

# Decentralization and Development



Top-rate hospital construction site in Ha Nam, Vietnam



Provincial government complex designed by a Japanese architect, Ba Ria-Vung Tau Province, Vietnam

**Policy Formulation in Developing Countries**

GRIPS Development Forum

# Types of Decentralization

(Source: World Bank Decentralization Thematic Team)

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- 1. Political decentralization**—giving citizens or their representatives more power in public decision-making.
- 2. Administrative decentralization**—transfer of **responsibility** for planning, financing & management of public functions from center to regions.
- 3. Fiscal decentralization**—ensuring sufficient **revenue** to regions through self-financing, cost recovery, co-financing, expanded revenue base, fiscal transfer, etc.
- 4. Market decentralization**—letting the private sector take charge through privatization and/or deregulation

**“An appropriate balance of centralization and decentralization is essential to the effective and efficient functioning of government. Not all functions can or should be financed and managed in a decentralized fashion.”**

# Merits & Demerits of Decentralization (Administrative & Fiscal)

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## **Merits**

- ❑ Promote local ownership, creativity, experimentation and autonomy. Increase policy sensitivity to local needs.
- ❑ Replace slow and rigid central planning and execution.
- ❑ Leave central authority with national policies while leaving routine plans and implementation to locals.

## **Demerits**

- ❑ Lack of local administrative and technical capacity or budget leads to ineffective planning and service delivery.
- ❑ Nationwide quality and standards are not enforced (for programs that require equality and uniformity).
- ❑ Loss of scale merit and difficulty in multi-region projects
- ❑ Non-developmental mindset and corruption may multiply - though this can occur at central level too.

# Federalism

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- ❑ **Federalism** is a political system in which center and regions have equal status. Center is more powerful in a **unitary state**; regions are stronger in **confederalism**.
- ❑ Federalism originated in USA (constitution, 1789). The purpose was to strengthen central government. But today, federalism usually intends to weaken the central grip and give more autonomy to regions.
- ❑ Federalist states include USA, Australia, Switzerland, Canada, Germany, India, Brazil, South Africa, Ethiopia, Russia, Belgium, EU (federal union)...
- ❑ In India, for example, powers are allocated as follows:
  - **Union**--defense, foreign affairs, banking, telecom, currency
  - **States**--police, trade, commerce, agriculture, irrigation
  - **Concurrent** (joint responsibility)--education, forest, trade unions, marriage, manufacturing, industrial zones

# Fiscal Federalism (FF)

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- ❑ FF is a research topic in public economics asking how various revenue and expenditure items should be allocated between center and regions.
- ❑ The question is relevant not just for federal states but also for unitary and confederate states.
- ❑ Key concepts:
  - **Transfer** (grants) from center to regions—conditional or unconditional
  - **Fiscal imbalance (FI)**—a situation where funds are not enough to execute designated regional expenditures
  - **Horizontal FI**—regions have surpluses or deficits; this should be corrected by equalizing transfer from center.
  - **Vertical FI**—in this case, revenues need to be reassigned, or central transfer should be made to cover deficits.

# Development Policy:

## What Should Be Decentralized?

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Obviously central—monetary and exchange rate policy, financial regulation, very large infrastructure

Obviously local—feeder roads, local irrigation, small power generation and other local infrastructure, community/village projects

### **Others require both central attention and regional care & differentiation:**

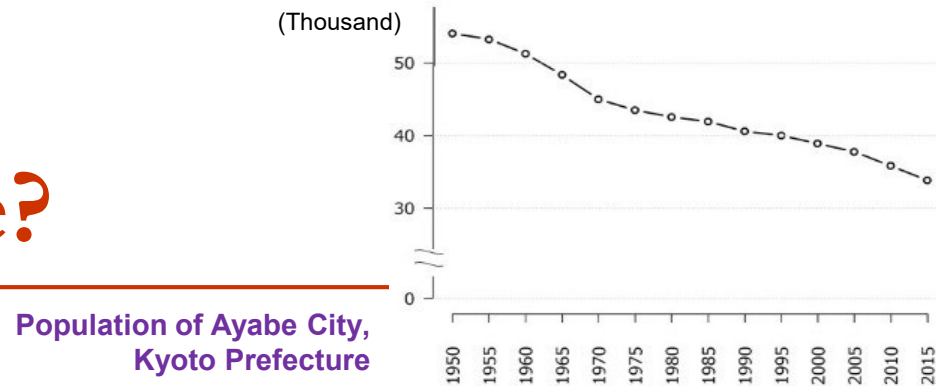
Health, primary & secondary education, universities, TVET, FDI, ODA, SMEs, agriculture, forestry, fishery, industrial sectoral policies, industrial zones, labor market and regulation, safety and environment standards, wholesale and retail trade, taxes, bond issue, transport infrastructure and services, power, telecom...

# Checklist for Decentralization

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1. Choice of federalism, unitary state or confederalism for each country.
2. Is local capacity sufficient to handle responsibilities?
3. How are expenditure (responsibilities) and revenue allocated, vertically and across regions? Are the formulas considered rational and fair?
4. Is there Fiscal Imbalance (revenue < expenditure) that enhances local dependency on the center?
5. How should we redress the imbalance between competent & rich regions and weak & poor regions?
6. Is there any wrong incentive for key players to engage in over-competition, over-building, skewed priorities, etc.? Or not to make effort to develop the region and generate more revenue?

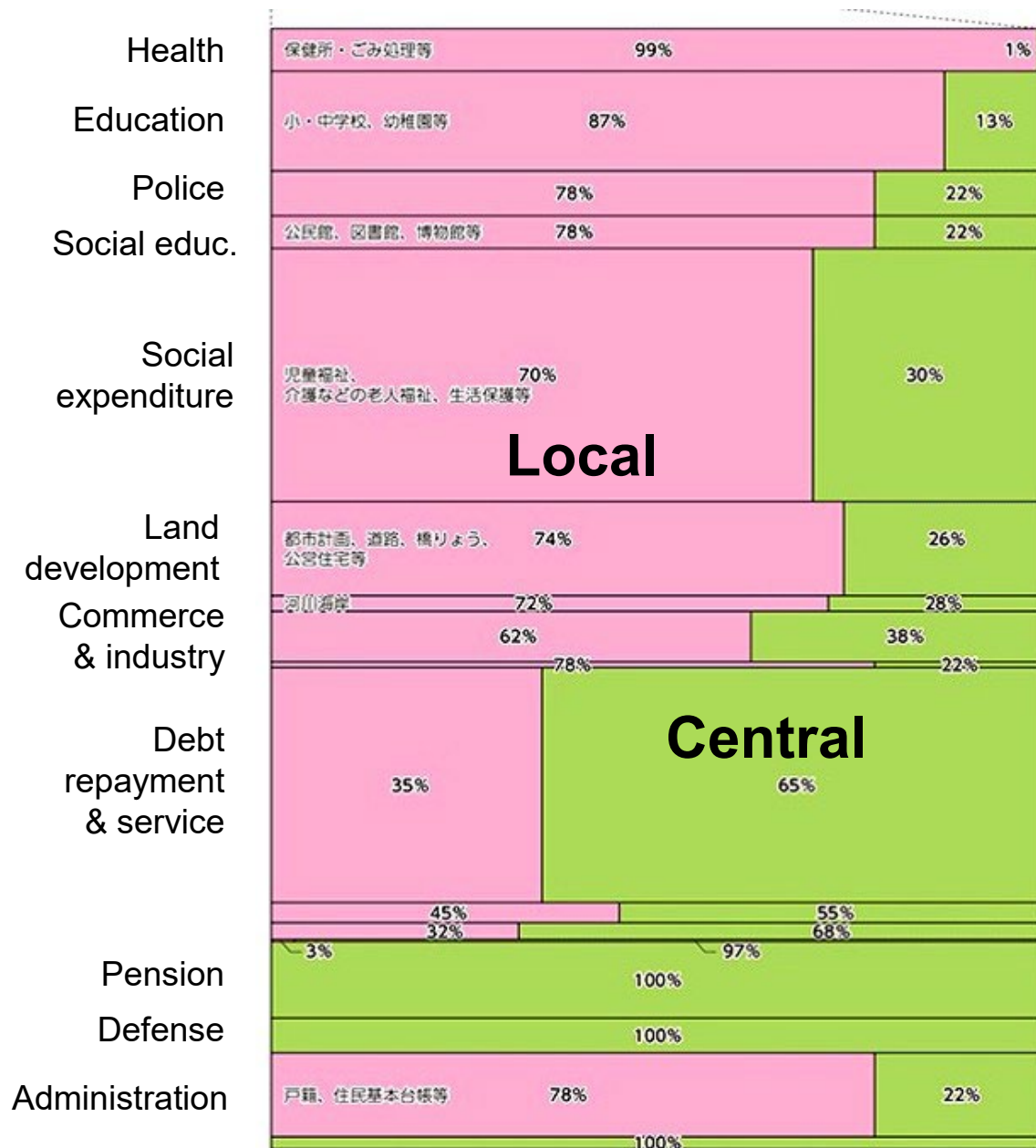
# Japan: Local Renaissance?



- ❑ Local economies suffer from aging, migration to cities, population decline, job loss and weak economy.
- ❑ In public finance, local expenditure share is >50% of total but revenue share is <50%. Thus, local budgets are structurally in deficit.
- ❑ Prefectures, cities, towns and villages heavily depend on central budget transfer. Transfer is calculated to cover revenue shortage. Local governments are subordinated to Tokyo and have to lobby to get more transfers.
- ❑ All prefectures (except Tokyo) receive central transfers. Some cities & towns do not need them if they receive special transfers & income from nuclear power plants, military bases, large industries & infrastructure, etc.



# Japan: Expenditure Shares - Local vs. Central (FY2018)



## Overall share

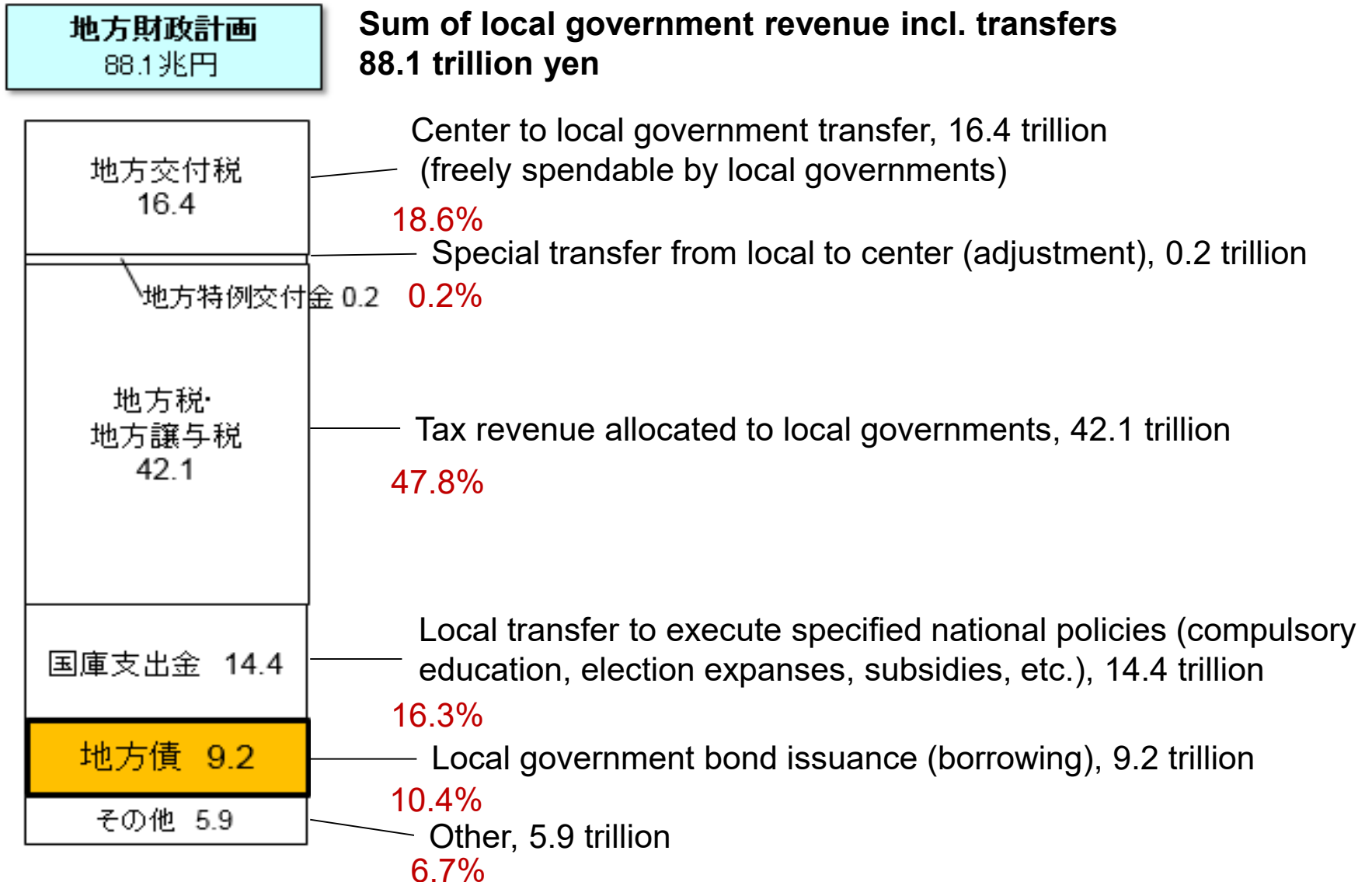
**Local 57.5% vs. Central 42.5%**

Japan needs re-assignment of local & central revenues so local governments do not have to rely on central transfers (adjusting shares of personal income tax, corporate income tax, consumption tax, excise tax, etc.)

Such reform was tried in 2002 but did not succeed.

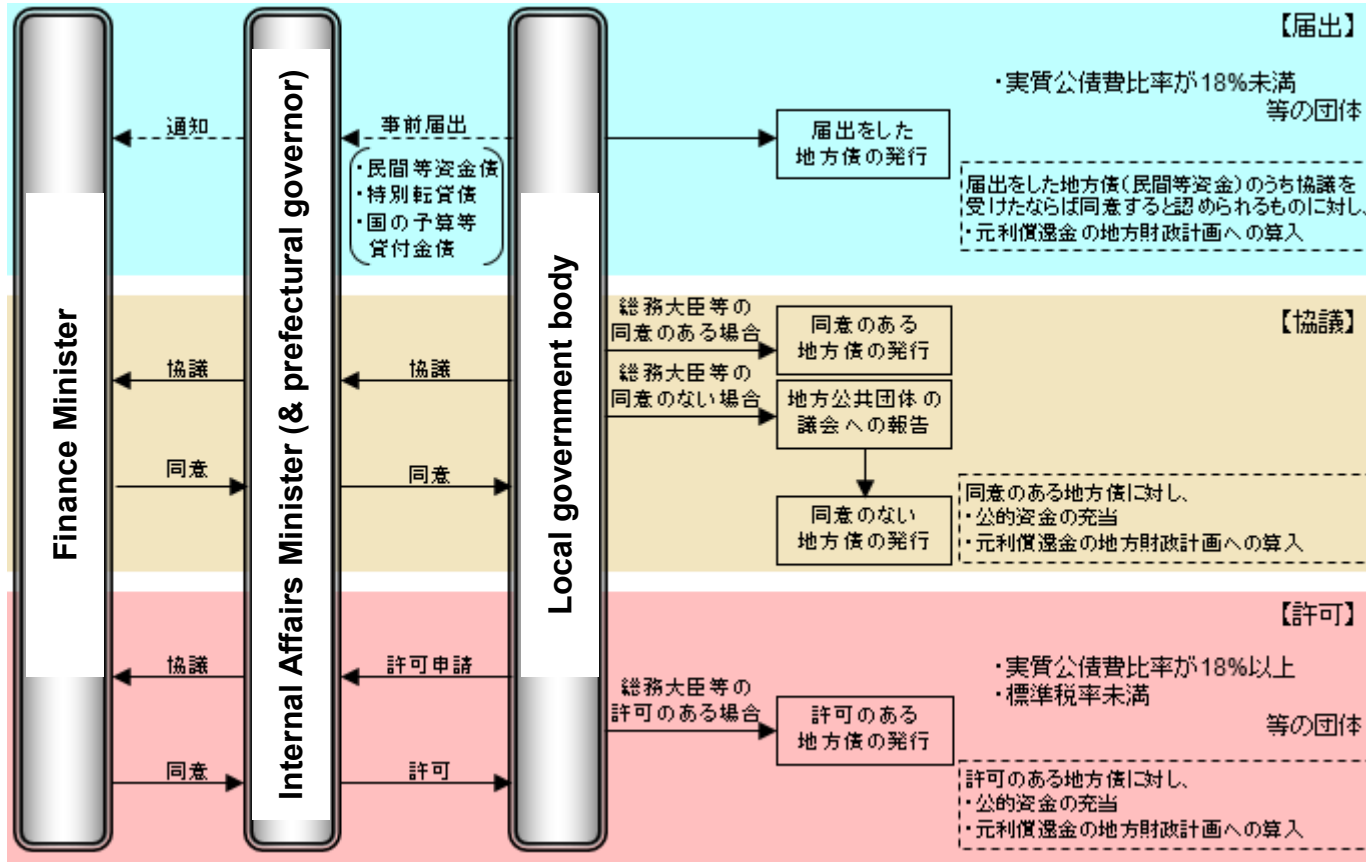
Source: Ministry of Internal Affairs & Communications, *White Paper on Local Finance* (2020)

# Japan: Local Government Revenue Structure (FY2018 initial budget)



# Japan: Local Government Bond Issue: Three Types

Depending on the degree of fiscal soundness, local government bodies are required to (i) simply report, (ii) negotiate with center, or (iii) get approval from center, when they issue local government bonds.



## Report only

Body with real public debt ratio of less than 18%, etc.

## Negotiation with central government (and prefectural governor) required

## Approval of central government (and prefectural governor) required

Body with real public debt ratio of 18% or more, etc.

# Vietnam: Vertical Grip

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- ❑ Central power is generally strong, with instructions coming down quickly to local levels (Hanoi – provinces – districts – communes). Budgets must be approved by the center. Reports go up to Hanoi.
- ❑ Local administration is a copy of central ministries.
- ❑ Quality of local service delivery – primary education, health, police, etc. – is reasonable, although corruption and nepotism are rampant (both center & local).
- ❑ Proactive cities & provinces do not like Hanoi's control.
- ❑ Planning is centrally regulated. Timing, budgeting, type of policy documents, and even the chapters & content of each master plan are specified by central authorities. All master plans look the same. There is little room for local adaptation, experimentation or innovation.

# Vietnam:

## Decentralized FDI & ODA



- ❑ FDI, ODA and industrial zone policies are devolved to cities and provinces (except large or special ones) unlike the centralized approach of Malaysia & Thailand.
- ❑ 5 cities & 58 provinces compete for FDI & ODA; too many local investment seminars & overseas missions.
- ❑ The Provincial Competitiveness Index is annually published by Vietnam Chamber of Com & Ind/USAID.
- ❑ About 300 industrial zones exist with various status (plan – construction – partially occupied – full). Each province has several IZs. But only those with good location and services attract high-quality FDI.
- ❑ Land and environmental policies are often different across provinces (eg. factory subleasing; permission for dyeing, plating & painting operations).

# Ethiopia:

## Federalism for Political Stability?

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- ❑ The regime which took power in 1991 was led by Tigray Region (north). Federalism was adopted for balance among four major regions.
- ❑ Cabinet members and other political appointees were chosen carefully to represent all regions.
- ❑ Federal-to-region block grant transfers (40% of total federal expenditure), financed by domestic sources and ODA, were allocated to regions based on population and economic formula. Four major regions received similar amounts per capita. Smaller regions received more.
- ❑ Regional uprisings against central authority ushered in a new government in 2018. However, regional conflicts continued. PM Abiy started an internal war (“security operation”) against Tigray Region in 2020. Ethnic and regional balance was destroyed.



### PM Meles (1991-2012)



Former rebel leader from Tigray. A strong control over citizens and opposition under federalism. Introducing East Asia's developmental model.

### PM Abiy (2018-)



From Oromia (largest population). Peace with Eritrea; Nobel peace prize; state enterprise reform; introducing competition. Starts military operation against Tigray.

## Ethiopia: Federal-to-Region Block Grant Transfers in Meles years

Source: Ministry of Finance & Economic Development.

Regions/cities	2008/09 (\$ million)	Population (million)	Per capita transfer (\$)
Capital			
Addis Ababa	–	2.74	–
Major regions			
Oromiya	531.9	27.16	19.6
Amhara	395.1	17.21	23.0
SNNP	315.2	15.04	21.0
Tigray	105.9	4.32	24.5
Other regions			
Somali	110.2	4.44	24.8
Afar	47.7	1.41	33.8
Benshangul/Gumuz	25.6	0.67	38.2
Dire Dawa	19.2	0.34	56.5
Gambella	16.9	0.31	54.5
Harari	12.9	0.18	71.7
<b>TOTAL</b>	<b>1580.6</b>	<b>73.82</b>	<b>21.4</b>

# India: Democratic but Economically Ineffective?

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- ❑ The Indian constitution designates manufacturing as “concurrent” (joint responsibility for center and state). Industrial policy encounters bureaucracy and delays.
- ❑ A large gap in economic performance exists between proactive states (Gujarat, Tamil Nadu, Andhra Pradesh, etc.) and not-so-active states.
- ❑ Industrial policy remains primitive by Asian standards: mainly deregulation & creation of industrial estates, with little creation of domestic value, competitive HR or champion firms; kaizen is purely private effort.
- ❑ Japan’s major industrial cooperation project, Delhi-Mumbai Industrial Corridor, faces inconsistencies and delay. Land acquisition is extremely difficult in India.



# Indonesia: Too Decentralized?

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- ❑ Decentralization has deepened in 2001-2003. This contributed to political stability and democracy. But it also led to lost central grip and uneven performance in such economic areas as TVET and SME promotion.
- ❑ Local administrative capacity is generally weak. A large number of local officials must be trained and retrained.
- ❑ SME promotion—mandate is scattered over different central ministries. Local governments often ignore central instructions and refuse to work with experts dispatched from center or JICA. Quality, funding and sustainability are lacking.
- ❑ The Ministry of Industry is now less able to carry out projects or impose uniform standards on SMEs, HR training, infrastructure, etc. across regions.

# China:

## Provinces Invest Aggressively

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- ❑ With its huge size, China may need federalism but its central authority is still powerful. However, it cannot control provincial actions perfectly.
- ❑ In the 1990s, two economic engines were Township & Village Enterprises (TVEs) and Special Economic Zones (SEZs). These permitted local state-owned enterprises and FDI to invest and expand.
- ❑ Provinces compete fiercely for investment attraction and local revenue raising. This leads to oversupply of industrial zones, real estate projects, steel mills and other production capacities.
- ❑ Central government can only use macroeconomic tightening or administrative instructions as a means to mitigate this regional competition.