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Notes on Different Forms of Decentralisation

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Task Force on Decentralization

- Decentralisation stands for a multitude of policy experiments. It is important to be clear what the major distinctions are and why they are relevant. In these notes, I lay out some of the basic issues and try to develop a simple map which allows us to put the experiences and proposals of particular countries into a common conceptual framework.

- An important first step in looking at any particular effort to decentralise is to put it into an appropriate intellectual map. This can allow experiences to be compared and lessons across time and space to be learned.

- In this discussion, I confine myself to *democratic* decentralisation. That is, we are in a framework in which elections are the principal mechanism of social choice in place in the society concerned. However, there are important examples (notably China) of non-democratic decentralisation.

- I will also devote most of my discussion to straightforwardly hierarchical systems which are easier to map. They give rise to a well-defined notion of decentralisation which is much harder to define outside that context.

- At the heart of any scheme of decentralisation is the transfer of power from a high to a lower tier of government. Here, tiers are to be understood hierarchically. At the top is the notion of a <u>national</u> government whose jurisdiction is bound by the limits of a well-defined nation state. Below that may be multiple tiers. The standard model is hierarchical:

For example,

<table>
<tr><td colspan="4">National</td></tr>
<tr><td colspan="2">Region A</td><td colspan="2">Region B</td></tr>
<tr><td>Municipality
A1</td><td>Municipality
A2</td><td>Municipality
B1</td><td>Municipality
B2</td></tr>
</table>

Figure 1.

- This is very stylised and some governmental structures may not be strictly hierarchical in this way. Clearly, at the beginning of any particular country study it would be useful to model the organisational chart to map the pattern of accountability and the resource flows that take place. In what follows, we will stick for the most part with the hierarchical model.

- In the hierarchical model, it is straightforward to define decentralisation as handing power to a lower tier of government. For practical purposes, this captures much of what we have in mind. Even in this hierarchical model, there are still many important distinctions. The following discussion centres mainly on the following issues:

    - Taxes versus spending authority: is the decentralisation in question on the tax or expenditure side? Even within these categories, which particular instruments are to be determined by lower tiers.

    - Nature of contracts: how do higher tiers of government retain the authority to affect lower tier resource allocation decisions directly or indirectly.

    - Nature of accountability to the beneficiaries of expenditures and/or tax payers. What are the processes by which authority is exercised in relation to both higher and lower tiers of government? Are lower tier governments directly accountable to their citizens?

    - Nature of the externalities between jurisdictions. Are the policies under consideration those that are likely to be subject to externalities between lower tiers of government? Are institutional mechanism being put in place to deal with this?

    - Nature of budget constraints faced: Are some tiers of government more likely to have harder budget constraints. What are the mechanisms in place to enforce budget constraints? Which tiers of government have access to capital markets?

(1) What is being decentralised?

- In the theoretical literature, decentralisation is often model as a wholesale devolution of taxing and/or spending authority. However, the reality is often a complex patchwork of authority for particular spending and taxing decisions. Even with a category, such as education, authority for designing the curriculum may be decentralised while school budgets are determined centrally.

- Many decentralisation experiences involve devolution of expenditure decisions while retaining tax authority (and budgeting authority more broadly) at a higher tier.

- Decentralising tax authority can result in changes in the mix of taxation and the overall level. This could differ from centralised provision in part because of different weights put by government on different tax payers. However, tax decisions could also change the efficiency of tax raising if compliance costs differ or there is better information at more local levels.

- Policy externalities in taxation or expenditure may be very different at different tiers of government. For example, decentralisation of capital tax decisions can lead to more intensive tax competition.

- Decentralising expenditure decisions may also reflect distributional weighting on beneficiaries of efficiency enhancement due to better information.

- Expenditure Decentralisation is on the whole more common than tax decentralisation. Some public finance economists have christened this the "fiscal" gap in federal systems. An important issue is whether decentralisation is increasing the size of this fiscal gap, and if so, whether this matters.

(2) Contracts between tiers of government

- In practical situations, it is likely to be very important to map the incentive structures in place when a decentralisation takes place. It is important not to take these as given as mechanisms of information provision and control will change over time.

- Decentralisation is purely nominal if the central authority could write a complete contract controlling the lower tier of government. This could be an especially important issue when only expenditure authority is decentralised.

- Decentralisation of spending power may come with centrally laid down constraints on spending patterns. It is important to understand how these constraints are enforced by higher tiers of government.

- Contracts could be limited by informational issues if lower tiers of government have information that it is hard for higher tier authorities to elicit. Thus, even if lower tiers of government have nominal control, it may still rely on higher tiers for information or expertise.

- Contract incompleteness is also important if contracts are subject to renegotiation *ex post*. This is particularly important where decentralisation involves long run investment decisions where there is some kind of commitment to sequences of payments. From the property rights literature, we know that in such circumstances, patterns of residual ownership rights can affect incentives in important ways. Thus, a key aspect of mapping decentralisation, may be to determine the structure of property rights between tiers of government.

(2) Accountability to Citizens

- For any given decision to grant authority to a lower tier of government there can be very different degrees of accountability.

- The most straightforward case (although not seen in practice) would be the creation of single issue, lower tier authorities accountable to taxpayers and/or expenditure beneficiaries.

- If decentralisation is to multi-issue authorities at lower tiers, then there is a question of whether the issues that are decentralised are salient relative to other decisions being determined.

- Even if there is democratic accountability, this will only work well if there is real political competition with appropriate incentives to seek out the preferred outcomes for the citizens. Thus, key to the accountability issue is the role of elites and special interests in affecting the decentralisation process. Of course, these influences are also germane to more centralised forms of policy making. The key issue is whether these have more or less influence over policy under decentralised conditions.

- There is also the issue of the methods of information generation available at the local level. Is there an active and independent press? Are there think-tanks and other methods of scrutinising policy? This may be endogenous and appropriate incentives for creating information may be a necessary part of changing the structure of government.

(3) Externalities

- A key difference between policy making at lower and higher tiers of government is the scope for externalities in policy making. The fiscal federalism literature has seen this as the main basis for favoring more centralised government. In spite of their centrality to theoretical debates about decentralisation, we know very little about them (empirically).

- One set of arguments focus on the scope for a "race to the bottom" where there is mobility across jurisdictions of relevant goods and factors. Clearly, a key issue in assessing any particular decentralisation is to discern whether this is likely to be an issue.

- There may be important interactions between externalities (due to mobility) and accountability mechanisms. Local tax setting can increase accountability due to exit while reducing the power of the voice mechanism.

- In terms of the design of decentralisation, a key issue is whether explicit mechanisms are in place to limit externalities. These could be explicit rules laid down by the centre that limit the scope of policy making (for example minimum tax rates). However, they could be explicit bargaining institutions that bring policy makers from different lower tier institutions together.

(4) Budget Constraints

- The nature of budget constraint imposed on lower tier authorities will be an important feature in mapping the institutional design. In some countries access to capital markets is restricted to higher tiers of government and in others lower tier governments are allowed direct access.

- In a world of perfect capital markets, this should create no special issues. However, issues may arise if more central tier governments cannot commit not to honour the debt of lower tier authorities. The possibility of bailouts can then becomes a key part of the incentives that arise under more decentralised decision-making.

- These kinds of bailouts appear to often have been at the centre of IMF concerns that decentralisation leads to greater fiscal indiscipline. This suggests that it is important to assess the nature of commitment possibilities at central levels of government.

- One key institutional feature of the economy may then become the availability of institutions to appraise the debt of particular government authorities.

Summary

- These notes have suggested a possible way of trying to map decentralisation experiences. By building such a map, we might hope to build a collective body of knowledge which transcends the specifics of country experiences and can be useful as a template for advice.

- The notes are incomplete and highly speculative. Two particularly important issues are how we think about the issues when systems of governance are not strictly hierarchical. Can we define decentralisation in any meaningful way for these cases? How do we think about accountability structures in non-democratic settings?

- If our task force is to be successful, it has to provide some kind of distilled wisdom on the topic that is broad enough to be portable, but specific enough not to be platitudinous. Clearly, this is going to be tough!