Decentralization and sovereignty: how policy space is eroded

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In many countries, citizens clamor for decentralization which can vest them with greater grassroots power and autonomy. The foundation of decentralization is the "principle of subsidiarity," which assigns power and responsibility to the lowest level of government – the level closest to the people being served.

However, *market decentralization* (another term for "privatization") shifts power and responsibility from governments to firms – even in the areas of health care, education and water services. Particularly in the absence of strong regulation, citizens, especially poor citizens, have little power over firms.

The impacts of decentralization were studied by researchers at the Organization for Economic Cooperation and Development (OECD) in 19 countries, who found that "decentralization has actually led to improvements in poverty reduction in only a third of the cases" (Jutting *et al.*, 2005). Countries where there has been no impact or a negative impact include Uganda, Ethiopia, Mozambique, Vietnam and Sri Lanka.

Many factors contribute to the disappointing impacts of decentralization. This article highlights how the international financial and trade institutions derail decentralization by diminishing "fiscal space" (i.e., options and resources) and transferring the rights of governments to investors. To take back power, citizens must not only struggle to establish accountable, representative government, but also take into account the ways in which the international financial and trade organizations, e.g., the International Monetary Fund (IMF), World Bank and World Trade Organization (WTO), can undercut their efforts.

Budget bosses

During the 1990s, Shahid J. Burki and Guillermo Perry, World Bank Vice President for Latin America and Chief Economist, respectively, engineered decentralization in the region. In *Beyond the Center*, Burki *et al.* (1998) argue that in order to protect against macroeconomic instability caused by subnational (i.e., state and local) fiscal excesses, it is necessary to have a "hegemonic and internally disciplined political party with the power to suppress any defiant behavior on the part of subnational politicians" and to revise electoral rules to "discourage party fragmentation…which makes policy-making more difficult and weakens the position of the president." The authors also stress the importance of rules and legislation that strengthen the office of the presidency in relation to the legislature, including "powers to rule by decree" and "an unassailable presidential veto."

In Latin America, this is called *presidencialismo*. This suits the reformers for whom the ultimate goal of decentralization is the transfer of public responsibilities to private sector actors. Indeed, decentralization redefines the boundaries of the public and private sectors.

The International Financial Institutions – the IMF and the World Bank – centralize power through policy conditionality attached to loans negotiated with the Finance Ministers of developing countries. Some conditions require Presidents to issue "Supreme" or "Executive Decrees." In the aftermath of protests against water price hikes in Cochabamba, Bolivia, the World Bank postponed its requirement that the Executive issue a Supreme Decree further raising water prices. In 2004, a loan called for Mozambique to issue seven decrees.[2] Such measures shift power from the legislative branch to the executive branch of government and undermine the democratic character and functions of the government.

By marginalizing parliaments, Poverty Reduction Strategy Paper (PRSP) processes have also facilitated this shift. Low-income country governments must prepare PRSPs – so-called national development strategies as a requirement for financing. Parliaments need not only greater engagement, but also more power in such processes. As it is, the IMF sets budget parameters for the governments of most low-income and highly-indebted countries to heed.

Donors and creditors do not use their power responsibly when their volatile aid flows create massive budget imbalances. Some countries, such as Ghana and Ethiopia, have absorbed rather than spent aid in order to off-set volatile aid flows, avoid currency appreciation, and build up reserves.[3] In addition, donors and creditors undercut governments when they channel financing through Program Implementation Units (PIUs) which operate in parallel with public administration and budgeting efforts.

When donor priorities appear in the budgets of local governments, these budgets need to be spent on the donors' goals rather than on other local needs. In some countries, such as Mali, donors are requiring governments to devote more resources to foreign-owned projects while local priorities are neglected.[4]

Attempts by donors and creditors to build government capacity for public financial management, including budgeting, have had mixed results. World Bank support for capacity building has encountered "considerable difficulty in the area of public financial management largely because of limited country ownership of the change agenda…"[5] Indeed, such efforts in Ghana were doomed because the government had different goals than the Bank.

Increasingly, donors and creditors provide "budget support," meaning that they pool their resources in support of national and subnational budgets. In 2004, a USAID study finds that the budget support process in Tanzania prompted the disengagement of many parliamentarians (Frantz, 2004, p. 7).

When donors pool their money, it relieves a government of the competing demands of many donors, but it also creates a donor/creditor policy cartel with many "budget bosses."

Steps to shift rights from governments to investors

The World Bank's focus on reforming investment regimes constitutes a centerpiece of its corporate strategy. This emphasis permeates its operations to promote decentralization through structural adjustment, public sector reform,[6] and sector-wide reform (e.g., health care, education) programs as well as its project financing.

Donors and creditors finance privatization, budget austerity, and economic liberalization programs that accompany the decentralization process. The impacts of such policies on local governments are discussed below.

Privatization

1. *Decentralization and Privatization*. Commonly, political decentralization precedes fiscal decentralization, so that local governments inherit "unfunded mandates" – that is, mandates to deliver services without the resources required to do so. This is particularly problematic because local governments may lack access to capital markets and rely heavily upon

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2 World Bank Poverty Reduction Support Credit I (PRSC I), 2004.

3 IMF, "The Macroeconomics of Managing Increased Aid Inflows: Experiences of Low-Income Countries and Policy Implications," 8 August 2005.

4 See the IMF's First Review under Mali's 3-Year PRGF arrangement. April 2005

5 World Bank, Operations Evaluation Department (OED). "Capacity-Building in Africa," 2005, p. 29.

6 In Fiscal Year 2005 almost half of the new Bank projects had at least one component addressing governance and public sector reform.

locally-generated taxes and fees for services. Due to the lack of resources, many local governments are forced to privatize assets and services.

The World Bank sometimes cripples local governments by promoting premature decentralization, placing additional financial resources and responsibilities upon local governments before they are prepared to handle them. (See Box 1.)

Box 1.

DECENTRALIZATION AND SERVICES IN SRI LANKA

The 2003-2006 World Bank Country Assistance Strategy (CAS) for Sri Lanka stipulated that the government would gain access to higher levels of financing if it increased the share of revenues transferred to the local level. On one hand, there is a good argument to be made that decentralization needs to be accompanied by corresponding increases in fiscal resources. On the other hand, the CAS suggests that this transfer will be the principal measure of effective decentralization – a classic case of using a simple input (money) to measure a complex outcome (good local governance). Because more World Bank funds are promised if these transfers are sped up, the government has an incentive to channel significant revenue streams before mechanisms are created for ensuring transparent and accountable governance at the local level. ■

In the privatization process, local governments are often faced with demands that they provide subsidies and guarantees for private firms.

2. *Subsidies.* As privatization proceeds at the subnational level, local governments are often required to provide subsidies for corporations. Some schemes provide "performance-based" subsidies to firms when delivery of services (e.g., health care, education, water) to poor populations is verified. However, there are serious transaction costs and constraints to such schemes, especially in low-income countries and those with weak governance.

Donors and creditors promote subsidies to corporations, since cross-subsidies between sectors (telecommunications and water) or between rich and poor rate-payers violate trade rules.[7]

3. *Guarantees.* Generally, investors expect local governments to provide guarantees – particularly for infrastructure projects – which shift specific price, demand and currency risks onto taxpayers. The Articles of Agreement of the World Bank (IBRD and IDA) require that, if the institution provides a guarantee to a subnational government, it must obtain a counter-guarantee from the central government. However, the World Bank and other creditors and donors launched a new Subnational Development (SND) Facility in July 2006 that offers guarantees to local governments without backing from the central government.

When private ventures backed by a guarantee fail, the local government is likely to assume large, debt-like financial obligations without any mechanisms for restructuring or writing down the obligations. Creditors might intercept transfers from the central to local government, leaving the local government impoverished.

4. *Infrastructure spending.* At present, donors and creditors are promoting infrastructure investment. Soon, infrastructure operations will constitute 40% of the World Bank's lending portfolio. The IMF raised its inflation targets to permit higher levels of government spending for infrastructure, among other things. Local governments are being asked to provide significant infrastructure financing and guarantees relative to their fiscal resources. Indeed, the World Bank estimates that during the 1990s, governments and public utilities provided 70% of the financing for public-private partnerships (PPPs) in infrastructure compared with only 22% from aid, and 8% from the private sector.

In 2005, World Bank expert Antonio Estache (2004) released a study of PPPs in infrastructure from 1994 to 2004 which found that efficiency gains were often at the expense of poor people and poor areas. Risks to government budgets increased as governments offered investors costly guarantees and financial supports that ensure profitability, minimize capital outlays, and greatly increase the fiscal exposure of government. Corruption also increased.

In order to expand the supply of infrastructure and social services, donors and creditors are also scaling up community-driven development (CDD) and social fund (SF) operations which finance community groups, civil society organizations, and local governments. World Bank lending in support of CDD approaches increased from USD 250 million in 1996 to approximately USD 2 billion annual investments (or 10% of the Bank's portfolio) in 2004. Social funds have received World Bank financing in about 60 countries for a total of nearly USD 4 billion from all sources.[8] World Bank evaluators found that:

> The experience with community development shows that despite sophisticated targeting mechanisms, the poorest and most vulnerable generally appear to have been missed while the better off among the community have gained more of the benefits... Where social funds have accounted for a substantial share of public expenditure, such as in Bolivia, Honduras, and Nicaragua, they have distorted the efficiency of resource allocation and have negatively affected sectoral and budgetary planning. And where community development projects have been implemented by setting up parallel structures for community participation rather than by working through local governments, they have actually weakened the capacity of local governments and the decentralization process.[9]

Three out of four of the water components of CDD projects failed.[10] External evaluators participating in a World Bank evaluation of such projects suggested that the Bank cease financing CDD and SF operations until performance can be improved.[11]

Budgets that mortgage the future

1. *Cutting Local Governments Loose.* Since 2002, investment reform has taken center stage in the World Bank's corporate strategy. Decentralization can upset the macroeconomic stability prized by investors. Hence, to restrain demand, restore macroeconomic balances and build creditworthy subnational governments, donors and creditors promote policies to:

- limit fiscal transfers from central to state and local ("subnational") governments;
- allow central government transfers to local governments to be "intercepted by creditors in order to collect debt-related obligations;
- require local governments to adopt hard budget ceilings which prevent central governments from bailing them out.

For instance, prior to the 2002 election in Brazil, leaks revealed that the IMF and the Brazilian Finance Ministry agreed to terms which required, among other things, a reduction in revenue-sharing with the states and municipalities, termination of revenue earmarking, and promises by President Lula Da Silva's new administration to resist pressures to reopen the debt restructuring agreements between federal and subnational governments.[12] This deal, which by-passed democratic debate and decision-making by the Brazilian Congress and people, placed state and local governments under significant fiscal pressure. (See Box 2.)

7 In addition, "non-discriminatory" trade rules do not permit a government to favor domestic firms or disfavor foreign firms engaged in "like" activities. Such rules, where they apply, could require that, where a government subsidizes domestic health care or water companies, it must also subsidize "like" foreign companies. (See GATS Article III, Paragraph 17).

8 Draft Concept Note, International Conference on Local Development, Washington, D.C., 16-18 June 2004.

9 World Bank, Independent Evaluation Group, draft Annual Review of Development Effectiveness (ARDE), 2004.

10 World Bank, Operations Evaluation Department (OED). "Efficient, Sustainable Service for All? An OED Review of the World Bank's Assistance to Water Supply and Sanitation," Report No. 26433, 1 September 2003.

11 See comments by Robert Chambers and Norman Uphoff in Annex R of the World Bank IEG's evaluation of "The Effectiveness of World Bank Support for Community-Based and -Driven Development," October 2005.

12 IMF, Brazil – "Request for Stand-by Arrangement," 30 August 2002, p. 23; and "First Review Under the Stand-by Arrangement and Request for Modification of Performance Criterion," 4 December 2002.

Box 2.

THE CASE OF BOLIVIA

In 2002, World Bank loans required that the Government of Bolivia 1) present a legal opinion confirming the legality of the use of revenue intercepts as collateral to municipal credit operations with any lender; 2) adopt major procurement reforms; and 3) require municipalities to adopt fiscal responsibility laws, which ensure that they maintain hard budget ceilings, precluding bail-outs from the central government.[13] Such steps are intended to improve the access of municipalities to financing from the international capital markets for their local investment programs.

Seven municipalities adopted fiscal responsibility laws and accepted fiscal targets that were based on the IMF's assumption of 4% Gross Domestic Product (GDP) growth in 2001. The actual GDP growth rate was only 1.2% with output declining in all areas except for natural gas production. Central government revenues plunged by 26% in 2001 and general transfers from the central to municipal governments were 11% less than projected. However, the municipalities with fiscal responsibility laws were constrained from borrowing; instead, they instituted new taxes and user fees and carried out cutbacks in programs and services. ■

2. *Budgets and Government Procurement.* Donors and creditors engaged in "budget support" operations are in a position to pressure governments to liberalize government procurement at central and subnational levels. Through procurement practices, governments have always promoted national or local productive, employment, and service sectors. However, as government procurement is liberalized, local suppliers and workers must compete for government contracts with global suppliers. Liberalizing government procurement is a sure path to privatization of services.

In Ghana, a binding condition of a 2003 World Bank loan required the liberalization of government procurement.[14] The loan conditionality was so invasive that a World Bank Board member expressed concern that the World Bank's heavy pressure was forcing Ghana to liberalize well beyond WTO requirements.

In 2005, World Bank evaluators stated that IDA exerted "significant pressure" on the government of Malawi to liberalize its procurement and that the Bank did not pay attention to government concerns about proposed procurement reforms, which were finally rammed through.[15]

Trade

1. *Trade liberalization policies.* By definition, trade liberalization cuts trade taxes, hence putting tremendous fiscal pressure on central governments, which turn to local governments to shoulder greater fiscal burdens.

In sub-Saharan Africa, trade taxes accounted for between a quarter and a third of total tax revenue. Consumption taxes (e.g., the value-added tax, or VAT) seek to recoup lost revenue from trade taxes. The VAT is highly regressive, meaning that it hits low-income groups the hardest.

Low-income countries usually fail to replace lost trade tax revenues from other sources. "Using a panel of 125 countries over 20 years, Baunsgaard and Keen (2005) find that low-income countries typically recover at most 30 cents for each dollar of lost trade tax revenue, even over the longer-term."[16]

A recent United Nations Conference on Trade and Development study predicts that the losses in tariff income for developing countries under the WTO's Doha Round could range between USD 32 billion and USD 63 billion annually. This loss in government revenues – the source of developing-country health care, education, water provision, and sanitation budgets – is two to four times the mere USD 16 billion in benefits projected by the World Bank.

While many legislatures have little influence over decisions to reduce tariffs, they are generally faced with a potentially catastrophic budgetary situation after the cuts are made.

2. *Trade and Investment Agreements.* The WTO, including the General Agreement on Trade in Services (GATS), came into force in 1994. The GATS applies its rules, or disciplines, to about 160 sectors. As *central* governments make commitments under the GATS and negotiate other trade and investment agreements, they are committing *local* governments to conformity with trade rules. These trade rules are enforced on the domestic legal and regulatory activities of "*regional*, or *local* governments" and "nongovernmental bodies in the exercise of powers delegated" by any and all government jurisdictions. These rules create a loss of fiscal and policy space at the local level.

When a government's human rights norms and trade rules come into conflict, the conflict would not be resolved in a domestic court, but rather in a secret international trade tribunal, beyond the public "eye."

A UN report, "Economic, Social and Cultural Rights: Liberalization of Trade in Services and Human Rights,"[17] presented extensive evidence that, although increased foreign private investment can upgrade national infrastructure, introduce new technology, and provide employment; it can also lead to:

- the establishment of a *two-tiered service supply* with a corporate segment focused on the healthy and wealthy and an under-financed public sector focusing on the poor and sick;
- brain drain;
- an overemphasis on commercial objectives at the expense of social objectives which might be more focused on the provision of quality health, water and education services for those that cannot afford them at commercial rates; and
- an increasingly large and powerful private sector that can threaten the role of the government as the primary duty bearer for human rights by subverting regulatory systems through political pressure or the co-opting of regulators. ■

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17 Report of the High Commissioner, 15 June 2002.