

# EAST ASIA DECENTRALIZES

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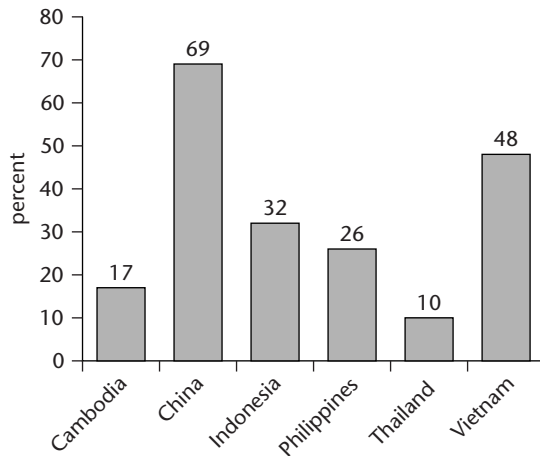
A fundamental transformation in the structure of government has been taking place across East Asia. Before 1990 most East Asian countries were highly centralized; today subnational governments have emerged as the fulcrum for much of the region's development. They deliver many critical services and account for a significant fraction of total public expenditures (see figure 1.1). Though East Asia's decentralization has come later than in some other parts of the world, it is now here to stay.

From China to Cambodia to Thailand, countries of varying sizes, income levels, and political systems are moving government down this path. Reform processes are under way in almost every country. Demands for accountable government whose services reach the grassroots effectively are on the rise. Thus, a wholesale recentralization of government is unlikely. With all that is invested in successful development of these decentralized public sectors, the key question is no longer whether to decentralize. It is how best to design intergovernmental structures and manage the implementation process to achieve optimal results.

In many countries initial progress is encouraging. Where decentralization "leaps" have been attempted, as in Indonesia and the Philippines, they have gone fairly smoothly. Intergovernmental fiscal systems have been institutionalized. Workers have been transferred from central ministries to local governments without significant disruptions. And local authorities have taken up their service-

delivery functions reasonably effectively. Where decentralization has proceeded more gradually, as in Cambodia and Vietnam, it has produced some gains in service delivery and public participation at the local level. Decentralization has also unleashed local initiative and energy. New service-delivery models have begun to emerge, and the potential for continued improvement and innovation has become tangible.

But there have also been problems, and there is a real danger that programs could stall. While East Asian decentralization does not pose the macroeconomic risks confronted in other regions, it does face three distinctive challenges, which play out differently in each country setting. The first challenge relates to the design of sound intergovernmental organizational arrangements. For example, unclear assignments of functions among levels of governments threaten to sidetrack decentralization reforms in some countries. The second challenge concerns the development of robust financial mechanisms for channeling money to subnational governments. In some countries, the failure to allocate sufficient own-source revenues to local governments could hamper their ability to deliver services, for example. The third challenge relates to the accountability of local governments and the capacity of their management systems. Attenuated accountability and weak management—of both financial and human resources—could constrain effective implementation of decentralized

**FIGURE 1.1 Subnational Expenditures as a Share of Total Public Spending**

Source: Refer to chapter 5, table 5.1.

functions by subnational entities. In sum, the potential benefits of harnessing the power of subnational government in East Asia are substantial. But national leadership across the region will be critical in responding consistently and systematically to these three broad challenges if decentralization is to live up to its promise.

### This Study

Clearly, governments in East Asia have an important stake in getting decentralization right. They will need to develop strategic approaches that fit country conditions but that also benefit from regional and global lessons of decentralization. This study seeks to provide guidance to country reformers by reviewing the East Asian experience so far, and by furnishing an analytic perspective on the design and implementation challenges that face policy makers in the region.

This chapter sets the stage for more detailed discussions in subsequent chapters. It provides an overview of East Asian decentralization. First, it shows why decentralization is an important issue in the East Asian context by highlighting its broad implications for economic, governance, and service delivery outcomes. The discussion then examines the origins of decentralization in East Asia, pointing to structural and political factors that have driven the process. The approaches taken by East Asian governments are discussed, and an

early view of the record provided. The chapter proceeds to examine the three main intergovernmental challenges outlined above, looking at the organizational structures, financial mechanisms, and subnational government management and accountability systems that have emerged in East Asian countries engaged in the decentralization process. This discussion touches on themes that will be taken up again in later chapters. Finally, the chapter distills some key messages for East Asian policy makers grappling with decentralization issues.

The ensuing chapters are organized as follows. Chapter 2 delves into greater detail on the frameworks, structures, and processes of decentralization across East Asian countries. Chapters 3 and 4 discuss the macro-fiscal issues of maintaining fiscal sustainability and ensuring interregional equity. Chapters 5 through 7 explore the nuts and bolts of decentralizing public management systems, including public expenditures, revenues, and human resources. Chapters 8 through 10 examine the nexus between decentralization and service delivery in key sectors: health, education, and infrastructure. Chapters 11 and 12 cover governance and citizen empowerment.

### Why Does Decentralization Matter for East Asia?

Intergovernmental reforms adopted in the process of decentralization are important because they inevitably affect broader country performance in three critical, interrelated areas: the economy, service delivery, and governance.

#### The Economy

East Asia's remarkable achievements in economic growth and poverty reduction over the past 30 years can be attributed largely to significant public investment in human capital formation and infrastructure, and to the establishment of a regulatory environment conducive to private enterprise.<sup>1</sup> With decentralization, subnational governments are now at the heart of a range of investment, fiscal, and regulatory activities that affect both the pace and quality of economic growth. For example, they are now responsible for planning and financing economic

infrastructure, such as local roads and irrigation schemes, and for regulating and taxing businesses. In some East Asian countries, such as Cambodia, the role of local and regional authorities in these areas is still limited. But in most, including China and Indonesia, it has become crucial.

There are fiscal dangers associated with decentralization. To the extent that newly empowered subnational governments can transfer significant financial liabilities to the center, the expansion of subnational activities could generate macroeconomic risks for national governments. With the possible exception of China, this has yet to emerge as a problem in East Asia. But local off-budget fiscal activity, subnational borrowing, and inadequate local control of contingent liabilities are common throughout the region. These weaknesses, combined with deepening autonomy and expanding access to domestic and international capital markets, could aggravate longer-term risk unless institutional, regulatory, and monitoring systems improve.

### *Service Delivery*

While many East Asian countries have strengthened the delivery of public services in recent years (chapters 8, 9, and 10), profound problems remain. It is precisely in the areas where these difficulties are concentrated—such as primary health, education, and potable water supply—that subnational governments in East Asia have assumed most of their responsibilities. As discussed in later chapters, performance in these sectors has been mixed. In addition, subnational governments have been required to assume regulatory roles in areas (such as environmental protection) for which they are poorly structured and have little technical capacity. The concern is that if local and intergovernmental systems do not function well, countries are unlikely to sustain positive service-delivery trends, or to reverse negative ones.

The equity of service delivery is also a concern. Wide divergences in natural resource endowments and economic concentration, combined with the design of frameworks for own-source revenues at the subnational level in most countries, have produced pronounced horizontal fiscal inequalities in East Asia. In China, the per capita own-revenue of

the richest province is 16 times that of the poorest region. In Indonesia, the Philippines, and Vietnam, own-source revenues are even more skewed. Such disparities can be mitigated by fairly designed systems of intergovernmental transfers. In the absence of such mechanisms, decentralization may reinforce inequitable distribution of services across jurisdictions, potentially posing serious concern for both subnational and national political leaders in the region.

### *Governance*

While the successes that came to be known as the Asian Miracle were partly attributed to well-performing public sectors, serious deficiencies in public sector governance were evident in many countries by the time the 1997 financial crisis hit East Asia (World Bank 2000). Low levels of government accountability, transparency, and probity contributed to the calamity. Despite postcrisis efforts to reform these governance weaknesses, problems persist. In particular, institutions of public financial accountability often diverge strongly from internationally accepted standards, especially with respect to procurement, accounting and auditing, and performance management and information systems in government (Mountfield 2001).

Perception surveys suggesting that corruption runs deep and wide across East Asia are particularly vexing. Transparency International's 2003 Corruption Perceptions Index ranks the six countries covered in this report in the bottom half of the 133 countries surveyed, ranging from China at 66 to Vietnam at 100 (Transparency International 2003). The World Bank's Governance Research Indicators for 2002 show East Asia's control of corruption in a steady decline since 1996 (Kaufmann et al. 2003). Country-specific diagnostic surveys in Cambodia, Indonesia, and Thailand also point to the high costs of corruption for households and enterprises alike.<sup>2</sup> Recent Investment Climate Assessments in Cambodia and the Philippines provide further evidence that graft—pervasive in the justice sector and revenue administration—is a major obstacle to doing business.<sup>3</sup>

Decentralization magnifies these governance challenges for subnational governments. Opportunities to strengthen grassroots accountability are

paired with risks that, absent tight central controls, corrupt practices could proliferate (Bardhan and Mookherjee 2000). Chapter 11 discusses these issues at length, emphasizing the importance of intergovernmental reform design to ensuring good governance in decentralized contexts.

### **What's Driving Decentralization?**

Decentralization is a process, not an event, and stipulating a starting point in any country is a difficult and sometimes controversial exercise. But there is broad consensus that, for most countries in East Asia, intergovernmental reform gained significant momentum in the 1990s. The evolution of intergovernmental reform has been distinctive for each country, but common dynamics can be identified. For the most part, long-run structural transformations—mainly economic and demographic—have created an environment conducive to decentralization, while powerful political imperatives have precipitated and shaped it.

*Structural factors.* In most East Asian countries, decentralization has been preceded by significant and continuous periods of economic growth and urbanization, broadly suggesting a relationship among these three phenomena (see table 1.1).

As nations develop and urbanize, there is growing pressure to provide services to rapidly expanding and increasingly concentrated populations (World Bank 2000). The challenges facing national governments in effectively administering services create demands to empower subnational governments to meet the burgeoning needs. Indeed, for developing and developed countries alike, evidence shows that growth in per capita income is associated with a declining central government share in public investment (World Bank 2000).

Urbanization rates in the region are particularly informative. With the exception of Thailand in recent years, urban growth rates over the last quarter-century have been high for the six countries under consideration here, particularly during earlier periods in China, Indonesia, the Philippines, and Thailand. Although Cambodia and Vietnam began urbanizing later, their urbanization rates have accelerated and are projected to be substantial

up to 2015. The interplay between economic growth, urbanization, and intergovernmental reform in East Asia is not clearly understood. But, as in other parts of the world, the basic economic and demographic transformations in East Asia seem to have created an environment conducive to decentralization, raising the stakes for intergovernmental systems to function effectively (World Bank 2000).

*Political factors.* While these structural changes have generated pressures for decentralization, political factors appear to have been the more proximate and powerful drivers of the process.<sup>4</sup> Democratization appears sometimes to have been an important trigger. In the Philippines and Indonesia, decentralization was adopted after the sudden collapse of authoritarian regimes (Marcos in 1986 and Soeharto in 1997, respectively) fueled demand for legitimate, local representation. Thailand's prodemocracy movement in the 1990s paired protests against the inordinate role of the military in politics with the development of an initial decentralization framework. Explicit moves toward pluralism have not figured in China and Vietnam. But in both cases, more audible demand for citizen participation and good government at the local level has driven decentralization. Certainly, the impediments that China's sheer physical size poses to effective central control has reinforced these tendencies through the refinement of an intergovernmental framework that has long had quasi-federal features (World Bank 2002a).

Political dynamics have also shaped the nature of decentralization arrangements. In Indonesia, the need to minimize the probability of provincial separatism in the fragile post-Soeharto era produced a system that favored subprovincial governments. Central political elites have also sought to prevent the emergence of regional provincial rivals by pushing authority and resources down to less powerful city and district levels of government. Faced with calls for grassroots "People's Power," post-Marcos regimes in the Philippines created multilayered systems that diffused subnational power among different jurisdictions, for example. In contrast, low levels of party competition in China and Vietnam may explain the relative administrative power of the provinces, as these don't act as platforms for rival political interests.

**TABLE 1.1 Economic and Demographic Trends in East Asia, 1975–2002**

	Population 2002 (millions)	GDP per capita, PPP, 2001 (in 1995 US\$)	Compound annual rates of growth, current/constant PPP			Urban population, % of total population		Urbanization rate		
			1975–1983	1984–1994	1995–2002	1980	2000	1975–1980	1985–1990	1995–2000
World	6,199	6,837	7.6/1.3	4.1/1.3	3.3/1.8	39.2	47.1	2.72	2.72	2.22
Cambodia	12	1,747	—	—	5.4/—	12.4	16.9	2.25	3.65	6.25
China	1,281	3,796	11.2/5.1	10.9/7.9	7.8/6.1	25.7	35.8	3.39	4.09	2.84
Indonesia	212	2,768	11.1/4.5	7.3/4.4	1.9/0.2	22.1	42.0	4.90	5.00	4.74
Philippines	80	3,672	8.5/2.1	2.1/–0.7	2.4/0.9	37.5	58.5	3.75	4.87	3.64
Thailand	62	5,932	10.8/4.3	9.7/6.8	2.1/0.0	26.8	31.1	4.71	2.36	1.61
Vietnam	81	1,956	—	7.3/4.8	6.2/4.7	19.4	24.3	2.56	2.85	3.22

Sources: World Bank (SIMA); United Nations 2004, tables A.2 and A.6.

Note: PPP = purchasing power parity.

**BOX 1.1 Variants of Decentralization: Pros and Cons**

*Deconcentration* refers to decentralization of central government ministries and arrangements whereby subnational governments act as agents of the center. Sometimes regional branches of central offices and agent governments have some authority to make independent decisions, usually within central guidelines. Often, though, deconcentrated local government lacks authority over the scope or quality of local services and how they are provided.

Under *delegation*, subnational governments rather than branches of central government are responsible for delivering certain services, subject to some supervision by the central government. Delegation may improve efficiency when subnational governments can better administer programs of national interest—including certain aspects of education, water, and health—in ways that better reflect local circumstances. The center, or sometimes intermediate government, determines what should be spent, and may also set minimum service standards, while subnational governments define the details. The design of intergovernmental fiscal transfers, and the degree and nature of central monitoring, influence the balance between central and local decision making under delegation.

*Devolution* is the most complete form of decentralization. Independent or semi-independent and, typically, elected subnational

governments are responsible for delivering a set of public services and for imposing fees and taxes to finance those services. Subnational governments have considerable flexibility in selecting the mix and level of services they provide. Other levels of government may provide intergovernmental transfers. For devolution to work, the central and local governments must act as partners, with the former keeping its commitment to devolve functions, and local officials agreeing to make difficult choices and develop the capacity to exercise their powers effectively.<sup>a</sup>

Intergovernmental systems usually have some elements of each of these variants. In principle, devolution should improve efficiency by giving citizens more influence over the mix and level of services, and by giving local governments greater incentives to mobilize resources. The associated efficiency gains—combined with the ability to mobilize untapped revenues at the subnational level (from the formal and informal sectors)—may prove particularly significant in countries with diverse economies, cultures, geography, or tastes for services. Indeed, assigning some local control over expenditure and tax decisions can be key to nation building.

a. Bahl 1999.

### How Are Governments Approaching Decentralization?

In response to these structural and political drivers, East Asian governments have taken different approaches to decentralization, combining standard elements of delegation, deconcentration, and devolution found in many intergovernmental reforms around the world (see box 1.1). Country approaches can be divided into three broad categories: fast starters, incrementalists, and cautious movers.

The *fast starters* (the Philippines and Indonesia) have rapidly introduced major structural, institutional, and fiscal reforms in response to a sudden and far-reaching political stimulus. Sweeping decentralization reforms were introduced in the late 1980s after the fall of Marcos in the Philippines,

and through a “Big Bang” decentralization in the aftermath of Soeharto’s fall and the 1997 financial crisis in Indonesia. These *fast starters* introduced the basic elements of a decentralization framework, subnational democratic elections, and substantial resource sharing swiftly. Considerable follow-up policy and legislative work to create a fully coherent and functional system remains.

The *incrementalists* (China and Vietnam) have taken a more piecemeal approach to decentralization. In China, the government made ad hoc policy decisions and passed legislation directly affecting subnational governments (some decentralizing, some recentralizing), but decentralization is not an officially documented policy. Instead, it is anchored in historical realities and broader political and

economic reforms. In Vietnam, decentralization policy has been more formal than in China, involving a sequence of specific legislative measures. But with the exception of a few bolder, asymmetric experiments in some of the major cities, decentralization in Vietnam has been limited and incremental. In both cases, decentralization has focused on administrative and fiscal reform, with modest political change and the retention of considerable central control over subnational governments (in law and policy if not always in practice).

*Cautious movers* (Cambodia and Thailand) have established significant elements of decentralization at the formal policy and legislative levels, but there has been limited progress with implementation. In Thailand, the ambitious decentralization framework developed in the wake of the 1997 Constitution has been only partly implemented. In Cambodia, elected commune councils have limited functions and receive only modest resources. The provincial system is stronger but heavily managed by national line ministries and centrally appointed governors. Only recently has the government undertaken further work on devolution policy. In both countries, the commitment to extensive decentralization appears to be limited.

### Cross-Country Trends

The broad categories outlined above describe a cluster of characteristics related to the pace and timing with which different countries have introduced decentralization. Other features of decentralization in the region defy straightforward classification. There is an ongoing unevenness in the way in which decentralization is being planned and implemented across countries.

For example, the degree to which countries utilize consistent and intentional policy frameworks to guide reform varies considerably and appears unrelated to the pace or appetite for reform. Indonesia decentralized faster than any other country in the region, but the Big Bang took place in the absence of a comprehensive policy framework. While recent revisions of the key Indonesian framework laws (Laws 22 and 25 of 1999, now Laws 32 and 33 of 2004) have clarified outstanding issues in the governmental transfer system, many other policy elements—such as the regulatory frameworks for subnational borrowing—have yet to be defined.

China lacks even the incomplete policy framework of the Indonesian case but has gradually developed one of the most decentralized intergovernmental structures in the region (World Bank 2002a). In contrast, countries with well-developed, more comprehensive policy frameworks have yet to implement decentralization reforms. Thailand's decentralization framework is elaborated in great detail in the Constitution, in law, and through parliamentary and cabinet decisions, but the country has been slow in carrying out reforms.<sup>5</sup>

Decentralization in East Asia is a complex blend of characteristics in other respects as well. Decentralized subnational governments have, for the most part, been assigned substantial functional mandates and responsibility over large fractions of total public spending. And even where limited recentralization has taken place (such as in China in 1994), this was a temporary move to improve system performance. So the trend has been mainly toward greater local autonomy—albeit at varying rates. The difficulty, however, is that this trend coexists with weak intergovernmental institutional environments and a record of generally poor (while in some instances improving) performance of core mandates by most subnational governments. In some countries (Indonesia, the Philippines) centralized, top-down systems for economic investment and service delivery have weakened. Oversight and regulation of the emerging intergovernmental arrangements are undeveloped. And local systems—lacking appropriate bottom-up incentives and human resource capacity—are not in place to take up the slack.

The result is a kind of “institutional limbo” which typifies decentralizing environments internationally. In East Asia, it has two main features. First, whether by design or as a result of slippages in the implementation process, intergovernmental structures have substantial internal inconsistency. The functions of different levels of government overlap. Bottom-up accountability of locally elected bodies is dampened by top-down methods for appointing key officials. And the discretion given to local authorities in spending unconditional fiscal transfers is effectively curtailed by central government control over human resources. The aforementioned substantial capacity constraints—both local and central—compound these policy and design deficiencies.

Second, the decentralization process itself has slowed, even among countries that had been on the

more accelerated, “fast starter” path described above. For example, repeated attempts to revise aspects of the Local Government Code in the Philippines have borne little fruit, and there are few signs of significant advances in implementing other key policy initiatives (e.g., the reform of the Internal Revenue Allotment grant system). In China, recent intergovernmental reform has become more modest, restricting its focus to introducing equalizing adjustments to the existing central-provincial fiscal transfer system. Reforms that would address more fundamental problems, such as those of subnational debt, do not seem to be on the immediate horizon. In Indonesia, aspects of Law 32 of 2004 represent a tightening of central control over local budgeting and own-source revenue decisions, altering the more deliberate move toward subnational autonomy present in the initial phases of the Big Bang reforms.

Of course, policy and design inconsistencies, along with stop-and-start progress, characterize institutional reform processes in developing countries around the world. Progress is rarely monotonic, and policy reconsideration and reformulation can even be sensible and salutary. To the extent that such fits and starts reflect problematic aspects of the decentralization process in East Asia, however, they are mainly explained by political and bureaucratic conflicts, which break down into three broad types.

First, conflicts between national agencies and subnational governments—usually over the pace of decentralization and resource questions (such as revenue allocations)—have been gaining importance. Some conflicts are explicit and formal, such as public disputes between central and local government officials over jurisdictional issues. Some are informal and implicit, such as disputes between local and central authorities over local tax bases and the regulatory powers of subnational governments. The latter are particularly prevalent in countries where the law remains unclear. In Indonesia, local authorities have increasingly begun to assert themselves in competition with central and provincial government in local business regulation. In China, local governments have disputed centrally imposed fiscal constraints and raised local revenues outside the regular budget in response.

Second, in most East Asian countries, conflicts among central agencies themselves over the

leadership and direction of decentralization are widespread:

- In Indonesia, the recently completed modification of Laws 22 and 25 (now Laws 32 and 33 of 2004) was complicated, and hence delayed, by policy disagreements between the ministries of Finance and Home Affairs. In fact, these laws now provide for simultaneous regulatory jurisdiction of both ministries over a number of subnational fiscal and financial matters.
- In Cambodia, responsibility for policy development and implementation of decentralization is divided across a number of key interministerial agencies, and coordinated progress has proven difficult. Only recently has the central government attempted to institute a single process of policy development on issues related to deconcentration and decentralization, backed by a program of joint donor support.
- In the Philippines, it appears that opposition from major government banks has played a role in ensuring that the legal and regulatory environment for local borrowing continues to place private investors at a competitive disadvantage (World Bank and Asian Development Bank 2003; Pellegrini and Ma 2002).
- In contrast to other regions, finance ministries in East Asia are less active in managing decentralization than are ministries of Interior, Home Affairs, or Planning, which have strong incentives to limit local autonomy. These central ministries often prevail, as those who would champion decentralization tend to be less powerful.

Third, in some countries, conflicts over the scope of decentralization have become an issue between elected political leaders and administrative bureaucracies. For example, the Indonesian Parliament developed its own bill to reform Law 22, as an alternative to the legislative drafting efforts of the ministries of Finance and Home Affairs. Similar dynamics appear to have slowed attempts to reform aspects of the intergovernmental transfer system in the Philippines.

While these conflicts may be no more pronounced in East Asia than in other decentralizing regions, it does appear that they have seriously impeded progress on key reforms in some countries (Cambodia, Indonesia, and the Philippines).

Even where agreement has been reached among central agencies on intergovernmental frameworks, the arrangements that have been struck tend to fix in place confusion over functional mandates that perpetuate interagency squabbles which, in turn, slow implementation. Moreover, in a number of countries, the absence of clear intergovernmental reform policies, combined with weak management capacity at the center, has generated incentives and opportunities for local authorities to work outside the formal system. Indeed, almost half of Chinese subnational government revenue is, by some estimates, not captured in formal local budgets (Ahmad et al. 2000). With decentralization, local payrolls for temporary workers have expanded in the Indonesia, the Philippines, Thailand, and Vietnam. Indonesian businesses are increasingly subject to regulation and taxation imposed by local ordinances that have not been harmonized with existing central government legislation. These practices are largely the unintended result of inadequately designed reform programs, and illustrate the difficulties countries face in trying to systematize decentralization policies.

### **Early Impacts**

Despite initial anxiety in many countries, the effects of decentralization in East Asia appear to have been largely benign so far. In particular, there seems not to have been a systematic deterioration in the delivery of key services, a major preoccupation in many countries. Indeed, while subnational governments have had difficulties with service delivery, so have some central governments. These are still early impressions. Comprehensive assessment of the effects of decentralization is yet to be done. But initial trends can be detected in three broad areas: resources (particularly fiscal resources), outputs and outcomes, and propoor service delivery.<sup>6</sup>

### **Spending Envelopes**

Overall, decentralization seems to have had a positive effect on aggregate fiscal spending. In health, average annual expenditure in Indonesia and Vietnam remained constant as a proportion of gross domestic product (GDP) during the most intense decentralization reforms, from 1997 to 2001. In the Philippines, health spending at the local level exceeded that at the national level by

2001, while total health spending remained in line with other East Asian countries. In education, the positive trend is more pronounced. In China, education spending nearly tripled as a share of total expenditure from 1978 to 2001 (from 6.7 to 18 percent). In the Philippines, total government spending on education grew from just over 2.5 percent to well over 4 percent of GDP between 1991 and 1998. In Indonesia, the share of spending on education has risen to 4 percent of GNP from only 1.4 percent before decentralization. The subnational share of education resources has also increased, partly because funds and functions have been transferred to the local level, and partly because local governments are expected to mobilize additional resources to perform these functions.

The record on infrastructure is mixed. Local infrastructure investment in China has recently been sustained at high levels, but an initial postdecentralization spending surge in the Philippines has given way to a slow but steady decrease in spending since 1995. There are some indications that horizontal disparities in spending in some sectors have widened during decentralization (education in China). But this has not been widely found and is not entirely consistent with the evidence on service-delivery outcomes.

### **Outputs and Outcomes**

The positive trends in health outcomes in East Asia that began in the 1980s have been broadly sustained through the period of decentralization reform. During the period of intensive intergovernmental reform in Indonesia, the Philippines, and Vietnam, infant mortality rates (IMRs) fell and life expectancy grew steadily, albeit slowly. In some countries, gaps in health status between rich and poor local governments have narrowed markedly. In the Philippines, the difference in IMRs between the richest and poorest regions was further reduced in the 1990s, and by 2000 the IMR of the poorest area was lower (Eastern Visayas, at 10.7 per 1,000 live births) than that of the richest (Manila, 19.4 per 1,000) (chapter 8). This favorable trend was due, in part, to improved health outputs and service coverage that extended its subnational reach: the proportion of births attended by trained health personnel, and the share of the population with access to water or sanitation, rose discernibly over

the postreform period. Similar trends were evident in education during periods of intergovernmental reform. As China decentralized, literacy rates rose from 1982 to 1999, most dramatically in the poorer regions. (Further examples of service-delivery trends can be found in chapters 8, 9, and 10.)

### *Service Delivery to the Poor*

The impact of decentralization on the poor is not well understood. National decisions related to decentralization (fiscal equalization, nationally mandated service levels) affect the poor. So do local processes (budgetary allocations, planning decisions, and service mix and quality). In 2001, pre-decentralization survey data on perceptions among Indonesian households of service delivery suggested that the poor knew less about programs and policies affecting them than did other groups. A postdecentralization follow-on survey is under way to understand these issues more deeply. Better monitoring and evaluation—and more data—are needed to get a fuller picture of service delivery performance in poor communities throughout the region.

### **Intergovernmental Systems: What Challenges Do East Asian Countries Face?**

As countries in the region continue to decentralize, they will need to design and implement reforms of their intergovernmental systems in the three broad

areas touched upon earlier in this chapter. These include the organizational arrangements that constitute a country's basic intergovernmental structure; the financial resources that subnational governments can mobilize and the way they are distributed; and the management and accountability systems that govern resource allocation and control at the subnational level. The following discussion highlights the key characteristics of these challenges. It draws on international experience to stimulate thinking about pitfalls to avert and innovative approaches that might be adapted to each country's circumstances.

### *Organizing the Intergovernmental System*

The first broad challenge faced by decentralizing East Asian governments is how to design the organizational structures of the intergovernmental system. This section examines how functions and expenditure responsibilities are assigned, explores issues related to coordination among intergovernmental structures and subnational entities, and examines questions of special configuration and subnational boundaries.

*Functional and Expenditure Assignments.* Substantial functions have been assigned to subnational governments in East Asia (see table 1.2). But in most countries, specific responsibilities are unclear, and overlaps among the different levels of government are common. In Indonesia, despite recent legal revisions (Law 32 of 2004), a lack of clarity regarding central and subnational functions

**TABLE 1.2 Expenditure Shares and Functional Allocations in East Asia**

Country	Subnational expenditure (% of total) <sup>a</sup>	Functional allocations <sup>b</sup>		
		Education	Health	Social welfare
Cambodia	17	Provincial	Provincial	Provincial
China	69	Local	Local	Local
Indonesia	32	Local	Local	Local
Philippines	26	Central, provincial, local	Central, provincial, local	Central, provincial, local
Thailand	10	Central, provincial	Central, provincial	Central, provincial
Vietnam	48	Provincial, local	Provincial, local	Provincial, local

Sources: Various country case studies prepared for this report and World Bank statistics.

a. 2001, except for China, Indonesia, and Vietnam (2002).

b. "Provincial" refers to the level immediately below the central or national level; "local" refers to all levels below the provincial level. Classifications vary across countries; municipalities, for example, can be at either the intermediate level (as in Cambodia and Vietnam) or the local level (as in the Philippines and Thailand).

**TABLE 1.3 Vertical Organization of Intergovernmental Systems in East Asia**

Country	Levels of subnational government <sup>a</sup>	Number of first-tier subnational governments	Average population of first-tier subnational governments (millions, 2002)
Cambodia	2	24	0.5
China	4	32	40.0
Indonesia	3	32	7.0
Philippines	4	149	0.5
Thailand	3	76	0.8
Vietnam	3	61	1.3

Sources: Various country case studies prepared for this report and World Bank statistics.

a. "Level" refers to an organ of government with some degree of formal budget (expenditure) authority. In some cases (such as Indonesia), this can be highly circumscribed, particularly at the lowest levels.

remains, as do a number of inconsistencies between Law 32 and various sectoral laws (such as Law 31 of 2004, which assigns all fisheries functions to the central government). In the Philippines, some clauses in the 1991 Local Government Code appear to distribute functions unambiguously across levels of government, but this clarity is diluted by other clauses allowing both national government agencies and local government units to initiate devolved activities. In China, there is no national law that clarifies the functions of each level of local government; expenditure assignments are decided by the provinces and thus differ across regions (World Bank 2002a).

Achieving greater de jure clarity on functional mandates will not entirely eliminate vertical interagency conflict, and even mature intergovernmental systems are characterized by some dynamic tension over jurisdictional issues. But East Asia may be able to learn from countries that have faced these questions in other parts of the world. As with many other issues, solving these problems is usually about overcoming political obstacles more than technical challenges, and an ongoing dialogue involving various stakeholders will be necessary to resolve these challenges in most countries.

*Organization of Intergovernmental Structures and Coordination among Subnational Entities.* The character of decentralization varies considerably across East Asian countries, ranging from deconcentration to devolution, and encompassing different levels of subnational government. The intergovernmental structures in turn have varying implications for the scope of intergovernmental

coordination, both among subnational governments and between subnational governments and the center.

All East Asian countries have multiple levels of subnational administration or government, but the structures vary widely (table 1.3 and chapter 2). These variations make simple cross-country comparisons difficult, but a rough pattern of vertical organization is evident. Intergovernmental structures in Indonesia and the Philippines are oriented toward the subprovincial level, though interprovincial variations in size, wealth, and influence are wide. In both, however, countries now have limited powers and functions relative to subprovincial governments—perhaps to the point that being precluded from oversight, coordination, and regulation of city and district governments has become dysfunctional for the intergovernmental system as a whole. Subnational structures in China and Vietnam focus more on the intermediate level. These are "nested hierarchies," in which central government determines the overall character of the system and deals directly only with provincial administrations; provinces oversee subprovincial levels; and so on (World Bank 2002). This has allowed the development of significant variation in fiscal and institutional arrangements below the provinces.

Cambodia and Thailand are at the other end of the spectrum, with the most centralized structures in the region. In both, there are elected subprovincial governments, but they have not been assigned significant resources, authority, or functional mandates. In Cambodia, provinces operate fully under the control of the center. In Thailand, provinces

have some independent functions in principle, but their realization in practice has been limited.

When planning and budgetary authority is dispersed laterally and devolved downward, there is a need for horizontal coordination across subnational entities and vertical coordination among levels of government. As the responsibilities of local authorities expand, the effects of their activities can spill over into neighboring jurisdictions, intensifying the need for horizontal cooperation across boundaries. This area has not yet been well studied, but initial indications are that horizontal cooperation has generally been weak in the region. There are some examples of progress in some sectors, such as the Joint Health Councils in Yogyakarta, Indonesia (chapter 8), but these tend to be exceptions. Some donor projects are attempting to introduce incentives to stimulate such cooperation—in China, for example—but systematic initiatives are not common in the region.

Vertical coordination between central and subnational governments is also critical for major planning and investment activities. In Indonesia, provinces are reportedly encountering difficulties in facilitating cooperation across local governments, leading to underperformance in tasks with large spillover effects and significant economies of scale, such as ocean management. An ongoing tug-of-war between the center and the regions on investment approval and land has cooled local investment (World Bank 2003b). These difficulties are related in part to the underlying lack of clarity in the division of functions and powers among the different levels of government—and in part to the changing scope and diminishing authority of national planning agencies under decentralization. To maintain efficient planning, budgeting, and regulation of infrastructure investment, governments need to make conscious efforts to develop models of vertical and horizontal cooperation that can function in a more complex institutional landscape.

There are many international examples of successful intergovernmental cooperation. A number of these lie in the area of tax administration. In the United States, the sovereignty accorded the states by the constitution has created a highly independent system of tax administration and generated the need for cooperative arrangements between state and federal tax authorities. These arrangements

aim primarily to improve tax compliance and enforcement, including the exchange of personal and corporate information between federal and state levels and across states. This exchange may be accomplished either through a voluntary uniform exchange of information or through separate bilateral exchange agreements. At present, 45 states use the uniform exchange of information agreement as a framework for exchanging this kind of taxpayer information—and for cooperative activities to combat tax avoidance (Duncan and McLure 2005; Ebel and Taliercio 2004).<sup>7</sup>

In Estonia, localities have the authority to levy local gross receipts taxes and then verify taxpayer reports by checking reported gross receipts against the central government's VAT declarations. To enforce the tax payment, localities may choose to deny operating licenses to businesses that have not paid the tax and/or they may choose to contract with the National Tax Board for collection of the tax (Sootla et al. 2000). Mexico presents a special case of cooperative administration whereby the central government may enter into agreement with states to audit and otherwise verify compliance with federal laws in exchange for a portion of the federal revenues. States thus reduce costs of administration by using their knowledge of the local economic activity, which the central government might not possess (Mikesell 2003).

*Spatial configuration and boundaries of subnational entities.* The wide variation in the structure of subnational governments across East Asia is consistent with the political and geographic diversity in the region. As decentralization has progressed, two important concerns have emerged for the spatial organization of local authorities. First, there is the question of the administrative efficiency and capacities of subnational units. In Cambodia, studies have raised issues about the ability of communes to operate effectively given their very small sizes (1,600 communes serve 12 million people) (Rusten et al. 2004). In Indonesia, where around 400 *kabupaten/kota*<sup>8</sup> governments serve well over 200 million people, the limited political connectivity between decision makers and constituents in large districts is often considered problematic.

Second, there is more fragmentation of subnational jurisdictions. In Indonesia, the number of *kabupaten* and *kota* increased from 292 to 434

between 1998 and 2003; in Vietnam, the number of provinces expanded from 61 to 64 during 2003. This fragmentation raises questions about whether the process for creating new subnational units creates incentives for increasingly inefficient local government structures. Recent research on Indonesia, for example, indicates that “perverse fiscal and bureaucratic rent-seeking initiatives also may be at work in the creation of new regions” (Filtrani et al. 2004, p. 3). Proliferation often introduces substantial instability in local institutional frameworks, discouraging economic investment and possibly undermining the institutional consolidation needed for effective government administration.

East Asia has much in common with other regions here. Decentralization in a number of African, Central European, and Latin American countries has been characterized by a proliferation of local governments, sometimes to the point where the average unit has become inefficiently small (Bird et al. 1995). In some of these instances, fragmentation has been followed by a later phase of consolidation, in others not. These dynamics are to some extent intrinsic to decentralization. But international experience provides examples of transparent processes that force a more objective examination of technical factors—such as the impact of boundary changes on the fiscal position and administrative capacities of local authorities—and that appear to lead to more rational outcomes. South Africa is worth examining in this regard. In 2000 it rationalized a wasteful and dysfunctional

system of more than 800 local authorities into 284 municipalities and districts by introducing legislation and establishing an independent, nonpolitical body to scrutinize local government boundaries on the basis of detailed, technical criteria. While the final boundary determinations were not without controversy, the overall streamlining of the system is widely regarded as having laid the platform for a major improvement in local government efficiency and operations (Glasser and White 2004).

### *Accessing and Distributing Financial Resources*

The second common challenge in East Asia’s intergovernmental reform relates to access by subnational governments to financial resources. This discussion covers fiscal resources such as own-source revenues and intergovernmental transfers, as well as local government borrowing activities and the extent to which they are subject to hard budget constraints.

*Own-source revenues.* East Asian decentralization has been characterized by a relative lack of own-source revenue autonomy, in both the range of local revenue sources assigned to subnational governments and their authority to determine the tax base and rate. As in other areas, comprehensive data on fiscal arrangements are not available for most countries in the region, but table 1.4 presents an informed impressionistic overview of key features of the intergovernmental fiscal structure, including own-source revenues (see chapter 6).

**TABLE 1.4 Subnational Fiscal Structure of Selected East Asian Countries**

Country	Own-source revenues	Shared taxes	Unconditional transfers	Conditional transfers	Informal revenues
Cambodia	Low	Low	High <sup>a</sup>	n.a. <sup>b</sup>	High
China	Moderate	High	Low	High	High
Indonesia	Low	Moderate	High	Low	Moderate
Philippines	Moderate	Moderate	High	Low	Moderate
Thailand	Low	High	Moderate	Moderate	Low
Vietnam	None	High	Low	High	Moderate

*Sources:* Subsequent chapters and unpublished country case studies prepared by World Bank staff for this report.

*Note:* “Low,” “moderate,” and “high” refer to the rough proportions of total subnational revenues attributable to each revenue source relative to international experience.

a. Refers only to the commune level.

b. Most “provincial” agencies are deconcentrated arms of central ministries, so the term “transfer” does not apply.

A brief survey of typical own-source revenues in East Asia demonstrates the overall lack of subnational autonomy. Among the six countries considered in this study, none permits personal income taxes or general sales taxes at the subnational level. The real property tax on land or on land and building improvements is effectively a national tax in Indonesia, Vietnam, and Thailand. Real estate (property) taxes are a potentially robust source of local revenue, but they are either permitted only on a very narrow base, as with unused land in Cambodia, or subject to maximum rates set by the center, as in China and the Philippines. Business receipts taxes are also underused, except in the Philippines and China, where they constitute about a third and a fifth of local revenues, respectively. Some decentralization laws allow the imposition of modest excises and fees, including those on motor fuel in Indonesia, vehicle and vessel use in China, markets in Cambodia and Indonesia, and public transportation in Thailand.

One result of this limited authority over subnational tax policy is increasing informality, through which subnational governments seek “unofficial” sources of revenue. Allowing subnational governments to enact new taxes and fees has generated some productive entrepreneurial behavior in several countries, but it has simultaneously created problems. Chinese subnational governments have developed an abundance of “illegal” extrabudgetary fees, with distortionary effects. In Indonesia, a proliferation of “nuisance” taxes yields limited revenues, imposes high administrative costs on subnational governments and compliance costs on taxpayers, and, in some cases, impedes inter-regional trade. Subnational governments in the Philippines have created a complex variety of taxes, fees, and charges, many of which are uncollected or undercollected.

Weak local revenue authority creates dependency on higher levels of government, restricts subnational autonomy, and undermines the link between services and finance needed for strong local accountability—a key factor in successful decentralization. Combined with the incentives for poor collection of allowable taxes and fees and the proliferation of “illegal” taxes, this contributes to a culture of noncompliance and undermines the integrity of the fiscal system. Although political dynamics pose serious challenges in this area, there

is significant scope—and an imperative—for most East Asian countries to empower and encourage subnational governments to generate revenues.

*Intergovernmental transfers.* Subnational governments are invariably in a better position to spend resources than to raise them, so intergovernmental transfers form a substantial part of the public sector fiscal structure in most countries. In OECD countries, subnational governments depend on transfers to finance about 40 percent of their expenditures, on average, with the numbers for Eastern Europe and Central Asia, and for Latin America and the Caribbean, slightly lower, and those for Africa closer to 60 percent (Ebel and Yilmaz 2002).<sup>9</sup>

East Asia follows this pattern, with transfers accounting for significant but widely varying proportions of total local revenue, ranging from nearly 100 percent in Cambodia to about 34 percent in Thailand. Local fiscal dependence on transfers is about 70 to 80 percent in Indonesia and the Philippines and 50 percent in Vietnam. In addition, in countries such as China, Thailand, and Vietnam, subnational governments obtain much of their income from shared taxes, a form of intergovernmental transfer. These vary widely across the region, and have important additional implications for the dependence of local governments on non-own-revenue sources of funding (see chapter 2).

Many East Asian countries have recently been moving toward internationally accepted “best practice” norms by simplifying complex intergovernmental transfer systems, improving the transparency and predictability of allocations, and increasing subnational government discretion over the use of these resources (Schroeder and Smoke 2003). This is particularly true in Cambodia, Indonesia, and the Philippines, where transfers are formula-driven and largely not earmarked. Thailand and Vietnam have also begun to move in this direction, though central control over the use of transferred resources remains tighter than in other countries. China’s transfer system is less transparent, having developed piecemeal over the years; recent efforts have focused on improving horizontal equalization.

These trends are positive, but the increase in local discretion over how transfers are spent often masks important constraints in local decision making. There is a degree of internal inconsistency

in the design of intergovernmental transfer systems. While transfer policies seem to favor local expenditure discretion, human resource policy tightly restricts it. For example, the Internal Revenue Allotment in the Philippines and the *dana alokasi umum* in Indonesia are not earmarked transfers. But because they are used primarily to cover local wage costs, and because the central government retains significant control over local civil service staffing and employment conditions, local discretion over the use of these grants is limited. The actual amount of intergovernmental transfer funds that can be spent on truly local priorities in the region is much smaller than first appears.

*Subnational borrowing and hard budget constraints.* Subnational borrowing varies widely across East Asia (see chapter 3). Such borrowing is virtually nonexistent in Cambodia, highly restricted in Indonesia, moderate in the Philippines and Vietnam, and extensive but indirect in China. The frameworks that regulate local borrowing and the actual practices of subnational governments are complex. In China, for example, subnational borrowing is illegal except when financed by higher levels of government. However, local authorities effectively raise credit (and hence incur liabilities) through special-purpose vehicles created for investment and financing. Therefore, while local borrowing is legally more constrained in China than in many other countries, it is in reality both widespread and unregulated.

The emergence of sustainable subnational borrowing in East Asia is hampered by a number of serious problems. First, while the economic and demographic growth of cities is propelling significant latent demand for financing for subnational loans, policy and regulatory frameworks are poorly developed. Thus, while the larger cities and towns in East Asia are in need of increased financing flows (primarily to fund infrastructure investment) and are expanding their capacity to service debt, the lack of reliable financial data, constrained borrowing authority, and the absence of rules in the event of default interact to undermine the de facto creditworthiness of subnational governments and make them unattractive investment propositions.

Second, private lending to subnational governments remains low throughout the region, even where central governments have attempted to stimulate it. This situation arises from the weak creditworthiness of subnational governments, as

well as the public sector–dominated character of the banking industry and the regulatory advantages typically conferred on state-owned banks. As a result, lending to subnational authorities, and the associated credit risk, tends to concentrate in the public sector even in countries such as the Philippines where greater private participation in the subnational debt market is an explicit policy goal.<sup>10</sup>

Third, there are questions about the extent to which subnational governments are subject to hard budget constraints (see box 1.2). China is the only East Asian country in which soft local budget constraints may pose a major problem at the macroeconomic level, largely because of the significant off-budget expenditures of local governments and their widespread—albeit indirect—borrowing. Cambodia is at the other extreme, as communes are responsible for only about 2 percent of total public spending and cannot borrow. While Cambodian provinces account for more spending (17 percent), 80 percent of that is under the direct control of the central government. Provincial off-budget activities are minor, and provinces may not borrow, leaving little scope for accumulating contingent liabilities. The other countries lie between these two extremes, although data weaknesses, the complexity of regulatory frameworks, and the opacity of local accounting systems make the situation unclear. In Indonesia, where subnational governments are usually entitled to borrow, but where these powers are currently restricted,<sup>11</sup> regulatory weaknesses and a poor record of loan repayment indicate potential concern in the medium and long term. Whether local borrowing will become a problem will depend on whether these restrictions are relaxed, as well as on reform of the subnational borrowing framework and the evolution of the intergovernmental transfer system, among other factors.

The degree to which subnational governments are subject to hard budget constraints depends on several aspects of the intergovernmental system, especially the regulatory environment surrounding subnational borrowing. Ultimately, if East Asian countries wish to expand sustainable private investment at the subnational level without misaligning incentives and risking undesirable macroeconomic impacts, they need to develop much more thorough policies and regulations and devote significant efforts to implementing them. This will require a fundamental reassessment of the

### BOX 1.2 Hard Budget Constraints

The ability of subnational entities to borrow funds is fundamental to the concept and practice of fiscal decentralization and local fiscal autonomy. Subnational borrowing can be an effective tool for local development, if limited to financing capital investment expenditure. When structured well, it can improve both economic efficiency, in which the cost of debt repayment matches the flow of benefits over time, and intergenerational equity, so that future generations who benefit from investments also share the responsibility for payment.

The key to making subnational borrowing work is the presence of hard budget constraints. These ensure that subnational governments cannot transfer the liabilities they accrue to higher levels of government, either by shifting debt service obligations upward or other means such as expenditure deferrals or the accumulation of contingent or implicit liabilities. The best way to enforce a hard budget constraint is to establish procedures that clearly signal that local governments will bear the costs (and accrue the benefits) of their fiscal decisions.

When this message is conveyed to creditors, asset owners, and voters, the market mechanism comes into play. First, creditors will demand sound fiscal decisions by withholding credit. Second, knowing that local fiscal decisions can directly affect property values and rents, asset owners will have a strong incentive to lobby against imprudent borrowing and debt buildup. Third, political factors may also be important in countries with local elections, where voters can oust underperforming local officials.

In well-established intergovernmental systems, the fiscal discipline of the capital market suffices. Yet markets work only when good information is available on local fiscal performance and risk, when the central government makes a credible commitment that it will not provide bailouts, and when accountability systems are robust. Where these conditions are not in place, as in many developing countries, two reinforcing strategies can help. First, it is important to ensure that subnational entities do not “pay down”

debts by borrowing from their own banks, or from a central financial authority that provides additional funding, without accompanying—and severe—consequences for default.

The problem with a subnational entity borrowing from itself is clear. A pattern of central government bailouts may also be costly. Not only will this undermine the center’s own credit standing, but it can also lead to selective allocation of credit across subnational governments according to political, ethnic, or religious favoritism. Capital investment can become inefficient, and national cohesiveness may be jeopardized.

The second strategy is to establish a fiscal framework that ensures subnational budget discipline. Central or higher-level governments may limit local borrowing to capital expenditures only, as in Argentina, Latvia, and Poland. They may place statutory limitations on local debt, as in Italy, Portugal, and Canadian provinces. And they may provide for a municipal bankruptcy law, as have Hungary, South Africa, and many member countries of the Organisation for Economic Co-operation and Development. Other rule-based approaches include prohibitions on foreign borrowing in Ethiopia and Ireland, and the establishment of intergovernmental coordinating committees. For example, the Australian Loan Council provides information to the financial markets on local government fiscal positions, and the French Regional Chambers of Accounts may establish remedial fiscal measures if a deficit appears.

A range of sanctions may also be established. In Austria, an explicit Domestic Stability Pact sets overall fiscal targets for municipalities as a group, and allows the transfer of surplus/deficit obligations and rights across subnational governments if the group target is not met. In Brazil, partly in reaction to sharp increases in subnational debt levels (up to 17 percent of GDP in 1996), the central government not only restricts debt service levels but also penalizes governors and mayors for irresponsible performance through impeachment or imprisonment.

objectives of subnational borrowing, close study of the local borrowing environment, a broad framework conducive to disciplined subnational credit activity, and the central capacity to monitor local credit activities, including collection and

dissemination of better credit data. East Asia could draw on the experiences of other countries that have begun—and in some cases successfully completed—such exercises, including Hungary, Mexico, Brazil, and South Africa.

Some East Asian governments are beginning to tackle at least some aspects of this agenda. For example, the Department of Finance in the Philippines has recently begun developing mechanisms to measure and monitor subnational liabilities, and the department intends to create an early warning system to identify impending local debt defaults. In the rest of the region, however, efforts appear to address much narrower concerns. Indonesia has focused on developing a regulatory system for the onlending of donor-sourced investment funds within the public sector (KMK 35). Notwithstanding the positive steps mentioned above, the Philippines has invested significant effort in restructuring the Municipal Development Fund Office into a nonbank financial institution that—like two government banks (the Land Bank and the Development Bank)—will cater to the subnational market. Governments have devoted much less attention to broader policy and regulatory issues surrounding subnational borrowing.

### ***Creating Sound Management and Accountability Systems***

Management and accountability systems often determine the performance of intergovernmental mechanisms. Designing and implementing systems that work on the ground are not easy tasks. This is where decentralization often falters. The following section examines three key elements of this third common challenge: human resource management; planning, financial management, and information at local and national levels; and local accountability systems.

*Human resources.* East Asian countries have started down the path of decentralizing human resources (see chapter 7). In most cases, subnational governments have the authority to hire and assign junior staff, but the central government retains control over the aggregate number and pay levels of local staff.<sup>12</sup> Under these arrangements, the overall management of the civil service effectively remains largely centralized.

To compensate for this limited local formal autonomy, subnational practices in some countries have tended to circumvent formal systems. In the Philippines and Thailand, local managers have avoided central guidelines by hiring contractual workers. In Indonesia and the Philippines, local

governments have often relied on nontransparent allowances to boost civil service pay. In China, where subnational governments return budget surpluses to the central government, local civil service employment has swelled in the absence of incentives to local managers to keep staffs lean.

The design of decentralization has also had important impacts on the accountability, incentives, and capacity of local civil servants. Unclear policies have sometimes created confusion concerning accountability relationships. In Indonesia, for example, conflicting laws have produced inefficient overlaps in authority. In China, the Philippines, and Vietnam, “double subordination” to central authorities and local assemblies conflates the accountability of local staff.

Though some East Asian countries have established formal mechanisms for merit-based recruitment and performance management, these tend to lack teeth in reality, and civil servants are rarely held accountable for their behavior. Seniority and party loyalty have frequently trumped performance in promotion decisions. In China, the awarding of across-the-board performance bonuses has undercut their ability to leverage civil service quality. In the Philippines, where staff performance has not, until recently, been rigorously evaluated, patronage and nepotism have figured prominently in recruitment and promotion. In countries where wages are low and absenteeism is endemic, service delivery quality cannot be maintained. Throughout East Asia, less well-resourced local governments are often unable to attract enough staff to fill the required number of spots or to fund centrally set wages. For local governments that manage to staff their civil services despite poor incentives, the lack of strong systems for career management also dampens the incentives of local functionaries to perform.

International experience shows that countries often neglect the details of administrative decentralization. In Central and Eastern Europe, confusion about the role of the postcommunist state prompted many governments to decentralize tasks without providing adequate resources (Verheijen 2002). In Latin America, local authority to control personnel costs was critical in enhancing macroeconomic management under decentralization (Burki et al. 1999). Yet even when far-reaching on paper, decentralization of human resource

management has usually been quite limited in practice. Governments tend to decentralize the civil service in similar ways, giving local governments autonomy to hire and fire staff and supplement centrally set salaries, while the center retains control over wage rates and interregional mobility (Evans and Manning 2004). Concerns about local capacity, interregional equity, and national unity can spur recentralization of the civil service and threaten the decentralization agenda.

Despite the relative inattention to administrative decentralization, a few interesting experiences in local civil service management provide lessons for East Asian countries. In Uganda, independent District Service Commissions manage the recruitment of local civil servants. The commissions have experienced some growing pains, such as limited ability to discipline and dismiss staff, but they can still serve as a useful model. In Pakistan, reforms envision organizing lower-echelon staff into cadres to facilitate their mobility across districts, while provinces will officially employ more senior staff to allow vertical movement into central government service. In this case, the challenge has been to ensure that district governments rather than provinces hold civil servants accountable for performance. Personnel exchange programs in Japan enhance the career prospects of local civil servants by transferring them between subnational governments and the center. Broadly, international experience suggests that some central controls on wages and civil service mobility, combined with local autonomy over hiring and promotion of more junior staff, have been the preferred policies for most countries moving from centralized to decentralized human resource management systems. These experiences show how important human resource arrangements can be to making intergovernmental systems work.

*Planning and financial management.* As is common in newly decentralizing environments, local planning in East Asia is fairly weak (see chapter 5). Though the Local Government Code of the Philippines prescribes a participatory approach to planning, less than a third of subnational governments accounted for external inputs in creating development plans, according to one survey (Azfar et al. 2000). Indonesia has also begun to introduce a participatory planning process at the *kabupaten* level, but project affordability is not a factor in expenditure choices, so this process creates “wish lists” that

do not inform the budget in a meaningful way. In China and Vietnam, insufficient coordination between planning and budgeting means that plans typically far outstrip resources.

The budgeting process is often inefficient and only loosely scheduled. In China, the budget process often starts only two months before the fiscal year begins, creating delays throughout the system as each level of government must wait for information from the previous tier before creating its own expenditure and transfer plans. In Indonesia and the Philippines, poor estimates and unpredictable release of transfers over the budget year distort budget execution.

Difficulties with local financial management systems are also common. In China, Indonesia, the Philippines, and Vietnam, programs to modernize financial management systems are in their infancy, particularly at the subnational level. Though management information systems in the Philippines and Vietnam produce general reports, they cannot do so in a timely or accurate way. Year-end accounts are thus not available in Vietnam until 18 months after the end of the fiscal year. In the Philippines, local financial management is still based mainly on manual systems.

Internal and external auditing of expenditures at the subnational level are of extremely low quality, suffering from low capacity and confused mandates. In Indonesia, the legal framework is unclear with regard to the authority of various auditors in examining local budgets. In the Philippines, internal auditing is nonexistent among most local governments, and the regional offices of the Commission on Audit, which have the power to audit local governments, are overstretched. In Thailand, only a few large-scale local authorities have internal auditors, and two external auditing units—the Office of the Auditor General and provincial auditing teams—have considerable credibility but limited capacity to provide services to all local authorities.

Decentralization implies a shift rather than a weakening of systems and capacity at the center. In fact, as the intergovernmental structure becomes more complex, central ministries need to develop new systems to monitor and manage it effectively. Two challenges are typical of East Asian countries. First, development of the systems connecting different layers of government often lags far behind the policy decisions and institutional arrangements

they are meant to support. Cambodia is an extreme case: grant disbursements to provinces are so consistently late and so divergent from initially budgeted amounts that budgets themselves have become virtually meaningless. But similar difficulties with the timely release of intergovernmental transfers are fairly widespread in the region.

Second, central governments face growing problems in monitoring the activities of local governments. China's deficiencies in managing subnational liabilities have already been mentioned. The Philippines and Vietnam have a limited ability to monitor and control the addition of "temporary" or "informal" workers to local establishments. In Indonesia, decentralization has undermined data systems in sectors such as education, for which local authorities are now responsible. As a result, the central government is less able to measure service delivery in these sectors than before decentralization (see chapter 9).

*Accountability systems.* A number of interlocking factors constrain local accountability in East Asia. Upward accountability—or central oversight of local administrations—tends to be stronger than other forms of accountability but suffers from a lack of clarity in functional allocations, incomplete flow of information, and inadequate monitoring. Horizontal accountability—the monitoring of local bureaucrats by local politicians, and of local government by local legislatures and courts—is diluted by clientelist politics and a serious lack of capacity among local countervailing powers. Downward accountability, or responsiveness to citizens, is often interrupted by a tendency to focus on compliance rather than performance.

East Asian countries have historically emphasized top-down, ex ante control of subnational expenditures. As decentralization evolves and local governments gain greater financial autonomy, both ex post review processes (such as external audits) and horizontal and bottom-up systems inevitably become more important in deepening accountability. For any of these to work, local data must be produced, shared, and maintained. In Vietnamese communes, poor record keeping makes monitoring the use of funds extremely difficult. In China, local reliance on extrabudgetary funds has reduced transparency, and thus accountability, in public spending. Thailand and Vietnam have experimented with mechanisms to shift from central con-

trol of expenditures to performance-based accountability, but these are in the early stages.

Low capacity within oversight bodies challenges horizontal accountability at the subnational level. Local legislatures and judicial institutions often lack the financial and human resources to hold local administrations accountable. In some cases, political corruption prevents local politicians from exercising oversight of local bureaucrats. In May 2004, 43 of 55 members of Indonesia's West Sumatra legislative council were found guilty of corruption. Though this experience highlights widespread corruption in local administrations in Indonesia, it also provides a successful example of judicial oversight and prosecutorial effectiveness.

Civil society groups, including the media, can also raise awareness of the extent and costs of weak governance, in terms of monitoring government performance and giving citizens a voice to demand accountability from their leaders (see chapter 12). The importance of civil society grows as decentralization expands citizens' access to government actors. In the Philippines, the Social Weather Stations produced a *Report Card of Pro-Poor Services* to share citizen feedback on public services. Vietnam is launching a similar initiative. In China, some localities have introduced Citizens' Charters through which service users rate how government agencies and public utilities perform against their stated commitments. However, although civil society organizations are growing rapidly in most East Asian countries, they tend to concentrate in national capitals and are therefore less influential at subnational levels. Where they do exist, local civil society groups are constrained by insufficient financial and human resources, political interference, and weak links to central organizations.

International experience shows that accountability stems from numerous processes and relationships, including those outside the formal public sector. Enhancing access to information is a critical step in bringing external pressure to bear on governments. In Mexico, the government has established a System of Evaluation of Municipality Transparency to measure how much information municipal governments are offering their citizens and to encourage greater transparency. In Uganda, after a Public Expenditure Tracking Survey revealed that schools had received only 13 percent of per-student grants, the central government launched a massive

information campaign, spreading the word through the media and on notice boards outside schools and district offices. Four years later, a repeat survey showed that over 90 percent of resources were reaching schools. Community report cards have produced similar successes, notably in Bangalore, India, where citizens rated public services and the media widely disseminated results. Workshops allowed providers and clients to interact, and some agencies took steps to improve their service delivery systems.

Finally, citizens need opportunities to hold local governments accountable. In the Brazilian city of Porto Alegre, an experiment in participatory budgeting improved public service delivery considerably and has since expanded to over 80 cities. The *gram sabha* public forum in Indian local governments and community oversight committees in Bolivia allow citizens to monitor government expenditures and help make decisions regarding future activities. Across the spectrum, the most successful mechanisms tend to be those that link information, capacity, and opportunities for participation.

### Conclusion: Key Messages and Challenges

As the preceding discussion has shown, East Asia's decentralization process—like the region itself—is characterized by heterogeneity as well as a set of shared features, many of which are common to the decentralization experience of other countries around the world. As elsewhere, the thrust of decentralization in the region has been determined largely by structural and political factors. These factors suggest that decentralization is likely to be a pivotal fact of East Asian life for the foreseeable future. It is already affecting prospects for economic development, possibilities for “good governance” in country institutions, and the quality of service delivery, especially for the poor. Some early indicators give reason to hope that outcomes in these areas are trending in the right direction—that is, that the benefits of decentralization in improving access and voice for local constituencies will outweigh the costs of disruption and inefficiency that overhauling formerly centralized institutions inevitably bring. But the decentralization process has been uneven and, in some countries, may actually have stalled. International experience sug-

gests that progress in moving decentralization forward is rarely monotonic; programs proceed in fits and starts. But there is cause for concern in East Asia that a low-level equilibrium has set in, with only minimal reforms proceeding at a glacial pace.

Recognizing the importance of national requirements in developing decentralization approaches, this report does not offer specific recommendations on the way forward. These must be developed at the country level. But the paramount need to make decentralization work broadly across the region may warrant general guidance to policymakers as they think about the strategies needed to advance the range of intergovernmental reforms appropriate to their particular contexts. Drawing on the earlier sections of this chapter, and previewing the themes that will recur in later chapters of this report, the following three broad substantive imperatives merit priority attention in decentralization:

**Improving the organization of the intergovernmental system** will usually require focused attention on policy and, often, legislative development in three core areas:

- *Clarifying the expenditure assignments and functional roles* of the various levels of government with a view to eliminating (or greatly narrowing) jurisdictional overlaps and reducing the gaps between mandates and funding.
- *Rationalizing the vertical and horizontal organization of the intergovernmental system* to ensure an appropriate balance in the roles of central, intermediate, and local authorities, and to inject greater transparency and objectivity into the processes that determine the size and geographic boundaries of subnational entities.
- *Developing systems to facilitate lateral and vertical cooperation* between subnational governments and central government agencies, particularly in the areas of planning and investment.

**Strengthening local fiscal and financial structures** involves expanding the financial resources available to subnational governments while improving their incentives to use these resources efficiently. Three focus areas are evident: *own-source revenues, subnational borrowing, and intergovernmental transfers*. Substantial progress has been made in East Asia with respect to intergovernmental transfer policy

and systems, but this dynamic area will require ongoing attention. In the other two instances, the picture is more problematic. Throughout the region, policy environments are not conducive to the emergence of enhanced own-source revenue or vibrant and disciplined borrowing systems. Little serious policy work is under way, and current solutions tend to be at odds with emerging international best practice. The problems that arise in these areas, including the lack of hard budget constraints at the local level, often stem more from enforcement failures than from poor policy. Rules need to be well designed and effectively enforced. And local authorities need to have incentives to raise revenues and control expenditures. Serious efforts are needed in this area.

**Developing the functional systems** that underpin the effectiveness of intergovernmental structures has three important dimensions:

- *Deepening and enhancing accountability.* Effective accountability systems required to reap the potential developmental benefits of decentralized government are consistently weak across the region. Substantial improvements are needed in formal and informal bottom-up processes of accountability at the local level, and in top-down systems for generating information and effectively monitoring local performance by the center. National and local governments alike need better data on all aspects of the local and intergovernmental system, particularly subnational finance and local government performance in delivering services. Systems must therefore be developed to ensure regular and accurate production and distribution of basic local government data.
- *Improving the performance of intergovernmental functional and management systems.* As intergovernmental structures evolve, systemic “plumbing” needs to be built to allow these structures to function properly. Intergovernmental transfers need to be disbursed, local financial statements need to be produced and audited, and budgets need to be produced in a timely manner. In many East Asian countries, these systems have not kept pace with the evolution of the intergovernmental structure, and local performance has suffered.
- *Building capacity.* The best-designed intergovernmental system in the world will not function effectively without sufficient capacity, particularly in the area of human resources.

While capacity limitations have surfaced as an important issue in decentralization processes throughout the developing world, two aspects require particular attention in the East Asian environment. First, insufficient capacity at the local level is not the only issue; central governments also require improvements in their ability to administer the intergovernmental system and drive the decentralization process effectively. Second, capacity-building efforts that focus purely—or even predominantly—on the supply side are likely to bring limited success. For capacity to expand and endure, reform efforts need to generate effective and ongoing demand for enhanced capacity at the local level, and to create systems for responding to that demand. Reforming subnational human resource systems will be critical to this endeavor.

Finally, in addition to these substantive challenges, three messages on the nature of the decentralization *process* are important:

- Given varying conditions within countries, intergovernmental frameworks will need to be crafted with enough flexibility to allow for appropriate asymmetries in the design and implementation of decentralization structures and processes.
- The inevitably uneven pace of reforms and the need to capitalize on political opportunities as they arise call for a reform process that is more piecemeal than comprehensive. International experience suggests that focusing on a few key areas where change is possible and getting these right is likely to yield greater success than trying to accomplish too much simultaneously on too many reform fronts.
- While the inevitably long-term nature of the decentralization process must be understood, each country’s policymakers should take stock of progress on intergovernmental reforms and assess whether the pace and energy of reforms are sufficient to meet the important challenges discussed in this report. Mindful of the magnitude of problems that are likely to accumulate if local and intergovernmental structures remain weak and incentives are not in place, governments need to combine political capital, strategic focus, and technical effort to ensure consistent progress on decentralization in the region.

## Endnotes

1. In 2001, central government spending on capital in East Asia and the Pacific was 3.6 percent of GDP, compared with 3 percent in Eastern Europe and Central Asia and 1.6 percent in South Asia. (Figures are derived from the World Bank's *World Development Indicators* and World Bank 2004b.)
2. In Indonesia, households perceived corruption as the top national problem. In Cambodia, urban citizens and foreign firms called corruption the leading problem, while rural citizens called it the second most serious problem (after the high cost of living), as did domestic firms (after street crime). In Thailand, respondents called it the third most serious national problem, after the poor economy and high cost of living. See World Bank, Partnership for Governance Reform in Indonesia 2002b; World Bank 2000; and Phongpaichit et al. 2000.
3. For example, in Cambodia, 82 percent of firms reported some level of bribe payments, and 71 percent of large firms suggested that such payments are frequent (World Bank 2004a).
4. This view is consistent with earlier regional analyses of decentralization by the World Bank in Latin America and East and Central Europe (Burki al. 1999; World Bank 2001).
5. To date, only 172 of the 245 functions specified for devolution in the Master Plan have been or are in the process of being devolved, and the rate of devolution has declined over the past two years. The Nine Policy Measures to improve local revenue mobilization, approved by the Cabinet in 1994, have made slow progress toward legal enactment (chapter 2).
6. These assessments are based on initial data that will need to be reviewed over time. Attributing impact to intergovernmental reform is also problematic, as decentralization has occurred in parallel with other policy changes.
7. A review of intergovernmental tax administration in E. Asia is provided in Ebel and Taliencio 2004.
8. *Kabupaten* are districts; *kota* (or *kotamadya*) are cities.
9. These figures are based on a limited sample of countries in each region.
10. Borrowing from private sector sources typically constitutes less than 1.5 percent of total annual subnational revenues in the Philippines, despite the 1996 Local Government Unit Financing Framework, which stresses private lending to local governments as a core objective.
11. The Finance Ministry has imposed a temporary freeze on subnational borrowing, but indications are that this will expire in 2005.
12. There are many legitimate reasons for the center to retain some authority over civil service management, such as to maintain minimum standards for the working conditions and professional qualifications of public servants, to broaden their career paths, and to unify a fragmented nation. On the other hand, as shown by Vietnam's experiment with block grants to districts and departments in Ho Chi Minh City, service delivery and operational efficiency can be improved by extending autonomy over budget allocations to civil service managers and allowing them to keep the savings.

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