Decentralization and Development

Policy Formulation in Developing Countries

GRIPS Development Forum
Types of Decentralization
(Source: World Bank Decentralization Thematic Team)

Political decentralization—giving citizens or their representatives more power in public decision-making.

Administrative decentralization—transfer of responsibility for planning, financing & management of public functions from center to regions.

Fiscal decentralization—ensuring sufficient revenue to regions through self-financing, cost recovery, co-financing, expanded revenue base, fiscal transfer, etc.

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 Economic Decentralization

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

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

- **Federalism** is a political system in which center & 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)

- FF is a research area in public economics asking how various revenue & 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—different regions have surpluses & 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?

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

Obviously local—feeder roads, local irrigation, small power generation & 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 & regulation, safety & environment standards, wholesale & retail trade, taxes, bond issue, transport infrastructure & services, power, telecom...
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 & 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 other transfers & income from nuclear power plants, military bases, large industries & infrastructure, etc.
Clearly, 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.

Sum of local government revenue, 88.1 trillion yen

- Center to local government transfer, 16.4 trillion yen (freely spendable by local governments): 18.6%
- Special transfer from local to center (adjustment), 0.2 trillion yen: 0.2%
- Tax revenue allocated to local governments, 42.1 trillion yen: 47.8%
- Local transfer to execute specified national policies (compulsory education, election expenses, subsidies, etc.), 14.4 trillion yen: 16.3%
- Local government bond issuance (borrowing), 9.2 trillion yen: 10.4%
- Other, 5.9 trillion yen: 6.7%
Japan: Local Government Bond Issue: Three Types

Depending on 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.
Local Abenomics

Abenomics is criticized for widening the rich-poor gap and leaving poor & regions behind. Thus, reviving local economies has become one of the pillars of current Abenomics. But so far, there are more words & ideas than implementable & effective actions.

The following ideas are floated or partially implemented, but impact remains small.

- New type of central transfers based on KPIs and PDCA (instead of rigid rules or lobbying)
- Special Zones for selective economic deregulation
- Relocating ministries & agencies to rural areas
- Increase experts who can advise & plan regional economic renaissance
Vietnam: Vertical Grip

- 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 structure & 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 & industrial zone policies are devolved to cities & provinces except large or special ones—unlike the centralized approach of Malaysia, Thailand, etc.
- 5 cities & 58 provinces compete for FDI & ODA; too many provincial 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 operational – full). Each province has several. But only those with good location & services attract high-quality FDI.
- Land & environmental policies are often different across provinces (eg. factory subleasing; permission for dyeing, plating & painting operations).
Working with Local Governments when Center Lacks Will & Capacity

JICA’s Province-based Economic Growth (PBEG) Initiative:
Select provinces with right policy mindset & industrial potential. Concentrate Japanese FDI & ODA to create success. Roll out to other provinces as models (not very successful).

**Ha Nam Province** (North, rural) - A dynamic provincial leader is attracting Japanese FDI & conducting proactive industrial & agricultural policy. Japan will help with TVET, infrastructure, research, FDI attraction, etc.

**Ba Ria-Vung Tau Province** (South, coastal) - Rich in natural resources but afraid of environmental damage. Japan will assist with environmental technology to simultaneously pursue heavy industry & clean environment.
Ethiopia: Federalism for Political Stability

- The current regime came to power in 1991 by military force led by Tigray Region (north). Federalism was adopted for balance among four major regions.
- Cabinet members and other political appointees have been chosen carefully to represent all regions.
- Federal-to-region block grant transfers, financed by domestic revenue & ODA, are calculated on region’s population & economic status. Four major regions receive similar amounts per capita. Smaller & less developed regions receive more. (Block grant transfers take up about 40% of total federal expenditure.)
- In 2016-18, regional uprisings against central authority broke out. PM Hailemariam resigned, and PM Abiy was inaugurated in 2018. However, political liberalization by new government increases domestic instability.
## Ethiopia:
Federal-to-Region Block Grant Transfers

<table>
<thead>
<tr>
<th>Regions/cities</th>
<th>2008/09 ($ million)</th>
<th>Population (million)</th>
<th>Per capita transfer ($)</th>
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</thead>
<tbody>
<tr>
<td>Capital</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Addis Ababa</td>
<td>–</td>
<td>2.74</td>
<td>–</td>
</tr>
<tr>
<td>Major regions</td>
<td></td>
<td></td>
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<tr>
<td>Oromiya</td>
<td>531.9</td>
<td>27.16</td>
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<td>Amhara</td>
<td>395.1</td>
<td>17.21</td>
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<td>SNNP</td>
<td>315.2</td>
<td>15.04</td>
<td>21.0</td>
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<tr>
<td>Tigray</td>
<td>105.9</td>
<td>4.32</td>
<td>24.5</td>
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<tr>
<td>Other regions</td>
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<tr>
<td>Somali</td>
<td>110.2</td>
<td>4.44</td>
<td>24.8</td>
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<td>Afar</td>
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<td>Benshangul/Gumuz</td>
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<td>0.34</td>
<td>56.5</td>
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<tr>
<td>Gambella</td>
<td>16.9</td>
<td>0.31</td>
<td>54.5</td>
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<tr>
<td>Harari</td>
<td>12.9</td>
<td>0.18</td>
<td>71.7</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>1580.6</strong></td>
<td><strong>73.82</strong></td>
<td><strong>21.4</strong></td>
</tr>
</tbody>
</table>

Source: Ministry of Finance & Economic Development.
India: Democratic but Economically Ineffective?

- The Indian constitution designates manufacturing as “concurrent” (joint responsibility for center & state). Industrial policy encounters bureaucracy & delays.

- A large gap in economic performance exists between proactive states (Gujarat, Tamil Nadu, Andra Pradesh, etc.) and not-so-active states.

- Industrial policy by central ministries remains primitive by Asian standards: mainly deregulation & creation of industrial estates, with little creation of domestic value, competitive HR or champion firms.

- Japan faces inconsistencies, ambiguities and delay with Delhi-Mumbai Industrial Corridor (Japan’s major industrial cooperation project). Land acquisition is extremely difficult in India.
Indonesia: Too Decentralized?

- Decentralization has deepened in 2001-2003. This contributed to political stability & democracy. But it also led to lost central grip & uneven performance on such economic issues as TVET and SME promotion.
- Local administrative capacity is generally weak. A large number of local officials must be trained quickly.
- SME promotion—mandate is scattered over different central ministries. Local governments often ignore central instructions and do not work with experts dispatched from center or JICA. Quality, funding & 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. in regions.
China:
Provinces Invest Aggressively

- 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 & expand.
- Provinces compete fiercely for investment attraction and local revenue raising. This leads to oversupply of industrial zones, real estate projects, steel mills & other production capacities.
- Central government can use macroeconomic tightening or administrative instructions only as a means to mitigate this regional competition.