

**FISCAL DECENTRALIZATION: THEORETICAL AND
PRACTICAL ISSUES
WITH EMPHASIS ON DEVELOPING COUNTRIES**

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ABSTRACT

The literature on fiscal decentralization has expanded significantly whereas at the same time many countries in developed, transitional and developing countries have switched to decentralized inter-governmental fiscal relations. The purpose of this paper is to survey the literature on the theoretical and practical issues related to fiscal decentralization and draw syntheses and general lessons with relevance to developing countries. The paper started by examining the various conceptions and the underlying causes for the recent trend toward decentralization. It summarizes the basic arguments for the benefits of fiscal decentralization advanced by Oates (1972) together with an account on its likely pitfalls, challenges and constraints. The reviewed literature on developed countries suggests weak or inconclusive evidence of the impact of fiscal decentralization on growth. Nevertheless, several developing countries have embarked on ambitious decentralization programs prompted by political as well as economic motives. Yet, several experts and the experience of Ethiopia reviewed in this paper suggest many challenges and hurdles, which are likely to derail the benefits from fiscal decentralization. Critics argued that fiscal decentralization may undermine allocative and productive efficiency, limit the benefits from economies of scale, endanger macroeconomic stability, adversely affect income distribution, aggravate regional disparities and increase corruption. The paper, however, concluded that increased democracy, improved institutional capacity, adequate revenue bases, clearly defined rules, gradual, pragmatic and multi-phases fiscal decentralization may be able to reduce some of these risks.

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1. INTRODUCTION

Worldwide, in developed, transitional and developing countries, there is a growing interest in fiscal decentralization. Several countries embarked on programs of fiscal decentralization motivated by expected economic efficiency and political gains. Correspondingly, the literature on the subject has expanded significantly, triggered by the seminal work of Wallace Oates in 1972 on "Fiscal Federalism" in which he put a compelling case for fiscal decentralization. Subsequent studies have branched into variety of themes, reinforcing Oates' theses, challenging their assumptions and theoretical foundations, testing them empirically or extending the analysis to the case of developing or transitional economies.

Despite the proliferation in the adoption of fiscal decentralization, the debate on its outcome has continued to surge with pessimism sneaking in among certain experts. For instance, in 1983, Rondinelli, Nellis and Cheema asserted that decentralization has hardly ever lived up to expectations in developing countries. After two decades, Fritzen and Lim (2006, p 1) concluded that "*the assessment of decentralization in a significant share of the academic and practitioner literature has shifted from marked optimism to one of caution, even pessimism*".

The question of whether fiscal decentralization would generate benefits as the theory envisions is highly relevant to developing countries (and particularly the poorer among them such as in Africa). Skeptics did not see guaranteed positive impact coming out of fiscal decentralization in poorer countries. Rather they believed that the risks of failures are high and that the right conditions for successful fiscal decentralization do not exist in many countries (Tanzi, 2001, and Prud'homme, 1995).

Even those who believe in the virtues of fiscal decentralization cautioned that there is no particular formula of decentralization that countries could follow. Each country is unique in its socio-economic, political, cultural, ethno linguistic and institutional set-ups and therefore would follow its own route to fiscal decentralization (Bird and Vaillancourt, 1998, Wallace Oates 2001). Yet, this does not rule out the utility of drawing general lessons from the decentralization experiences. For even Bird and Vaillancourt (1998), who concluded that "*Lessons for policy in any one country may be drawn only with caution from the welter of confusing details and often contradictory evidence that constitutes the experience of other countries*", asserted that case studies published in their jointly edited book provide "*several possibly useful guidelines for decentralization policy*" (Bird and Vaillancourt, 1998, p 36).

It is, however, the contention of this paper that as the trend towards fiscal decentralization in many countries has persistently grown, the right questions to ask should not center only on whether fiscal decentralization is good for them or not but also on the conditions under which it could lead to positive outcomes. The purpose of this paper is, therefore, to survey some of the literature on fiscal decentralization and draw syntheses and general lessons, with the objective of relating the main conclusions to developing countries.

The paper is organized into seven sections. Section 2 provides definitions of decentralization, traces recent trends and motives and explains the basic tenets of fiscal decentralization in the revenue and expenditure assignment problématique. Section 3 sheds some lights on the merits and pitfalls of fiscal decentralization and discusses the issue of the asymmetry in the optimal degree of fiscal decentralization. Section 4

discusses the empirical evidence of the impact of fiscal decentralization. Section 5 considers the case of developing countries, examining the experimentation and impact along with the constraints and problems facing fiscal decentralization in those countries. Section 6 evaluates the Ethiopian experience of fiscal decentralization, while Section 7 concludes and draws lessons of particular relevance to developing countries.

2. DEFINITIONS & RECENT TRENDS

2.1 What is Fiscal Decentralization?

Any country has normally a government that exercises power over the entire national territory. In addition, virtually, all countries have one or more levels of government that exercise authority over a particular sub-national region. The concept of decentralization is defined with reference to the degree of independence in decision making of various levels of government units. It embraces three different variants, namely, the notions of (1) de-concentration, (2) delegation and (3) devolution.

De-concentration is the handling over of some amount of administrative authority or responsibility to lower levels of government (Rondinelli, Nellis and Cheema, 1983). De-concentration in this sense has little to do with decentralization where decisions regarding levels of provision of specified public services in a particular jurisdiction genuinely reflect the interest of its citizens (Oates, 1972). As such, de-concentration is a more control-focused procedure where financial control and policy remain under the central authority when determining local actions, i.e., the decision making authority is maintained by the central office or is directly vested in the regional branch through a set of core guidelines and regulations (Martinez-Vazquez and McNab, 2001 and Ndegwa, 2002). In other words, local authorities may be allowed limited independent

responsibility for performing certain well-defined local functions, but only within some confines of prescribed central policy.

Delegation is the situation where semi- autonomous entities are delegated the managerial responsibility for specifically defined functions (Rondinelli, Nellis and Cheema, 1983). Here, the local government is expected to assist the central authority in achieving its allocative goals more efficiently. Local government will have to follow the policy guidelines of the central government.

Devolution involves devolving fiscal powers to autonomous and independent lower level governments which are separate and distinct from the central government (Rondinelli, Nellis and Cheema, 1983). Fiscal decentralization and intergovernmental fiscal relations deal with how public expenditure is organized and financed between these different levels of governments. Fiscal decentralization thus constitutes the public finance dimension to decentralization, in general, defining how and in what way expenditures and revenues are organized between and across different levels of government (Oates, 1972). Yet, for them to be able to deliver their duly responsibilities, local governments need to be fiscally empowered. Fiscal decentralization, then, can be conceptualized as the empowerment of communities and citizens by fiscally empowering their local governments (Oates, 2001). In such a context, fiscal decentralization is often more narrowly seen as devolution of fiscal power. Fiscal decentralization, one would conclude, is more about empowering lower-level governments to have the necessary authority and control over the use and management of devolved financial resources.

While the above classifications and definitions are often used in the fiscal decentralization literature, there are some other variants of decentralization sometimes

used. Treisman (2002) distinguished between six conceptions of decentralization (vertical, decision making, appointment, electoral, fiscal, and personnel), for which he developed measures based on mid 1990s data from 166 countries. He then tested how these different conceptions correlate with countries' size, level of ethno-linguistic divisions, colonial history, economic development and degree of democracy. Fritzen and Lim (2006), in turn, cited the four broad categories of administrative, fiscal, political and market decentralization. What is common between all these classifications is that they are based on what is being decentralized.

2.2 Resurgence of Interest in Fiscal Decentralization

As far back as 1956, Alison Martin and W. Arthur Lewis, as quoted by Oates, (1993), noted that it was a typical case to find more fiscal centralization in developing than developed countries. This observation was supported with a calculation made by Oates in which he found in 1985 the share of central government in total public expenditure was higher in the developing countries (85%) than in developed countries (65%). Analysis of data in the World Bank's World Development Report (WDR) also confirmed the observation noted by Oates (WDR, 1997).

The two distinct systems of government, namely the federal and unitary, co-existed for decades. Early federal states included the USA, Canada, Brazil, and Switzerland. By the early 1980s, a slow shift to fiscal decentralization has begun in Europe and Latin America. In Latin America, the share of public expenditure managed by regional governments more than doubled during the 15 years which ended in 2000. In Brazil, for instance, the share of public spending by local governments reached half of the national public expenditure (World Bank, 1997). Again, following the collapse of central

planning and the Soviet block, central and eastern European countries embarked on a strong decentralization drive that made significant devolution of authorities. By the end of the 1990s numerous countries started decentralization to the extent that the WDR (1997) described the period as the age of decentralization. Virtually in all continents, North & Southern America, Western Europe, Asia and Africa, in large and small countries, developing and developed countries, the switch to decentralization has been accelerated (Woller and Phillips, 1998).

Tanzi (1995) cited the developments concerning the European Union as one reason for the increased interest in decentralization. In the case of Western Europe, he saw in the establishment of the European Union the creation of a central entity that devolves important economic power to member states. This, in away, has inspired a number of countries to follow a modified version of this path. Tanzi added that the over reliance on the central government gave way to a growing suspicion regarding its ability in delivering the tasks of macroeconomic stabilization, and address the issues of income distribution, poverty reduction and unemployment. This, he argued, jeopardized the ongoing expansion of the public sector favoring devolution of functions to both market and local jurisdictions. Tanzi (2001) included deepening democratization, globalization, and the rises in incomes as major sources of pressure toward more fiscal decentralization. Bird (1993), in turn, emphasized the pressures that induced some developed countries to tune their fiscal structures in accordance with the realities of the "post-welfare state" era. He cited Canada as an example of countries that have initiated a revival of interest in issues such as tax assignment.

In conclusion, the literature cited diverse causes for the trend towards fiscal decentralization including the recent democratization drive, the transition from central planning to market economy, failure of the central governments, rising incomes, regional inequalities and the ethnicity problem.

2.3 The Assignment Question

While the theoretical case and the underlying motives for decentralization could be straightforward, the practical aspect might not be so. The effective implementation of decentralization reforms calls for a rigorous examination of the reform process. This, as stressed by (Oates, 2001), entails a clear definition and alignment of fiscal functions among different tiers of government taking into consideration the range of historical and political circumstances characterizing different countries. According to him, the appropriate assignment of expenditure responsibilities and the alignment of these responsibilities with taxation and revenue sources should be articulated in outlining fiscal policies. This issue is complex and involves a variety of factors including who pays for what, who provides what, who executes and who supervises the delivery of public services.

While assigning public sector responsibilities in the most possible decentralized way may allow for some efficiency gains (to be discussed later), there is no standard or unique distribution of these responsibilities amongst tiers of government. It differs from country to country and is determined, as said earlier by historical, economic, political and cultural factors (Bruton and Hill, 1996). Disequilibrium in the assignments of those

responsibilities, as argued by Wildasin (1997) may lead to financial and fiscal crisis requiring institutional restructuring in order to arrive at sustainable arrangements.

Expenditure Assignment

The assignment of expenditure responsibilities means specifying functions to different levels of governments. This assignment tends, to some extent, to be fixed over time even though economic conditions and technology tend to change. The basic rule determining, in most fiscally decentralized systems of government, which level of government should do what is known as the 'subsidiary principle'. This rule suggests the assignment of each function to the lowest level of government consistent with its efficient performance (Bird, 1993). Usually, this principle holds when the benefits from a particular service accrue to citizens living within the geographical boundaries of the jurisdiction providing it. However, in the presence of externalities and spill-over between different jurisdictions, decentralized provision might instead results in inefficient level of production of public goods (Oates, 1972, 2006). This has also been pointed out by Besley and Coate (2003) who argued that when spillovers become less significant and where different jurisdictions have homogeneous taste for public expenditure then the problem of centralized provision with shared costs is worsened.

Taxation Assignment:

Results obtained by Fisman and Gatti (1999) suggest that decentralizing government expenditure may not be beneficial unless accompanied by decentralization of revenue generation. Besides, assigning expenditure to different levels of government

gives rise to the fact that finance must follow function. As in the case of assigning expenditure responsibilities, there is neither an optimal way of assigning revenue nor a possibility of matching revenue sources with expenditure assignments (Oates, 2001). Furthermore, it might be hard to identify the different revenue sources and consider their adequacy to different tiers of government. For instance, revenue sources that are generally associated with central governments include: corporate income tax, trade (import/export) tax and value added tax. The traditional theory of fiscal federalism prescribes a very limited tax base for subnational governments. This includes, among others: real estate property tax, regional personal income tax, motors vehicle fees, user fees and some excises and maybe taxes and levies on local businesses (Oates, 1972, Bahl and Linn, 1992). This theoretical proposition has, in a way, become conventional practice, since in most countries the central government is reluctant to provide lower level governments access to more lucrative taxes (Villela, 2001).

Usually, the revenue generating power of local jurisdictions falls behind their expenditure responsibilities giving rise to asymmetry between expenditure and taxation decentralization. In such circumstances, as discussed later, intergovernmental fiscal transfers have a significant role to play in ensuring that subnational governments have adequate revenue to achieve the social optimum (Wildasin, 1991).

3. POTENTIAL BENEFITS & COSTS

3.1 The Merits of Fiscal decentralization

3.1.1 Economic and Cost Efficiency Arguments

The basic economic argument for fiscal decentralization was articulated by Oates (1972) around four dimensions. First, fiscal decentralization enhances economic efficiency by providing an allocation of resources that is more responsive to local tastes and preferences. The proximity of decision makers to the public allows for tailoring kinds and levels of services provision to the preferences and tastes of citizens. As Oates puts it: *"For a public good-the consumption of which is defined over geographical subsets of the total population, and for which the costs of providing each level of output of the good in each jurisdiction are the same for the central or the respective local government-it will always be more efficient (or at least as efficient) for local governments to provide the Pareto-efficient levels of output for their respective jurisdictions than for the central government to provide any specified and uniform level of output across all jurisdictions"* (Oates 1972, p 35). Clearly, there is a wide range of goods that are local in nature and whose demand and cost vary across jurisdictions. Accordingly, the efficient level of output of such local goods and services should vary across jurisdictions. Thus, on efficiency grounds, allocation of resources requires varying output such that marginal benefits equal marginal costs in each jurisdiction (Oates, 1993).

Second, labor mobility or the 'ability of people to vote by their feet' further enhances the welfare gains from fiscal decentralization. A consumer can select the place of residence or the community that best provides the basket of services that suits his preferences. In this context, fiscal decentralization provides a mechanism through which

resources can be efficiently employed to provide the mix of goods and the level of provision that corresponds to individual's need. (Tiebout, 1956). A world of mobile economic agents who vote with their feet helps the public sector to make an important contribution to efficient resource allocation by insuring that economic agents are able to obtain the mix of goods and services that, at the margin, equate costs and benefits (Oates, 1993). In a typical Tiebout model with costless migration, economic agents seek out a jurisdiction that provides exactly the public good mix that they wish to consume. In so doing, economic agents reveal their preference for the local public outputs and contribute to the creation of a Pareto-efficient output in the public sector.

Third, decentralization increases both the static and dynamic efficiency in the production of public goods. With a large number of independent producers of a good, fiscal decentralization fosters competition among jurisdictions and induces them to use the most efficient techniques of production (Oates 1972). The adoption of a particularly effective technique in one jurisdiction creates competitive pressures that tend to compel other jurisdictions to adopt similar or even better techniques.

Fourth, fiscal decentralization allows for a thorough cost benefit analysis to take place and to contribute to more efficient levels of public output because communities- been required to finance their own public programs through local taxation- will be more likely to weight the benefits of the program against its actual costs (Oates, 1993).

3.1.2 Innovation and experimentation

Another important argument favoring decentralization is that it allows innovation and experimentation and thereby enhances production efficiency. When the provision of

a public service (such as education) is the responsibility of a lower tier of government and when these governments are free to provide the service in any way they see appropriate, some governments might be innovative discovering better ways and means of providing the service, and other jurisdictions will emulate the successful ones, adapting those innovations to local needs and adding further touches and developments (Oates, 2001). When the service is imposed by a national monopoly, which adopts a uniform approach to providing the service, there will be little or no experimentation, and thus old methods may continue to be used even when better alternatives are available (Tanzi, 1995).

3.1.3 The political Economy Consideration

In an often cited essay (On Representative Government), John Stuart Mill (1861) was one of the early writers to argue that decentralized political institutions often made possible wider engagement by the citizens in public administration. Thus, by itself this helps in realizing a desirable objective, which is as equally important as other economic considerations. For the case of fragile states, it has also been argued that decentralization *“can provide political glue for countries with ethnic diversity.”* (Tanzi, 1995, p 2). Tanzi gave the example of Ethiopia, which switched to decentralization as a way to address the ethnicity problem in the country. Boko (2002) also cited Ethiopia as an example where the federal constitution strives to reunify the country by accommodating the identity of ethnic groups through the process of decentralization.

Besley and Coate (2003) have also introduced a political economy perspective for assessing the relative merits of centralized and decentralized systems. Their analysis was

based on the assumption that shared costs in the provision of public goods create conflict of interests, which will influence voting in the Legislative Assembly as different representatives work to maximize the interests of their respective districts. They concluded that in the case of non-cooperative behavior by the representatives, a centralized system will lead to non-optimal allocation. They added that even in the case of cooperative decision making there is a risk of excessive spending as a result of compromises.

3.2 Pitfalls of Decentralization

Decentralization also has undoubted pitfalls whose thorough analysis and close examination help to understand the choices and design the policies. The most important ones are discussed below.

3.2.1 Undermining the Allocative and Productive efficiency

The first cautionary notes raised concern the basic economic argument that fiscal decentralization enhances efficiency in the production and allocation of public goods and services. Many economists have actually expressed fears that decentralization might undermine both the productive and allocative efficiency since some of the fundamental mechanisms assumed by the conventional federalism theory appear to be fragile and might not be met in many countries (Prud'homme, 1995). Not only that the anticipated gains in allocative efficiency resulting from fiscal decentralization might turn to be small but also local provision of public goods might not be more cost-effective than national provision.

3.2.2. Limits the benefits from economies of scale

Though it has been widely recognized in the literature that local provision of public services may entail economies of scale, there has been skepticism as to the range of local public services for which economies of scale imply nationwide supply. In addition, it has been pointed out that while both central and local bureaucracies are likely to operate quite far from the technical production frontier, central bureaucracies are likely to operate closer to it (Prud'homme, 1995.) Central institutions have the resources to invest in research and development, technology, promotion and innovation. Consequently, they are in a position to recruit more qualified people offering higher salaries, better career and promising future. In contrast, lower level governments might not be able to offer a working environment attractive for qualified personnel and conducive for efficient production and might not, therefore, benefit from economies of scale in operations.

3.2.3 Risk of macroeconomic instability

Although within the framework of fiscal decentralization, the management of the overall macroeconomic performance is usually vested with the federal government, yet, fiscal decentralization render this task difficult to implement. To be effective in performing its fundamental tasks, as maintained by Prud'homme (1995), the share of central government of national taxes and expenditure must be sufficiently large in relation to total taxes and expenditure as well as to gross domestic product. Under fiscal federalism, he added, where assignment of expenditure responsibilities and revenue

collection are largely accorded to subnational governments, the federal government will be left with a margin that is too small for any effective policy action of controlling prices and demand, the result being high inflation and poor macroeconomic management. Furthermore, subnational governments have no incentive to undertake economic stabilization programs because most of the impact would be outside their jurisdictions, that is, they reap only partial benefits when they undertake the full political cost.

3.2.4 Limits the ability to redistribute income across individuals

A substantial body of public expenditure literature holds that redistribution of income should be vested with the central government (Musgrave, 1959, Oates 1972). First, because decentralized distribution of income could be self-defeating since attempts of subnational governments to impose taxes on the rich will only induce them to move to other jurisdictions with lower tax rates (Wildasin, 1991). Second, looking at it from a national perspective, attempt of subnational governments to redress income inequality might not be successful, since the poor in well-off regions might fare better than the poor in less developed regions. Furthermore, criticism has often been raised against the theory of fiscal federalism in ignoring inter-personal disparities and only concentrating on inter-regional disparities (Prud'homme, 1995). Critics argue that transfers to low-income jurisdictions might not effectively reduce income disparities. Poor people- they add- need to be empowered by improving development potential rather than by a mere transfer that raises their incomes and leaves no long-run impact.

3.2.5 Increases regional disparities in fiscal capacity:

Differences in fiscal capacities among national governments create larger inequities across jurisdictions of the nation if taxation is more decentralized. Then, reduction in income disparities doesn't necessarily correlate with a reduction in regional income disparities. Prud'homme (1995) pointed out that attempt to redress income disparities through transfer might end up benefiting richer regions consolidating regional disparities. He added that empowering the poor, offering more job opportunities, better infrastructure and access to education and health facilities might prove more effective in alleviating poverty than a mere redistribution of income. A centralized system might, therefore, be in a better position securing equity in the distribution of income across individuals and jurisdictions. A consolidated national budget might, therefore, reduce inter-jurisdictional disparities by increasing the impact of national policies designed to correct regional inequities.

3.2.6 Incentives for Corruption

The decentralized environment, it has been argued, may be more conducive to corruptive practices because the proximity of local officials to specific interest groups makes them subject to their pressing needs and hence to developing unethical practices (Bardhan, 1997). At the same time there are fewer obstacles to corruption at the local level where collaboration between politicians and local officials can take different forms (Prud'homme, 1995). The tendency for corruption increases, as well, in situations where there is a loose budget constraint for local public spending and where information flows, transparency, accountability and control practices are limited. While this is true for all

tiers of governments, in practice it may be more widespread in lower levels of government.

3.3 The asymmetry in the optimal degree of fiscal decentralization

3.3.1 Intergovernmental transfers

Those merits and pitfalls do not apply symmetrically on the expenditure and taxation side. Often, the assignment of revenue sources falls behind expenditure responsibilities giving rise to asymmetry of expenditure and taxation in the optimal degree of fiscal decentralization which could be defined along the line of Pareto conditions in such a way that there is no reallocation of assignments that permits some jurisdictions to be better off without making some others worse off. Such discrepancy between spending and taxation creates a gap that calls for closure through a system of intergovernmental relations (Shah, 2004). Bird (1993) stressed that such a system, should be both firm enough to serve as a basis for action but also flexible enough to be compatible with country's specific institutional structures. Intergovernmental transfer, a major feature of this relationship, has a number of objectives: correcting the vertical imbalance (the gap between the expenditure responsibilities assigned to subnational level and the revenue assigned to or shared with this level), reducing horizontal imbalance between rich and poor provinces to, stimulating subnational tax effort (encouraging localities to raise more own-source revenue), and influencing subnational spending decisions in accordance with central preferences.

The actual design and working of a fiscal system is, to a great extent, an individualized matter that takes shape depending on prevailing institutional structures.

However, the conventional theory of fiscal federalism has laid out, in admittedly general terms, some guidelines for these relationships. It states that own-source revenue must make a significant part of total revenue such that the central government has less chances of intrusions in local affairs (Oates, 1972). Provided that decentralized jurisdictions have adequate sources of revenue, intergovernmental transfers, the theory maintains, must not be excessively large and should allow for the possibility of marginal funding at the provisional or local level (Oates, 2001). Furthermore, dumping a lot of money on an ill-prepared local government causes more of damage than a cure (Bird and Vaillancourt, 1998). Transfers are preferred to come in a lump-sum form that allows recipient governments to meet their exact scheduled responsibilities, expansions over and above those responsibilities are to be funded from own sources of revenue such as increasing the tax burden within jurisdictions.

3.3.2 Subnational Borrowing

One more aspect of fiscal structure that further reinforces the asymmetry between spending and taxation is debt finance that surely has a fundamental role to play in fiscal federalism. In particular, subnational borrowing, serves as a buffer stock for spreading out payments for public sector investments that provide services over a long period of time, but certainly, not as a means of escaping poor fiscal decisions (Oates, 2001). Wildasin (2004) maintained that the presence of a well defined framework for borrowing and issuing bonds is crucial in order to assure a hard budget constraint for local governments. However, subnational governments, being bailed out by the government whenever the need arises, might presume that they face a soft budget constraint, a matter

that preserves incentive to run budget deficit and accumulate arrears. One way, suggested by Bird and Vaillancourt (1998), of establishing a basic setting of hard budget constraint is to allow no borrowing for finance purposes other than capital investments (in most transition and developing countries, subnational finances have virtually unrestricted access to unlimited borrowing, including in the cases of transition economies, foreign borrowing). The theory of fiscal federalism, as Litvack, Ahmed and Bird, (1998) argued, has also accentuated borrowing finance as a way of securing intergenerational equity.

4. THE IMPACT OF FISCAL DECENTRALIZATION ON ECONOMIC GROWTH

The relationship between fiscal decentralization and economic growth is a multifaceted one where causality runs both ways. This obviously leaves us with a complex and less clear view of what impact fiscal decentralization can have on economic growth or of whether fiscal decentralization is actually a function of the level of economic growth (Martinez-Vazquez and McNab, 2001).

The recent resurgence of interest in fiscal decentralization has increasingly emphasized its effectiveness and efficiency in providing the mix of output that is differentiated according to local tastes and circumstances. As explained before, this results in higher levels of social welfare than the centrally determined one. It also leads to more efficient levels of output across all jurisdictions and thereby contributes directly to economic development. A contrasting point of view argues that decentralization more likely comes with achievement of higher economic development (Martinez-Vazquez and McNab, 2001). From this perspective, the direction of causality goes the other way: it is

economic development that comes first; fiscal decentralization then follows. Bahl and Linn (1992) claim that as economies mature and incomes rise, the economic gains from fiscal decentralization intensify, that is, fiscal decentralization is directly related to the level of economic development. This contention is well documented by empirical evidence since most measures of fiscal decentralization, such as the share of expenditure or revenue of subnational governments in general governments budget, are positively correlated with the level of development, generally measured by per capita income (Akai and Sakata, 2002)

The vast empirical literature on the relation between fiscal decentralization and economic growth, which addresses variety of issues, came up with plentiful evidence, sometimes conflicting and largely inconclusive. This could be attributed to a number of factors including the right specification of the model and choice of parameters. While the majority of the empirical studies on this relation employs Barro's (1990) endogenous growth model, some others, like Davoodi and Zou (1998), depart from Barro's model by including private capital and multiple capital spending. Using a panel of 46 developing and developed countries covering the period 1970- 1989, results obtained by Davoodi and Zou (1998) came to be inconsistent with economic theory since they found a negative relationship between fiscal decentralization and economic growth in developing countries and no relationship for developed countries.

Investigating the impact of fiscal decentralization on economic growth, Akai and Sakata (2002) used data from 50 states in the United States. They quantified fiscal decentralization using four measures: (1) Revenue indicator (Ratio of local government to combined state and local government), (2) Production indicator, (Ratio of local

government expenditure to combined state and local government expenditure), (3) Production-revenue indicator which is the average of (1) and (2), and (4) Autonomy indicator defined as local government own revenue share to its total revenue. Akai and Sakata conclude that fiscal decentralization contributes to economic growth because expenditure decentralization has a positive impact on per capita GDP growth, yet Zou and Jing (2005), in a separate study, argued that a comparison of the relative levels of expenditure and revenue decentralization at U.S. State level suggest a different conclusion. According to them, expenditure is 7.5% more decentralized than revenue, thus to argue that decentralization promotes growth is to imply that expenditure and revenue should diverge rather than converge as orthodox economic theory suggests, that is to say a mismatching rather than a matching between revenue and expenditure is conducive of economic growth.

Using Barro's endogenous growth model and annual historical time series for the U.S economy from 1948-1994, Davoodi, Xie and Zou (1995) measured fiscal decentralization as the share of spending by each level of government in consolidated government spending. Their findings suggest that the existing spending shares for local and state governments in the U. S. are consistent with growth maximization but higher fiscal decentralization may be associated with lower growth implying that the degree of decentralization, after a certain level, is negatively correlated to economic growth.

Using panel data for 30 provinces in China, Zou and Jing (2005) examined the relationship between fiscal decentralization and growth under two different regimes: The fiscal contract system (1979-1993) and the tax assignment system (1994- 1999). Their findings came to be inconsistent with economic theory suggesting that in the case of

China a close match between revenue and expenditure has a negative rather than a positive impact on rates of economic growth. Their findings suggest that under fiscal contract system, provincial economic growth in China is negatively associated with expenditure decentralization and positively associated with revenue decentralization. The introduction of the tax assignment system resulted in a substantial change in estimated results. Provincial growth rates show no statistical significant association with expenditure decentralization. However, it shows negative rather than positive association with revenue decentralization with a high level of consistency and statistical significance. Thus, they concluded that the conventional wisdom of economic theory that fiscal decentralization improves allocative efficiency and promotes economic growth does not apply in the case of China where local governments do not have economic and social endowments to generate the revenue required to finance their spending requirements.

Woller and Kerk (1998) presented an empirical examination of the relationship between fiscal decentralization and economic growth in less developed countries. Investigating a sample of twenty- three less developed countries, they failed, however, to find a systematic relationship between the two. In their investigation, they used per capita growth rates as a dependent variable which they derived by constructing a set of purchasing power parity and adjusted measures of real GDP using data from IMF's International Financial Statistic CD- ROM as well as the Summers and Heston's Penn Tables. They used four measures of fiscal decentralization: (1) The ratio of local government revenues to total revenues, (2) the ratio of government revenues less grants-in aid to total government revenues, (3) the ratio of total government expenditures to total governments expenditure, and (4) and the ratio of local government expenditure less

defense and social government expenditure. When examining five-years averages of the explanatory variables, their findings suggested a weak inverse relationship between revenue decentralization and economic growth rates. No statistically significant relationship was found when examining three-years averages and annual data among the other three decentralization variables (Woller and Kerk, 1998)

5. The CASE OF DEVELOPING COUNTRIES

As mentioned earlier, several developing countries embarked during the last decades on a decentralization process that reversed earlier post independence trends of political and fiscal/economic centralization. This section addresses three questions: First, what were the motives for decentralization in the developing countries? Second, how has fiscal decentralization fared? And third, what are the major constraints and problems that undermine a positive role for fiscal decentralization in these countries. (The next section will examine the case of Ethiopia.)

5.1 The Underlying Motives

The motivations behind the decentralization process in developing countries are numerous and often do not coincide with the theoretical proposition that supports decentralization as a mechanism to improve and democratize the allocation and use of public resources. Decentralization in those countries is subject to processes that vary from country to country, according to the institutional, political and economic circumstances (Ndegwa, 2002). In some African countries, such as Tunisia and Morocco, economic factors took priority in determining the process of fiscal decentralization seen

as a tool of economic restructuring seeking more efficiency and efficacy in the allocation of public resources. It was, in such cases, implemented by strong central governments that tend to dominate the way responsibilities are allocated and are effectively carried out.

A contrasting point of view gave little importance to economic factors and maintains that in most developing countries the economic impacts of fiscal decentralization have not been calculated beforehand (Rondinelli, Nellis and Cheema, 1983). According to this school, socio-political factors played a major role in many developing countries that were torn with ethnic conflicts and separatist movements. These countries have seen in decentralization a way of defusing social and political tensions and ensuring cultural and political autonomy. The ever escalating civil conflicts, along with the failure of central governments in achieving public efficiency and in broadening the benefits of growth and independence provided incentives for many African countries, such as Ethiopia, Nigeria and Sudan to adopt decentralized systems of government (Ndegwa, 2002, Boko, 2002).

5.2 Experimentation with Fiscal Decentralization

The multiplicity of the deriving forces behind decentralization in developing countries is equally matched by diversification of experimentation and variation in the degree of responsibility and discretion in decision making that is transferred by the central government to subnational governments. Rondinelli, Nellis and Cheema (1983) argued that those variants are not mutually exclusive, that some governments used them simultaneously while others have shifted from one to another. They cited de-concentration as the most frequently used form of decentralization in developing

countries since the early 1970s. They gave the example of Indonesia, Morocco, Pakistan, the Philippines, Sri Lanka, Thailand and Tunisia where de-concentration was encouraged through financial grants from the central to subnational governments. According to them, those countries, in varying degrees and different forms, handed some administrative authority or responsibility to lower level governments giving them some discretion to plan and implement programs and projects. In Pakistan the "Markaz" councils were to integrate and coordinate the agricultural credit, public works, marketing and infrastructure development activities. In Sri Lanka, coordinating committees were established, their members were to reconcile and integrate local development activities of national departments and agencies. In Tunisia, the "Gouvernorats" were to receive annual grants for the government to carry out local employment generation and development projects (Rondinelli, Nellis and Cheema, 1983)

Many other developing countries have opted for delegation, transferring managerial responsibility for specific functions to public entities and agencies controlled only indirectly by the central government. In Latin America, as mentioned by Rondinelli, Nellis and Cheema, the government has delegated a wide range of functions to public authorities. Mexico delegated a variety of functions to independent commissions and councils, using state marketing boards and mixed enterprises in pursuing high priority development ventures. In Brazil, public and mixed enterprises and societies account for almost half of the liquid capital investment. In East Africa, Tanzania and Kenya, public corporations and special authorities have been used, among others, to finance, construct and manage physical infrastructure projects, such as highways, dams, hydroelectric facilities, railways and transportation systems (Rondinelli, Nellis and Cheema, 1983).

For Villela (2001), the devolution of fiscal functions and the power sharing arrangements that took place in Latin America in the past few decades led to arise in the share of public expenditure managed by subnational government from 8% to almost 15%. Similarly, in Africa countries such as Algeria, Benin, Burkina Faso Ghana, Mali, Nigeria and Sudan have devolved, in varying degrees, fiscal functions to lower level governments according them some kind of fiscal autonomy.

5.3 Constraints and Problems

While some have seen fiscal decentralization in developing countries as "*panacea and cure for all the ills*", others considered it "*an addition to their already heavy burdens*" (Bird and Vaillancourt, p 2). Indeed if one looks at the conditions set by Prud'homme (1995) as necessary for the successes of fiscal decentralization, one can not be optimistic that immediate welfare gains can be realized from fiscal decentralization in developing countries. Developing countries, in general, have lower degree of central government efficiency, larger regional inequalities, lower GDP per capita, larger rural population and less urbanization,

5.3.1 Participation and Democracy

The way people's preferences are not well revealed through the political mechanism is an important constraint for successful fiscal federalism in developing countries. Litvack Ahmed and Bird (1998) argued in favor of a well functioning democratic political system but claimed that it is insufficient unless accompanied by meaningful political participation at the grassroots level. They gave the example of India as one of

the world's established democracies but because local participation depends on the social cast system, the poor have no or little influence. Meaningful participation of citizens ensures the voice and choice of all citizens is integrated in the provision of the right mix of public goods and services. Through their participation in the political process, the poor can exert pressure on leaders and make their voice heard.

Clearly, the absence of citizens' voices in developing countries along with the exclusion of stakeholders in legislation and policy making processes undermines the success of the decentralization process. Though various constitutions in developing countries entrench the right of citizens to participate in policy making and that of sub national actors to shape central decision, most countries suspend civil and political rights, violate the rules and indulge in suppressive practices that jeopardize individual freedom and sub national autonomy.

5.3.2 Institutional Capacity

Rules may be set and objectives clearly defined. However, enforceability of policies and the translation of goals to realities may be undermined by existing poor institutions in developing countries. Wildasin (2004) maintained that the quality of institutional capacity contributes in major ways to efficient and equitable resource allocation. Bardhan (1997), in turn, claimed that in developing countries technical local staff is disadvantaged by poor training, isolation and low interaction with other professional. Many of those countries suffer serious information constraints, deficient accounting systems and mechanisms of monitoring public bureaucrats. According to him, public sector reforms starting with civil service and including institutions, regulations and

the quality of the human resources is necessary. In addition, reforming public expenditure management is equally critical for the enhancement of fiscal gains.

5.3.3 Revenue base and financial resource

Ensuring that subnational governments have adequate revenue to meet their spending responsibilities is a corner stone for successful federalism. To this end, assigning tax responsibilities to rural areas, especially in developing countries, is a particularly difficult task. Rural areas are usually very poor, have low, fragile tax bases and can only impose low tax rate. In addition taxing business activities assume the existence of such activities which is normally not the case (Prud'homme, 2001). Neither income tax nor consumption tax form a reliable source of revenue in rural areas. Furthermore, as argued by Prud'homme (1995) the self-sufficiency nature of economic production and the bartering arrangements in most rural areas render taxes on consumption goods not easy, difficult or even impossible to access. This renders subnational governments, which by their very nature vulnerable to a wide range of natural and economic shocks, helpless in facing those shocks and argues instead in favor of a more centralized taxation system that distribute the risk.

Another problem regarding the assignment of revenue sources in developing countries is related to the power conflict that often arises. While subnational governments need to have at least some revenue discretion in order to fully benefit from fiscal decentralization reforms, central authorities do not allow lower level governments the necessary revenue autonomy. Thus, in many fiscal federations, the revenue generating power of jurisdictions falls behind their expenditure responsibilities. In addition, revenue

decentralization often raises some equity concerns with wealthier jurisdictions always being able to raise more revenue than poorer ones.

5.3.4 Clarity of rules and assignments

Where the move to decentralization is done in an ad hoc manner without proper spelling of the rules and functions, as it is the case in many developing countries, decentralization is unlikely to lead to improved public sector efficiency. Most developing countries lack the clarity of rules that defines the range of responsibilities for each level of government. This point is stressed by Villela (2001) drawing from the experience of Latin America when he stated that the assignment of responsibilities should be clarified and well articulated. While rules that clearly spell proper assignment of expenditure and alignment of revenue along with many others that promote accountability and transparency provide a good foundation for successful fiscal federalism, yet some developing countries' economies were chocked by excessive regulations that could have a quite damaging effect on the economy's performance. Although he has no data to prove this hypothesis, Tanzi (2001) argued that informal observations give it enough support. He added that since expenditure tends to be more centralized and since revenue resources are often not aligned in a sufficient and efficient manner, subnational governments tend to over rely on a tool that they can easily manipulate- namely regulations. Thus, the clarity of rules and objectives should be reinforced by regulations regarding the quality as well as the intensity of those rules to constrain any hampering effects they could have.

6. THE EXPERIENCE OF ETHIOPIA

Ethiopia is a country where the government has expressed strong commitment to the decentralization process but faces tremendous challenges. It is also a country which shares with other African countries widespread poverty, undeveloped human and natural resources, poor institutional capacity, and inadequate physical infrastructure and productive capacities. This section attempts to examine Ethiopia's decentralization experience, especially relating this experience to the issues and conclusions drawn from the literature reviewed in the preceding sections. While the intention is to assess the extent to which fiscal decentralization managed to achieve the objectives for which it has been instituted, the section will focus on the impediments to achieving these objectives. The section starts by describing the background and country context. It then reviews the steps taken to institutionalize fiscal decentralization before it assesses from rudimentary evidences and studies the impact and the hurdles in the face of successful decentralization.

6.1 The Country Context:

Ethiopia is the third most populous country in Africa with a current population of more than 76 million. It is one of the poorest and least developed countries in the world (with a GDP per capita of about USD 100), and among the four with the lowest human development indexes according to the UNDP's Human Development Report (2005). About 45% of the population lives in absolute poverty. Through the years the economy was vulnerable to a wide scope of disasters such as famine, drought, flood epidemics, earthquakes, civil war and mass displacement. There are wide disparities in demographic

and socio-economic indicators between urban and rural areas, as well as among the various regions. The country is endowed with a potential cultivable land and a large number of working age population (more than 30 million of the population is under 15 years old).

The country's agricultural sector, poorly developed as it is, sustains more than 80% of the population and accounts on average for about half of GDP. Partly owing to this fact, the performance of the national economy considerably fluctuates with the performance of the agricultural sector. National food security has always been deteriorating at household level, despite growth of cash crops at the national level. A combination of factors have exacerbated the food insecurity and resulted in widening the food gap. Among these come the unfavorable weather changes, the environmental degradation, the population pressure and the continuous decline in the size of per capita land holding.

Over the last forty years, the Ethiopian economy has changed from a liberalized economy (till 1974) to a centrally planned one under the military (the Derg) regime (1974-1990) and again back to a liberalized one (after 1991). There were some improvements in the socio economic indicators during the 1990s, but were marginal as confirmed in the UNDP's Human Development Report (2005). A number of factors, including ecological crisis, a protracted civil war and economic mismanagement have contributed to such a situation with increased food insecurity, severe economic imbalance, loss of competitiveness and social crisis involving millions of displaced persons, refugees, demobilized soldiers and unemployed people.

The geographical diversity of Ethiopia is matched by ethnical multiplicity. There are 80 different ethnic groups, with the Amhara, Oromo, and Tigrayans making up more than 3/4th of the population. This ethnical structure has increasingly manifested itself in strong rivalries, separatist movements, secessionist tendencies and demands for regional autonomies.

Ethiopia represents an interesting case study as far as fiscal federalism is concerned as it might be far from being ideal for successful fiscal decentralization. It is a low income country with high poverty rates, low physical infrastructure and poor human and natural resources. Nevertheless, the reform on fiscal policy is high on policy agenda and the country tried to seek safe refuge in fiscal decentralization to heal the hostilities between different groups.

6.2 Institutionalizing Fiscal Decentralization:

Prior to the 1990s Ethiopia's history is one of highly centralized political and economic (including fiscal) systems. In the face of rising Ethiopian nationalism and weak nationhood, Emperor Haile Selassie centralized the political power despite the federal status of the country then. After the fall of the empire regime, a socialist government adopted a central planning system based on the Marxism Leninism ideology. However, since the early 1990s, Ethiopia has been in the process of transforming its basic political and economic institutions towards political and economic liberalization and fiscal decentralization. The government forwarded a multiphase strategy for deepening democratic decentralization and the adoption of the 1995 constitution resulted in the creation of a federal state, centered around ethnically– based regions within which lower

levels of government (called Woredas) constitutes the basic unit of decentralized democratic governance. The constitution stipulates that regions should be formed on the basis of ethnic settlement patterns, language identity, and the consent of the people concerned.

In the federal structure of Ethiopia, there are nine regional states, and two special city administrations, Addis Ababa and Dire Dawa – representing the largest cities. The states are then subdivided into 75 zones and 560 woredas (districts) which were envisaged to be centers of socio-economic development enjoying to a limited extent some autonomy in expenditure. The woreda represents the basic unit of planning and political administration. Below the district, are the Kebeles, which number approximately 15,000, represent urban dwellers associations in towns and peasant associations in rural villages (World Bank, Ethiopia Public Expenditure Review, 2004)

The motives behind the decentralization process have mainly emanated from sub national claims for greater autonomy. Decentralization, in Ethiopia was then envisioned, as mentioned by Tanzi (1995) and Boko (2002), as an effective instrument to alleviate strong ethnic rivalries and satisfy demand for autonomy from different regions so as to hold together the ethnically fragmented country. Furthermore, decentralization is seen as a way to improve governance and service delivery in this highly populated country.

The assignment of expenditure:

During the past decade, a profile of fiscal relations evolved defining spending and taxation assignments as well as a system of intergovernmental transfer. Generally, the allocation of responsibilities and revenue alignment in Ethiopia are broadly in line

with those in the theory of fiscal federalism. However, the constitution is clearer with regard to the specification of federal expenditure responsibilities than to those of subnational governments. The federal government is vested with the formulation of national policies including socio-development policies, foreign policy, macroeconomic management as well as infrastructure policies including, rail, waterways, major roads and postal and telecommunication services. Subnational governments were assigned the duty and right to implement their own development policies providing public goods and services to their citizens in areas such as health, sanitation, education culture and sport. In addition, expenditure responsibilities that are not expressly accorded to the federal government are reserved for subnational governments (World Bank, Ethiopia Public Expenditure Review, 2004)

Revenue generation and fiscal transfers:

In Ethiopia, as typically the case in developing countries, the federal government has much more power and capacity for generating revenue than subnational entities. Constitutionally, regional governments can draw resources from profit and sales taxes on businesses, agricultural income taxes and land use fee, and personal income tax from employees of the regional governments. Yet, in view of the limited tax base, regional governments can not raise considerable revenue. As a result, vertical imbalances are high and regions are dependent on federal transfers. In most regions locally generated revenues could not even cover recurrent expenditures (World Bank, Public Expenditure Review, 2004). This leaves subnational governments with meager resources to meet their responsibilities and creates a huge gap between expenditure and revenue which in turn

implies reliance of subnational governments on funds transferred from the center and underscores the need for a well designed system of intergovernmental transfer. Such a system becomes particularly important in a country like Ethiopia where the federal government retains strong interest on the way regions spend these transfers.

The system of intergovernmental transfer was first introduced in Ethiopia in the early 1990s and ever since has passed through different phases and amendments. At its preliminary stages, transfers were arbitrarily determined by assessment of individual projects in different regions. In 1994/95 a fairly complicated formula of intergovernmental transfer was introduced and has ever since been undergoing some modifications. The formula is basically based on a weighted average of some indexes with the assigned weights being changed so often. These indexes are: (1) relative population, (2) Poverty index, (3) Development index, (4) Index of revenue raising effort and sectoral output performance. Transfers from subnational government to Woredas have also followed the same formula. While the intergovernmental transfer follows such a deterministic formula, the share of budget going to region is less deterministic and is decided each year based on a combination of projected national revenue, priorities of programs at federal levels and historical funding as well (World Bank, Ethiopia Public Expenditure Review, 2004)

6.3 Evaluation of the Decentralization Experience: Problems and Impact

The Ethiopian case illustrates the many problems of fiscal decentralization in a poor least developed country. As mentioned before, the current Ethiopian regime's preoccupation with fiscal decentralization emanates from strong convictions that

decentralization will result in greater political decentralization and democracy, which will go a long way in reducing the ethnic tensions and build national unity. Decentralization is also expected to lead to improved governance, local responsiveness and political participation. These, in turn, are expected to result in efficiency in public services delivery. The ultimate dividends are political stability and welfare gains. However, realizing quick easy successes without addressing variety of problems and constraints, proved illusive. As will be shown below, the experience of Ethiopia in fiscal decentralization reveals the need for a multi-phase implementation of decentralization. Before deepening fiscal decentralization, a priori phase of intensive effort is needed to reform the civil service at the federal and regional levels, build institutional capacity, improve public service delivery, enhance public expenditure management and strengthen revenue mobilization. In addition, given that various regions differ in their readiness and capacities, some of the decentralization measures need not be applied uniformly and at the same time in all regions.

6.3.1 Extent of Fiscal Autonomy

Prior to discussing the impact of decentralization on its ultimate objectives (growth, poverty, governance, regional inequalities etc), it is important to know how the intergovernmental relationships were translated into real fiscal autonomy, or more generally, fiscal power to carry the various mandates assigned to the sub national levels. In a sample of 30 African countries analyzed by Ndegwa (2002), Ethiopia's local government share of local public expenditure was only 2% in the year 2002. Using as an index of fiscal decentralization an average of intergovernmental transfer and the ratio of

local to state expenditure, Ethiopia ranked among the least fiscally decentralized African countries. Local governments in nineteen African countries control less than 5% of national public expenditure in 2002. In contrast, subnational governments in Mexico exercised in 1988 11.6 % but were able in 1996 to exercise 28.66% of state expenditure (Villela, 2001). This comparison reflects in away that though by constitutional intent, Ethiopia is a decentralized federation, yet in practice regional governments enjoy limited autonomy.

To some observers, it is appropriate to characterize the Ethiopian experience as one of de-concentration where limited autonomy of local governments could be explained by a variety of factors such as the dependence on transfers from the federal treasury, which basically a result of limited capacity for generating local revenues. A World Bank report (2002) summarized the situation as follows:

“The country was seeking to embed a radically new brand of ethnically-based federalism across a vast, diverse society, while simultaneously delivering a broader menu of basic services to a predominantly rural populace, historically disempowered under successive monarchical and dirigiste government.

Recent diagnostic work suggests that the regional governments have responded to this challenge largely by using existing systems of administrative hierarchy to undertake development planning, allocate public resources, and implement service delivery programs. As a result, local governments, and specifically woredas, have generally emerged as de-concentrated units in program implementation rather than genuine, democratically elected executives in their own right. In addition to generating various operational inefficiencies, this form of administrative de-concentration has hindered the

development of democratic and accountable local governments, capable of delivering services in a demand-responsive and sustainable manner. In addition, opportunities for involving communities more systematically in all aspects of service delivery have been unexploited.” (World Bank, 2002, p 4)

Not only is the Ethiopian experience rather viewed as one of de-concentration, but furthermore, decision making on public expenditure allocation is mostly taken at the federal level. To fulfill conditions for debt relief under the Heavy Indebted Poor Countries (HIPC) initiative and with the encouragement of donors, the government developed in 2002 a poverty reduction strategy, the Sustainable Development and Poverty Reduction Program (SDPRP). In this strategy, the government committed itself to working towards meeting the Millennium Development Goals (MDGs) by 2015. The SDPRP set the targets and instruments for stimulating growth and for achieving social improvements through the provision of services in agriculture, health and education. The SDPRP viewed decentralization and empowerment as important means for achieving these objectives. Though programs and policies developed in the SDPRP coincide with citizen's basic needs, targets were set at the national federal level. Regional or lower levels governments may have some room for independent decision making, including selecting the implementation of programs spatially or inter-temporally. However, this role is constrained due to a predominant consensus that certain key targets in education (gross enrolment and literacy) and health (infant and maternity mortality, vaccination and health facilities) have externalities and merits beyond any regional jurisdiction.

6.3.2 Institutional Capacity Constraints

In addition to the financial resource constraint, a major problem facing fiscal decentralization in Ethiopia is the lack of institutional capacity translated in deficiencies in human resource base, and weakness of institutional and organizational set ups at all tiers of governments. A study done for the large region of Oromiya region, for example, concluded that there were severe manpower and capacity constraints in the region. Salaries were low, many posts were not filled and turnover was high (World Bank, 2001). The Public Expenditure Review of the World Bank also mentioned under spending in regional budgets' capital expenditure due to absorption problems and difficulties in managing projects implementation (World Bank Report, 2004). A Review of the Education Sector Development Program (2002) pointed to inadequate planning and management capacity at the lower level of government making it difficult to implement the national program. It concluded that skills to interpret policies, collect and analyze appropriate data were lacking. It also concluded that weak program management and implementation capacity has contributed to low budget utilization in civil works and procurement. High turnover of professional personnel was one contributory factor to the low program management capacity.

The government, however, considered the build up of capacity as an on-going process. It has therefore adopted a Capacity Building Program. Of its various components, civil service reform, district-level decentralization, urban management and public sector financial management are critical to the success of the decentralization process. The country's development partners provided financial and technical support to

these programs. Yet, progress in addressing the capacity problem has been slow and proved to be more complicated than envisaged.

6.3.3 Delivery of social services

Such disappointing way of fiscal autonomy is to some extent understandable in the context of a poorer country like Ethiopia. At 35% of GDP in 2002/03, public spending in Ethiopia is high by sub-Saharan African norms. However rapid population growth has compounded the public expenditure requirements in Ethiopia. With a total population of over 76 million, growing at a rate of 2.7 per year, i.e. 2 million more persons per year, the population is projected to reach 106 million by 2020. The rapid population growth has significant implications on public expenditure, expanding the need for wider services coverage in health, education, food and water supply. Over 12 million children are not in school, 1.9 million additional children need to be immunized each year and 51 million people are estimated to be without access to clean water. Thus, the need for a coherent, well established system of public expenditure and services delivery is evident.

6.3.4 Impact on Poverty and Regional Inequalities

As mentioned earlier, poverty in Ethiopia is widespread and deep with nearly half the population living below the poverty line, many of whom are extremely poor, highly vulnerable and at great risks of starvation. During the last decade, there has been some progress in poverty reduction and improvement in social indicators reflected on marginally lower rates of illiteracy, malnutrition, infant and maternal mortality and

improvement in health and education indicators. However, it is difficult to find a clear link between these improvements and fiscal decentralization, as there are other forces at work. These include political stability (whereas there was prolonged civil war before), macroeconomic stability, increase of poverty reducing expenditure and reforms and liberalization which encouraged investment.

There are also significant regional inequalities reflected in evident differences in poverty headcounts between regions. As an example, highest percent was 57.9 in Tigray region; lowest was 24.6 in Dire Dawa and the median was 34.7 in Oromiya (Pankhurst and Gebre, 2003). According to the World Bank's Country Report of 2005, consumption poverty has perpetuated during the 1990s with indications of an increase in urban poverty and inequality and a slight decline in rural poverty (World Bank, Country Report, 2005). An assessment of the impact of SDPRP revealed a reduction in urban-rural gap in the social indicators and wellbeing, but with no established link to decentralization. One conclusion given in the review of the Education Sector Development Program (2002) showed that regional inequalities as reflected in some social indicators are increasing. The review explicitly indicated that the gap between the lowest and highest performing regions in gross enrolment ratio (GER) in primary education increased between 1996 and 2001. The standard deviations of the GER for the regions have also moved up during the same period. The widening gap could be attributed to differences in institutional capacities.

6.3.5 Implications on budgetary balance

The shift to a decentralized system of government expectedly led to extra budgetary spending resulting from the start up cost of establishing regional governments and local bureaus and other related expenditure. Realizing the potential challenge that fiscal decentralization poses to budgetary balance, the government initiated a two-fold response: First, it started to improve tax policy administration and revenue collections at the federal level while ensuring that regions do not pursue any uncontrolled resource mobilization through local taxes or borrowing. Second, it introduced reforms in public expenditure management including budget preparation process, public expenditure planning, expenditure tracking, cash management, budget information systems, auditing, accounting and reporting (Government of Ethiopia, 2003, Annual Progress Report on SDPRP).

For most of the last decade, the government's budgetary performance has been satisfactory. This is partly due to reforms and the peace which followed the agreement with Eritrea. Moreover, donors continued to provide assistance to the government through projects financing or humanitarian and other assistance. As a result of good performance in macroeconomic policies, the creditors including the IMF and the World Bank granted debt relief and support to the country under various arrangements (See IMF website and 2006, Article IV Consultations). Nevertheless, given the ambitious public services programs, which accompanied decentralization, the risk of budgetary imbalance has become high. The fiscal deficit before grants is still high in the country (about 10% of GDP) and the country largely depends on foreign aid. The IMF has always encouraged the country to avoid resorting to domestic debt borrowing and advised it to continue

improving public expenditure management. Although on balance, the government managed to absorb and mitigate the extra budgetary expenses resulting from decentralization, the risk to fiscal sustainability remains significant requiring vigilant and disciplined policies.

7. CONCLUSION

The interest in fiscal decentralization has increased worldwide during the last two decades with variety of developed, transitional and developing countries keen to reap perceived economic efficiency gains and political advantages. Vast literature on fiscal decentralization was stimulated by Oates' monumental work on "Fiscal Federalism" published in 1972. Oates advanced the argument that in view of variations in costs and preferences across local jurisdictions, fiscal decentralization improves allocation and production efficiency by making it possible for lower levels of government to deliver public services in direct response to local demand. Productive efficiency will be enhanced as subnational governments become accountable to their citizens. In addition to the economic case, the literature also acknowledged the political rationale for fiscal decentralization, which allows participation and addresses the fears of ethnic conflicts.

Subsequent work on the subject extended to the theoretical foundations and empirical testing of Oates' conclusions. Empirical evidence from developed countries is ample though inconclusive (See section 4). However, while mature federations (to use the expression chosen by Wildasin, 2004) managed to improve their inter-governmental fiscal relations, developing countries have been grappling with defining these relations and building the requisite systems, institutions and policies. The empirical evidence for

these countries could not confirm whether fiscal decentralization has led to growth, development, poverty reduction, improved social services delivery, or accountability. The lack of clear evidence of the positive impact of fiscal decentralization in developing countries, in turn, raised skepticism about its value in these countries. The literature, nevertheless, reveals some general lessons.

Experience shows that fiscal decentralization in several developing and especially least developed countries looks closer to been de-concentration or administrative decentralization, as the case of Ethiopia described in section 6 demonstrates. De-concentration, nevertheless, could be seen as a step towards decentralization. If a conscientious decision is made, learning by doing can take place and gaps and deficiencies could be identified and addressed.

Experience also reveals, as in the case of Ethiopia, that in view of the initial difficulties, fiscal decentralization could better be done in a multi-phases, gradual and pragmatic approach. Thus, there is a need for prioritization and proper sequencing. As subnational jurisdictions differ in their institutional capacities and readiness, a country can follow a multi phase approach for different regions. What is needed then—in addition to patience—is, first, close monitoring of the experience and, second, flexibility and pragmatism in sequencing and implementation.

The lessons of other countries suggest that the design should be tailored to the local conditions; the objectives be clearly defined and the instruments well selected. Once the appropriate fiscal system is selected and consensus around it is built, policy makers need to know, agree and commit themselves to appropriate instruments and assign responsibilities in clear constitutional and legal mandates. The assignment of

responsibilities includes those related to revenues, expenditure, intergovernmental transfer and access to borrowing to all levels of government.

The existence of good capacity for public financial management and services deliveries is essential for improving accountability, transparency, and participation. Proper expenditure management, accounting systems, auditing and monitoring procedures should ensure that planned expenditure conforms to budgeted expenditure which in turn consistent with people's choices. Democracy, participation, transparency and institutional capacity for public expenditure management are critical for the success of fiscal decentralization.

Policy makers also need to reflect and later monitor and assess what have been described in the literature as potential problems, pitfalls or challenges, which could hold back fiscal decentralization ((Prud' homme, 1995 and Tanzi, 2001). These include excessive damaging regulations and restrictions of the movement of capital, labor and goods, vulnerability to corruption, potential conflict in macroeconomic arrangement, poorly managed central government, large rural economy, significantly high income and regional inequalities and the existence of politically powerful and manipulative local elites.

Yet still the delivery of services and economic growth in developing countries could be hindered by the two major constraints of revenue and institutional capacity. How revenue is generated and shared and how public expenditure is assigned are pivotal issues for fiscal decentralization. There is no easy formula for assignment of responsibilities to different levels of government. However, the center needs to address the issues of vertical imbalance (more revenues generated in the center) and horizontal

imbalance (where regions differ in their capacities to generate revenues). Revenue generation needs to take into account considerations of the allocative and administrative efficiency as well as equity and incentives.

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