial role in monitoring local government's performance, ensuring that governments do what they are supposed to do in a timely and cost-efficient manner (cf. Eckardt, 2009).

Clearly, besides investment in training and technical equipment, increased local participation has provided important incentives for decision makers to adopt innovative strategies in administration and management (Campbell and Fuhr, 2004).

In essence, for local capacity building strategies to achieve their objectives, the question of adverse incentive structures in the overall public sector needs to be tackled as well. For example, as long as top-down political bargaining yields good results, or "easy" finance is available to local governments, local decision makers may not be fully motivated to get into the (politically delicate) business of reforming their public institutions (Fuhr, 1994).

CONCLUSION

The evidence presented in this articlehas shown that decentralization can be part of a strategy to improve the capability and effectiveness of the state. It encompasses mechanisms that increase openness and transparency, strengthen incentives for participation in public affairs, and where appropriate, bring government closer to the people and to the communities it is meant to serve. Such reform, however, also carries some serious risks.

Upgrading public sector capabilities at all levels of government will take time and requires paying close attention to the potential dangers: there is a risk that efforts to open up government to a broader array of needs and interests will not improve effectiveness or accountability if they tend to shut out other groups further.

But the experience of governments the world over suggests some clear starting points: *First*, work to ensure broad-based public discussion and evaluation of key policy directions and priorities. This means making information available in the public interest and establishing consultative mechanisms such as advisory councils, deliberation councils, and citizen committees to gather the views and preferences of affected groups.

Second, encourage, where feasible, the direct participation of users and beneficiary groups in the design, implementation, and monitoring of local public goods and services. Enhance the capacity and efficiency of local organizations and institutions rather than replace them.

Third, where appropriate, adopt a carefully staged or sectoral approach to decentralization in priority areas. Introduce strong monitoring mechanisms and make sure that sound intergovernmental rules (and *vertical incentives*) are in place to restrain arbitrary action at central and local levels.

Fourth, at the local level, focus on the processes (and *horizontal incentives*) for building accountability and competition. Where local governments are weakly accountable and unresponsive, improving both horizontal and vertical accountability will be a vital first step to achieving higher state capability.

There are always some dangers inherent in a strategy of greater openness through decentralization. Creating more opportunities for voice and participation gives rise to an increase in the level of demands made on the state, which can in turn increase the risk of gridlock or capture by vocal interest groups. And if there are no clear-cut rules to impose restraints on different tiers of government and incentives to encourage local accountability, the crisis of governance that afflicts many centralized governments will simply be passed down to lower levels, and may increase political instability.

Such obstacles on the path to decentralization are not insurmountable. The first step towards decentralization is making the objectives of reform clearly intelligible to citizens and the business community. Such communication and consensus-building will reap a double benefit. Not only willthe support for reform increase, the government will be armed with a better sense of how to do it right.

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