

# Fiscal decentralisation in developing countries

## Lessons for Bangladesh



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There is an ongoing debate in Bangladesh in civil society and among policymakers, whether the country should move from a highly centralised unitary state to a more devolved entity. Demand for more decentralisation of government derives from a combination of citizens' wanting to get more involved in the process of government and dissatisfaction with the results of centralised economic planning. To strengthen local governments can bring the state closer to people and force the state to be more accountable to its citizens. During the past two decades, many developing countries have implemented decentralisation reforms. Fiscal decentralisation, the devolution of taxing and spending powers to lower levels of government, has become important to governance in many countries. This brief examines fiscal decentralisation experiences in developing countries and explores factors affecting the reform process that could inform future policy and research on fiscal decentralisation in Bangladesh.

Odd-Helge Fjeldstad

Senior Researcher, CMI  
& Research Director,  
ICTD

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MICHELSEN  
INSTITUTE

### DECENTRALISATION REFORM: GAP BETWEEN PRINCIPLES AND REALITY

There is little agreement among scholars and policy makers, and scant empirical evidence, as to whether the devolution of power to subnational governments actually increases or decreases their effectiveness in supplying public goods and raising own-source revenues. Available evidence is inconclusive on the impacts of decentralisation with respect to citizens' welfare, governance and democratisation.

Roy Bahl (2008) highlights two difficulties in

assessing decentralisation outcomes in less developed nations. First, decentralisation is often a remedy for certain specific political or social problems rather than just a fiscal strategy. Decentralisation reforms are often a response to crisis or shifts in political dynamics. The reforms are rarely adopted primarily for the reasons argued by democratisation and fiscal federalism theories. Second, policy makers commonly give limited attention to the implementation of decentralisation programmes. There is rarely a strong strategic orientation. The main motives for decentralisation reforms

are usually complex with many vested interests. The reforms often suffer from poor intergovernmental coordination, policy inconsistencies and resistance from key stakeholders, including central government ministries and trade unions. Local political realities can severely constrain implementation of even a well-designed intergovernmental fiscal system endorsed by national legislators and administrators. In most developing countries, administrative capacity issues are critical at both the central and subnational levels.

Fiscal data are vital in order to strengthen revenue forecasting and economic and social impact analysis to enhance the quality of policy making at both national and sub-national levels. However, generally, there is a lack of appropriate and reliable data and information for good policy design and administration. Implementation of the reform is often flawed because governments do not fully recognize the benefits and costs of decentralisation and the preconditions necessary for successful reforms. Thus, there is a growing recognition that implementation strategies have received too limited attention in fiscal decentralisation. Paul Smoke (2013) observes: *There has been too much attention on what should be done, and less focus on what can be done given the political, institutional, economic and financial constraints.* Consequently, decentralisation reforms in many developing countries have progressed slowly. It takes a long time for benefits to be realised and recognised.

#### **A SOUND REVENUE SYSTEM - A PRE-CONDITION FOR SUSTAINABLE FISCAL DECENTRALISATION**

In many countries, the expenditure tasks devolved to subnational governments

substantially exceed their capacity to raise revenues from sources under their own control. Local governments must therefore depend on intergovernmental fiscal transfers (including revenue sharing arrangements under which they receive a share of central taxes) to close the resulting fiscal gap. In addition, when any significant taxing power is devolved to subnational governments, existing differences in needs and capacities between different governmental units at the same level of government are invariably exacerbated, thus creating a potential problem of inequality and fiscal imbalance. One cannot design an appropriate system of subnational taxation without simultaneously designing an appropriate system of intergovernmental transfers.

But local governments' own taxation arrangements also deserve more attention. They affect large numbers of people, and can often be arbitrary, coercive, corrupt and non-transparent. They are costly to administer, difficult to enforce, carry high compliance costs and create economic distortions that can undermine important development goals including commercialisation of smallholder agriculture and formalisation of small and micro enterprises. They are often regressive. Without tackling problems of basic design and methods of collection, any top-down drive to increase local revenue mobilisation thus risks being counter-productive.

#### **LOCAL GOVERNMENT "OWN REVENUE" INSTRUMENTS**

The main sources of own revenue for urban municipalities are usually property taxes, business licenses, market fees and various user charges. They have the potential to provide substantial and reliable revenue if well administered, but in practice all have serious drawbacks. For property tax the main constraints include weak capacity to implement accurate valuation practices; poor collection; lack of clear ownership titles; and lack of political support for enforcement. Business licenses create high compliance costs due to complex procedures; may not reflect ability to pay; provide opportunities for rent seeking; and are often poorly administered, so they generate little revenue. User fees may encourage efficient use of public sector resources, but also suffer from defects including inequitable burdens on low income users, ineffective collection and billing arrangements, poor quality services and persistent resistance to payment. However experience also points to opportunities for reform, including simplifying methods of property valuation and upgrading skills; making business license systems simpler, more transparent and effective, for example by introducing single business permit systems; and improving compliance in paying user fees – for example through shared private

### **PILLARS OF FISCAL DECENTRALISATION**

What is the best arrangement of fiscal powers and responsibilities between the different levels of government? The answer to this question depends on a range of preconditions and the country specific context. Decentralisation reform is about much more than technical adjustments of the division of responsibilities between different levels of government. It is very much about power and politics in the individual country. Yet, decentralisation reforms are commonly framed around three pillars:

1. There is a need for clarity of roles and responsibilities between different levels of government, including:
  - Who provides what services?
  - Who taxes what?
  - Who is accountable to whom?
2. Sub-national governments need a minimum degree of autonomy on the expenditure and revenue sides, staffing etc.
3. The third pillar refers to institution building. Sub-national governments must possess the required administrative and technical capacity to effectively carry out their assignment responsibilities.

water taps in informal settlements. Key issues affecting voluntary compliance and social cooperation include citizens' trust in others, and the perceived trustworthiness of government.

Local governments have experimented with a variety of options to improve tax collection including outsourcing collection to central government, private agents and semi-private partners such as market cooperatives. For example in Tanzania collection of property taxes, market fees and other levies has been outsourced to a range of different agents. The evidence is inconclusive as to whether

of being an inefficient, unaccountable and unresponsive provider of public services at the local level. Most subnational governments in Bangladesh will continue to depend on fiscal transfers from the central government. It is important to make the transfers more predictable and transparent. To improve coordination between central and local government should be important aspects of fiscal decentralisation reforms. However, experiences from other developing countries suggest that there is scope for enhancing revenue especially for urban councils by improving the cost effectiveness of collection and reducing losses through evasion and



Implementation of the reform is often flawed because governments do not fully recognise the benefits and costs of decentralisation and the preconditions necessary for successful reforms.

outsourcing has led to better revenue administration; however, it can establish a platform from which future change can be facilitated. Success depends on the quality of local government management, the extent of political support for reform, and the transparency of the process. Assessing revenue potential can be a problem: if this is underestimated, it can result in an agent capturing a disproportionate amount of revenue collected.

#### **CONCLUSION AND IMPLICATIONS FOR POLICY AND RESEARCH**

Decentralisation reforms hold many promises – including local level democratisation and improved service delivery for the poor. However, if fiscal decentralisation is as effective as claimed, one would expect that this would be clearly supported by empirical evidence. But available evidence is inconclusive on the impacts of decentralisation with respect to citizens' welfare, governance and democratisation. It is a matter of fact that effective implementation often lacks behind the political rhetorics. And the effective delivery of promises also depends on a range of preconditions and the country specific context. It is also important to emphasise that decentralisation reform is about much more than technical adjustments of the division of responsibilities between different levels of government. It is very much about power and politics in the individual country.

Fiscal decentralisation deserves more attention from policymakers: it brings many people into direct contact with public authorities and thus plays an important role in shaping state-society relations. Local governments in Bangladesh have a record

of corruption. This requires a multifaceted approach and strong political support from central government, in order to improve administration capacity, encourage compliance, and reduce the scope for corruption and political interference.

Key measures include:

- Improve the availability of good quality information, enhance opportunities for citizens to demand accountability;
- Establish a *Local Government Financial and Fiscal Commission* that can coordinate, compile data, analyse and advice local and central government;
- Simplify revenue collection processes and fees structures, for example for business licenses;
- Adopt a more pragmatic approach to property tax, taking account of the limited capacity of urban councils to undertake valuation and enforcement;
- Harmonise central and local government taxation to reduce double taxation and inconsistent policies.

There is a need for better understanding of technical issues and the political and economic dynamics influencing specific subnational contexts and revenue sources. Future research on fiscal decentralisation in Bangladesh should aim to shed light on the links between taxation, improved service delivery and accountability; and political economy factors associated with different revenue sources and their implications for business development and taxpayer compliance.

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Author: Odd-Helge Fjeldstad. Editor: Ingvild Hestad. Copy editor: Lisa Arnestad.

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