

PUBLIC EXPENDITURE ON THE FRONTLINE: TOWARD EFFECTIVE MANAGEMENT BY SUBNATIONAL GOVERNMENTS

Edward Mountfield and Christine P. W. Wong

East Asia has been home to some of the world's most centralized public expenditure management systems. From a macroeconomic perspective, this approach may have had its merits—for example, allowing for a rapid fiscal response during the 1998 crisis. However, such top-down approaches have typically not been conducive to locally responsive service delivery (World Bank 2000d, pp. 31–33). Countries have often achieved fiscal discipline at the expense of effectiveness and efficiency. To accomplish broader national objectives—not only macroeconomic stabilization but also poverty reduction and effective and efficient local service delivery—public expenditure management is moving closer to the frontline.

Intergovernmental reform of expenditure management presents some major opportunities. Local management of spending can support service delivery that is more responsive to the needs and wishes of local people and more efficient given local conditions. Equally, there are significant threats: duplication, poor coordination, growing inequity, and even the collapse of essential services.

Of the five most populous low- and middle-income countries in East Asia—hereafter referred to as the EA5¹—four are designing programs to transfer expenditure responsibilities to lower-level governments. Indonesia is implementing a “Big Bang” decentralization program. Thailand has committed to implementing a gradual but potentially major decentralization program. Vietnam has recently legislated to shift greater expenditure authority and responsibility to provincial People's Councils. And the Philippines continues to explore policy options for strengthening its comprehensive program of decentralization started a decade ago. The fifth country, China, is alone in moving in the opposite direction: since the late 1990s it has instituted a program to reform public expenditure management that will—at least in the short run—increase central scrutiny of local spending. However, since China has gone furthest among the EA5 in assigning spending responsibilities to subnational governments, the recent changes should be seen as part of a continuing effort to find the right balance between central control

and local flexibility, rather than a rejection of decentralization.

Given the EA5's relatively recent moves to decentralize expenditure management, deriving conclusions as to whether these countries have "failed" or "succeeded" in terms of service delivery would be premature. Instead, this chapter reviews experiences so far with decentralizing expenditures in the EA5. The chapter presents some empirics on expenditure decentralization and provides an initial assessment of the nascent expenditure management systems at subnational levels in these countries. Finally, the chapter analyzes the extent to which the incentive framework and institutional environment in each country are likely to foster successful subnational expenditure management.

Subnational Expenditure Management in the EA5: Some Empirics

The extent to which EA5 countries have decentralized public spending varies. By the conventional measure of subnational shares of total spending, China is by far the most decentralized of the five, with subnational spending at 69 percent. It is

followed by Vietnam, with 48 percent. At the lower end is Thailand, where subnational spending is just 10 percent of the total. The East Asian archipelago countries are somewhere in the middle: the Philippines is at 25 percent and Indonesia reached 31 percent after Big Bang decentralization. Table 5.1 compares the subnational expenditure shares of the EA5 with those of other countries.

In a study of some 100 countries, Roy Bahl and his colleagues at Georgia State University found the share of subnational expenditures to be positively correlated with per capita gross domestic product (GDP) and land area, and negatively correlated with ethnic diversity.² Transition economies as a group also tend to be more decentralized than expected from the other variables. Led by the two transition economies of China and Vietnam, the EA5 have decentralized more than the average 14 percent of total expenditures that Bahl et al. found for developing countries, but have decentralized less than the average of 35 percent in developed countries. Even considering these factors, however, the authors found that China and Vietnam were more decentralized than expected in the 1990s, Indonesia and Thailand less, and the Philippines exactly at the expected level.³

TABLE 5.1 Expenditure Decentralization in East Asia in Comparative Perspective

	Subnational expenditure (% of national expenditure)
China 2002	69
Indonesia 2002	32
Philippines 2001	26
Thailand 2001	10
Vietnam 2002	48
Developing countries 1990s	14
Transition countries 1990s	26
OECD countries 1990s	32
Other large countries, 1990s:	
Germany	40
India	46
Japan	61
Pakistan	29
Russia	38
United States	46

Sources: Bahl 2002; World Bank 2003a; staff estimates.

Note: OECD = Organisation for Economic Co-operation and Development.

However, while subnational spending share is a convenient measure for comparing decentralization across countries, it is often misleading when the locus of spending does not coincide with the level of decision making, as has often been the case in East Asia (Bahl 2002). Vietnam is a perfect illustration of this shortcoming. Despite its high subnational spending share, Vietnam was—until it implemented the new State Budget Law in January 2004—formally one of the least decentralized countries in the world. Local governments were essentially carrying out deconcentrated functions at the behest of the central government, which determined service levels and standards.

Another conventional yardstick for measuring decentralization is the pattern of expenditure assignments. Table 5.2 shows expenditure assignments for the EA5 and other countries. China again appears to be the most decentralized of the five. Compared with the other countries, China has transferred a much larger portion of expenditure responsibilities to local governments, including several big-ticket items—not only education and health, which are common local functions in many countries, but also unemployment benefits and pensions. The latter make China highly unusual. Pensions and unemployment benefits often exceed the financing capacity of subnational governments, and their cyclical nature makes them often inappropriate for such governments. In almost all other countries, these responsibilities are either central or shared with state governments. Indonesia and Thailand are also quite decentralized compared with other countries, with education and health assigned solely to local governments. In the Philippines, health is a joint responsibility of state and local governments, while education remains a central government responsibility.

Table 5.2 shows expenditure assignments, but again we must be cautious in interpreting such summary tables. The table identifies only the level of government responsible for providing services, not necessarily the one that finances the services. Indonesia, for example, assigns costly functions like education and health to subnational levels, but finances them through specific transfers from the central government. Subprovincial governments in China, in contrast, receive limited transfers from which to fund their expenditure mandates. Local

governments are responsible for not only providing but also financing their service responsibilities, with little support from either earmarked or equalization transfers.

Differences in how countries report the division of responsibilities may also muddy comparisons. Such differences may simply reflect different transfer instruments. A central government that earmarks transfers for education would more likely report education as a joint responsibility than a central government that provides block grants to local governments.

Given the heterogeneity of the EA5, another dimension is worth mentioning: multiple levels of subnational government. China's intermediate level of government is larger than that of most countries: each such government has an average of 45 million people. Prefectural units—mostly municipalities—have an average population of 3.7 million, making them as large as or larger than provinces and states in many countries. Considering the size of countries themselves is also important in drawing inferences about state versus local service provision. Even accounting for size, China is extreme in having transferred so many responsibilities to the lowest levels: municipalities and counties—not provinces or the central government—are responsible for social welfare provision.

Public Expenditure Management Processes in the EA5

East Asian countries have substantially expanded the extent to which subnational levels manage public expenditure. The most critical expenditure management processes, which are nascent and still evolving, include the following:

Policy analysis and planning. The policy responsibilities of government departments and the legislature must be clear, appropriate, and transparent. An effective policy analysis and planning process should identify clear development goals and priorities, provide a realistic fiscal framework for public expenditure rather than encouraging a “shopping list” approach, and inform planning with sound, evidence-based policy analysis. Such a process should also involve sector departments within the subnational government rather than just planning and finance departments; provide a mechanism for the central government to coordinate policy with

TABLE 5.2 Expenditure Assignments in East Asian and Comparison Countries

Country	Defense	Foreign affairs	Environment and natural resources	Unemployment insurance	Industry and agriculture	Education	Health	Social welfare	Police	Highways
EA5 countries:										
China	F	F	F, S, L	L	F, S, L	L	L	L	L	F, S, L
Indonesia	F	F	..	..	L	L	L	L	F	F, S, L
Philippines (1)	F	F	..	..	..	F	F	F	..	..
Philippines (2)	F	F	..	..	..	F, S, L	F, S, L	S, L	S, L	..
Thailand (1)	F	F	..	..	..	L	L	..	L	L
Thailand (2)	F	F	..	..	..	L	L	..	L	L
Vietnam	F	F	F, S, L	..	F, S, L	S, L	S, L	F, S, L	F	F, S, L
Comparison countries:										
India (1)	F	F	F, S	F, S	F, S	F, S	S	F, S	S	F
India (2)	F	F	F, S	F, S	F, S	F, S, L	S, L	F, S	S	F
Japan (1)	F	F	..	..	L	F, L	F, L	F, L	L	..
Japan (2)	F	F	..	..	..	L	F, L	F, L	F, L	L
Malaysia (1)	F	F	L	..	F, S	F	F, S	F, S	F	F
Malaysia (2)	F	F	L	..	F, S	F	F, S	F, S	F	F
Countries that assign constitutional powers:										
Canada	F	F	F, S	F, S	C	S	S(F)	F, S	F, S	S
United States	F, S	F	F, S	F, S	S	S, F	S(F)		F, S	F, S
Switzerland	F	F	C	C	F, S	C, F, S	S, C	F, C	S	F, S
Australia	F, S	F	F, S	C	S, C	F, S	F, S	C	S, F	F, S
Germany	F	F, S	C	C	C	C, S	C, F, S	C	C, S	C
Austria	F	F	F, S	F	F	F, S	C, F, S	C	F, S	F, S

Sources: World Bank 2003a, annex 4; other World Bank information.

Note: 1 = responsibility, 2 = provision, F = federal/national, S = state/province, L = local, C = concurrent, (..) = not identified.

subnational governments; and institute processes that allow for extensive consultation with service users, frontline providers, donors, and civil society. Finally, both the planning framework and the underlying analysis should be made public and widely disseminated, and the planning framework updated regularly—ideally annually, as part of the budget cycle.

Budget formulation. An effective budget cycle should have a logical sequence and timing and build on the planning framework. The budget should also reconcile development goals and policy priorities with a realistic assessment of fiscal constraints. The budget should cover all subnational expenditures, including capital and current expenditures as well as subsidies, transfers, interest, and net lending. The budget should explicitly incorporate the use of extrabudgetary funds, including those financed by donors; minimize earmarking of resources; and clarify the future budget implications of investment decisions. Once again all stakeholders should be involved, with budgets widely disseminated and enough time allowed for consultation and debate before legislative approval.

Budget execution. Budget execution should adhere as closely as possible to the estimates approved by the legislature (although under clearly prescribed circumstances the finance agency may have the authority to change departmental allocations during the fiscal year). Annual cash requirements for each spending unit should be forecast so cash management is efficient and consistent with releases and authorizations to spend. Arrears should not be significant as a proportion of total spending, and planning and control systems should protect against overspending, provide effective crosschecks between human resource management systems and payroll, and establish competitive and transparent procurement.

Monitoring and accounting. National law needs to establish financial reporting and accounting rules for subnational governments that reflect recognized accounting standards. Subnational governments need to collect comparable data, to facilitate policy analysis as well as management of national fiscal targets. In-year and end-year statements should be produced shortly after the end of the fiscal year and made routinely available to all stake-

holders. And governments should monitor budget outputs and outcomes to the extent possible.

Auditing and evaluation. A clear distinction should be made between internal and external audit. End-year accounts of subnational expenditures should be audited under a reasonably rapid timetable, ideally by an independent auditor general or under his or her supervision. Audit reports should be scrutinized by the legislature and made public in a timely fashion. When the auditor general issues an adverse report, policy makers need to take appropriate follow-up action. Audits should include budget outputs and outcomes as well as financial inputs to the extent possible. They should also systematically evaluate a sample of projects and programs, with the results drawn upon in planning and budget formulation for subsequent years.

Assessing East Asian Countries

To what extent do the EA5 countries have these core expenditure management processes in place? To answer that question, we reviewed published and unpublished reports on expenditure decentralization in these countries.⁴ We found that such processes generally remain weak at the subnational level (see table 5.3). Planning processes are disconnected from fiscal planning and budgeting processes, and poorly coordinated with planning at other levels of government. Budget formulation suffers from major delays and is fragmented, with parallel budgets for investment projects and recurrent expenditures managed by separate institutions. Budget execution is slow, with long delays in effecting appropriations, significant divergence between approved appropriations and outturns, and corruption in procurement. Monitoring and accounting systems often produce data that are neither timely nor accurate. Auditing is typically weak, and evaluation almost nonexistent.

Part of the explanation is that countries such as Indonesia, Thailand, and Vietnam are just beginning to decentralize expenditures. However, time does not automatically solve these problems: China and the Philippines are still struggling to build the institutions they need despite starting one and two decades ago.

We provide further assessment, with country-by-country examples, on the next page.

TABLE 5.3 Strength of Core Expenditure Management Processes at Subnational Levels

	China (1980)	Indonesia (2001)	Philippines (1992)	Thailand (1999)	Vietnam (1994–1996)
Policy analysis and planning	○	●	●	○	○
Budget formulation	●	●	○	●	●
Budget execution	○	○	○	○	●
Monitoring and accounting	○	○	○	●	○
Auditing and evaluation	○	○	○	○	○

Source: Authors' assessment.

Note: ● = strong, ● = medium, ○ = weak. Start date of decentralization in parentheses.

Policy Analysis and Planning. Vietnam has an established tradition of planning at subnational as well as national levels. Provincial Planning and Investment departments coordinate inputs to a Five-Year Plan and a five-year Public Investment Program (PIP). The national Five-Year Plan and PIP then consolidate these plans. However, problems persist. First, under Vietnam's system of "double subordination," reporting arrangements remain confused: the provincial departments of Planning and Investment report not only to the local People's Committee and People's Council, but also to the central Ministry of Planning and Investment, and through it to the National Assembly. Second, the local planning process occurs with little reference to fiscal constraints. Provinces submit investment plans that would typically add up to much more than the resources available. Third, the planning process encompasses only the investment budget (capital projects plus the often donor-funded development projects), paying little attention to the cost implications of development expenditures or the future budgetary implications of new spending commitments. Vietnam has started piloting medium-term expenditure planning, both at national and provincial levels, bringing planning of capital and recurrent expenditures under a single framework. However, establishing this system fully will take some years.

In China, provincial Planning Commissions address the priority areas declared by the central government in its Economic Development Plans. As in Vietnam, capital budgeting is separate from

recurrent budgeting at each level of government. For example, a provincial Finance Bureau determines the annual capital provision, but a provincial Planning Commission allocates these resources between projects. These agencies rarely use cost-benefit analysis or other selection techniques.

In Indonesia, the center has traditionally dominated planning processes. These processes have started to evolve since the Big Bang decentralization of 2001, and the government has introduced a number of subnational planning instruments. Participation of civil society at the village level has greatly increased, reflecting new regulations that prescribe this participation. Planning processes are thus both top-down and bottom-up. However, major weaknesses remain. It is unclear how and when the top-down and bottom-up planning processes are integrated, for example. There is a large amount of duplication between these planning processes, as well as some inconsistency. The planning process is largely devoid of considerations of affordability: only the annual regional plan takes fiscal considerations into account. This results in much disappointment at all levels of government: district governments must make difficult choices and sharp cuts in the wish lists of villages, bureaus, and the district as a whole. Also similar to Vietnam is the focusing of planning on the development budget and capital projects rather than on the budget as a whole. Altogether, this situation is inconsistent with Indonesia's plans to require "performance budgets" from regional governments under Government Regulation 105/2000. However,

only a few regions, such as Semarang, have prepared to move in that direction. The lack of clarity regarding the postdecentralization role of the national development planning agency, BAPPENAS, further confuses these processes.

In the Philippines, the Local Government Code prescribes a participatory approach to planning, but compliance is poor. The code mandates that each local government have a comprehensive, multisectoral development plan formulated by its Local Development Council (LDC) and approved by its legislature. However, fewer than half of local governments have an LDC in place. According to the code, one-quarter of LDC members should come from nongovernmental organizations (NGOs) and people's organizations. However, one survey found that fewer than one-third of local development plans have benefited from meaningful input from NGOs and people's organizations. The planning that does exist focuses heavily on capital projects. Some cities and provinces report having medium- and long-term development plans. However, most smaller local governments have only an Annual Investment Plan. Project prioritization is usually an ad hoc process, conducted with little reference to costs and benefits. Local officials report that their investment plans are formulated independently of regional and national investment plans, and vice versa.

Budget Formulation. In Vietnam, provincial Departments of Finance manage budget formulation at subnational levels, supervised by the provincial People's Council. Province-level spending units supervised directly by the provincial government submit their spending bids to the provincial Department of Finance. At the district level, Bureaus of Finance filter the spending bids of district-level spending units and communes. The provincial People's Councils previously submitted their budgets to the central Ministry of Finance for review and approval by the National Assembly. Under the new State Budget Law, however, the provincial People's Councils have enhanced authority to approve provincial spending plans, with the National Assembly responsible principally for approving revenue shares and transfers from the center, plus the consolidated budget. Transfers from the center to the provinces for stable periods

of three years will also promote local budget planning.

Although seemingly coherent, this subnational budget process has continuing weaknesses. Perhaps the most significant problem is the separate Department of Finance and Department of Planning and Investment at the provincial level, and the relatively weak coordination between these finance and planning functions. This produces a disconnect between planning and budgeting processes, and between recurrent and capital spending, with plans focused on capital investments and little forward planning for recurrent spending. The rural transport sector, for example, has recently attracted major capital investment: only 269 communes now have no road access to district centers. However, a lack of maintenance provisions means that many roads fall into disrepair soon after construction is complete. Requiring communities to contribute to road maintenance places a disproportionate burden on the poor: World Bank staff estimate that such annual contributions equal 9.8 percent of the annual poverty line in the relatively poor Northern Uplands, compared with 4.6 percent in the country as a whole.

In China, the 1994 Budget Law governs the budget formulation process at central and local levels, but major weaknesses in subnational budgeting persist. The period allowed for preparing the budget is too short, often beginning only two months before the start of the budget year in January. This has a cascading effect through the five-tiered system, since each tier has to wait for information from the higher level before it can formulate its own expenditure and transfer plans. Because capital subsidies usually require matching funds, subnational governments have to hold large reserves. Budget formulation occurs on an annual basis, and the budget is not explicitly linked to a medium-term strategy or a multiyear plan. Instead, budgeting is essentially incremental, characterized by passive distribution of resources among existing structures and services. Extrabudgetary funds finance portions of expenditures in most subnational departments, and many local governments finance investments off-budget. The main budget includes considerable earmarking.

Budget formulation in Indonesia's regions remains principally an administrative exercise,

largely guided from the center, with district governments and regional councils getting involved late in the process. All spending units submit their budget proposals to the local government's budget committee, which in East Lombok, for example, includes representatives of the regional secretary, the finance bureau, the revenue office, the planning bureau, and the legal bureau. The budget committee reviews revenue estimates and spending plans before finalizing the budget proposal around October for submission to the Regional Council. At least in some provinces, the Regional Council approves the budget before the start of the budget year in January. However, regional budget preparation during the first few years of decentralization has been compressed as a result of late approval of the national budget, which determines transfers from the center.

These processes are further complicated by continuing confusion regarding relationships between national and subnational governments, and between agencies at each level. According to regulation 105/2000, the Ministry of Home Affairs is still in charge of issuing budgeting guidelines, but the Ministry of Finance sets standards for financial management throughout the public sector.

In the Philippines, the integrity of local budgeting is distorted, as in Indonesia, by poor revenue estimates during the budget formulation process. In particular, the Internal Revenue Allotment (IRA) supplied by the central Department of Budget and Management has been highly unreliable: in 1998 the IRA estimate was 9 percent short of actual releases. The shortfall dropped to 2 percent and 6 percent in 1999 and 2000, respectively, but shot up to 15 percent in 2001. Budgeting is largely conducted in an incremental fashion. Community participation is limited: budget hearings are officially open to all interested parties, but local governments often do not circulate the budget document or expenditure statements.

In Thailand, annual budgeting has been relatively well-established in local administrations since it was first instituted. Local authorities prepare their budgets in conformance with central mandates. Executive bodies usually ready their budget documents between May and July and submit them to the local council in August, with final endorsement by provincial governors or district heads by the start of the budget year in October.

However, only a small proportion of Thailand's public spending is managed at the local level.

Budget Execution. In Vietnam, provincial People's Councils approve subnational budgets. However, provincial and district branches of the State Treasury Department—part of the central Ministry of Finance—supervise financial execution of the approved budget. Treasury offices are responsible for issuing line-item allotments, approving checks drafted by spending units against those allotments, maintaining records of unspent balances, and compiling periodic financial reports. These mechanisms have proven broadly effective in preventing overspending, helping Vietnam earn its reputation for fiscal prudence. Although procedures exist for real-locating the budget during the fiscal year, divergence between budget plans and outputs is smaller than in most countries at similar levels of development. However, multiple layers of control also contribute to delays in projects and programs. Furthermore, a portion of subnational expenditures—although often eventually accounted for by Treasury—remains outside the budget execution process.

Indonesia has established procedures for apportioning and executing the approved budget. However, delays in issuing warrants pose a significant problem. The main reasons for these delays are lack of information about revenues from the center and lack of clarity of central regulations regarding decentralized funds. In the first year of decentralization, many regional governments were forced to engage in a major budget adjustment. The main cause was a centrally mandated increase in civil service wages announced in July 2001 (although contingency transfers offset the impacts of this increase).

In China, likewise, budget execution at local levels has been characterized by slow disbursement. Late approval of the budget and the long delay in effecting appropriations mean that spending units cannot plan their spending efficiently. A significant portion of expenditures thus occurs during the last months of the year.

Procurement processes remain weak and poorly administered at national and subnational levels in most EA5 countries. In Vietnam, the Ministry of Planning and Investment formally oversees procurement at all levels of government, but its scrutiny is weak and indirect, and a clarifying Procurement

Ordinance has yet to be approved. In Indonesia, Law 25 of 1999 (now Law 32 of 2004) allows regions to establish their own procurement regulations, with upcoming tenders published in local newspapers. However, Presidential Decree 18 of 2000 allows for preferential treatment of local bidders, and many regional officials see procurement as a means to support local contractors rather than a way to obtain the best price. In the Philippines, the Local Government Code decentralized procurement to local governments at a time when the legal and institutional framework was unclear and nontransparent. Although the country has since strengthened the national procurement framework, local policies and practices still raise concerns, including delays, excessive local preference, and contract price negotiation, which often becomes an entry point for corruption. In Thailand, local politicians often intrude in the procurement process.

Monitoring and Accounting. Experience from around the world has underscored the importance of having the central government set and enforce standards for financial reporting. National law needs to provide reporting and accounting rules for both the central and subnational levels. Such provisions help ensure that subnational governments generate financial reports that are comparable with those of other localities. They also help ensure that the central government can generate data for the entire government, for both analyzing policy and managing fiscal targets. Local capacity constraints may also require the central government to lead in this technically complex area. However, under a systematic program, local governments can often quickly develop their capacity to fulfill this task.

China, Indonesia, the Philippines, and Vietnam all have programs to modernize their financial management information systems at national and subnational levels. In the Philippines and Vietnam, the central government has the legal authority to set and enforce financial reporting standards. Both countries also have centrally specified charts of accounts, accounting systems, and reporting procedures. However, while these systems can produce general government reports, they are not timely or accurate. For example, end-year accounts are 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 sys-

tems. Each country is implementing new financial management information systems that should strengthen overall government reporting.

In China and Indonesia, each budget level maintains its own accounting system. Both countries have established some reporting requirements, but institutional confusion over the powers of central agencies to specify and enforce these requirements has undermined them. In Indonesia, for example, the decentralization law splits subnational responsibility for financial management between two ministries—Finance and Home Affairs. In both countries, the quality of reporting is poor, financial reports are difficult to compare, and consolidating these reports is difficult. This situation reflects poor financial management information systems. For example, in Indonesia, subnational units submit quarterly budget reports and financial accounts to the Ministry of Finance mostly on paper. These two countries are investing in strengthening their financial management information systems. However, success will depend on their ability to resolve issues regarding the authority of central government to impose accounting systems on subnational governments.

Auditing and Evaluation. In Indonesia, local audit arrangements remain confused. Law 25 of 1999 determined that “prevailing regulations” should govern audits of local budgets. These regulations assigned the central government’s internal auditor, the Supreme Audit Authority, the Inspectorate General of the province, and the Inspectorate General of Home Affairs as external auditors. Presidential Decree 74 of 2001 has since assigned three internal auditors the right to audit local budgets: the local government’s auditor, the province’s auditor, and the inspectors general of line ministries on technical aspects. According to Law 5 of 1973, the Supreme Audit Agency—the only external auditor in the country—has the authority to audit all levels of government. However, a draft law submitted to Parliament in September 2000 puts this authority in doubt.

In Vietnam, the State Audit of Vietnam (the external auditor) has existed for less than a decade. The Ministry of Finance recently issued 21 new auditing standards that reflect international standards and strengthened reporting to the National Assembly. Formally, the State Audit of Vietnam includes provinces and has five regional offices. In practice, however, the role of the state auditor at the

subnational level has not been established, and most auditing is performed by the State Inspection Office (the internal auditor) and the network of provincial inspection offices.

In the Philippines, the Commission on Audit has the power to audit local governments. However, the internal audit function is nonexistent in most local governments. Until recently, the commission's regional directors were overstretched, personally supervising the audit of all government agencies in the region, although the government took steps in 2002 to address that problem.

Auditing is a weak link in China's subnational expenditure management. Local audit bureaus do ex post audits of local budgets. Audit bureaus may also select particular departments for a more in-depth audit and are also charged with auditing extrabudgetary funds. Each local government at the province level and below has its own audit bureau with similar responsibilities. However, although local audit bureaus also report to the People's Congress, they are under the direct authority of the executive branch, compromising their independence. They are also underresourced and in need of staff training.

In Thailand, only a small number of large-scale local authorities, such as the Bangkok Metropolitan Administration, Pattaya City and Nakorn municipalities, have internal auditors. Two external auditing units—the Office of Auditor General and the provincial auditing teams—have considerable credibility but limited capacity to provide auditing services to all local authorities.

In most EA5 countries, subnational budget evaluation is still in the earliest stages of development. In China, local budget evaluation barely exists. In Vietnam, the government has conducted three provincial expenditure reviews and is planning several more. In Indonesia, the head of a region is required to present an annual accountability report to the Regional Council. However, because the budget documentation does not specify measurable targets, evaluating outputs and outcomes is difficult.

Subnational Expenditure Management: Getting Institutions and Incentives Right

The institutional environment for subnational public expenditure management will play an important part in determining its evolution in the EA5. Central

governments have an important role to play. Unless they establish appropriate institutions and incentive frameworks, successful subnational expenditure management processes are unlikely to develop. Key factors include the following:

Clear assignment of responsibilities. Clarity is essential regarding which expenditures each level of government is responsible for. According to Wallace Oates's "decentralization theorem," "each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize the benefits and costs of such provision."⁵ The European Union has adopted the "subsidiarity" principle, which asserts that lower levels of government should have responsibility for spending and delivering services unless there is a convincing case for assigning that responsibility to higher levels.

Matching of resources to responsibilities. The resources available to each subnational government should reflect the costs of the services it must provide. Such a match can occur through some combination of tax and revenue assignment, tax- and revenue-sharing agreements, unconditional grants, conditional block grants (transfers subject to conditions or service standards), targeted grants for specific purposes or projects, and appropriate borrowing authority. These resource flows should be as stable and predictable as possible to facilitate local planning.

Matching of authority to responsibilities. Subnational governments will build stronger expenditure management processes—and deliver services more effectively—if they have the necessary degree of authority over those resources. Central governments sometimes pass functions and resources to subnational governments but then deny them the control they need to deliver responsive and high-quality services. Such overconstrained approaches rest on the often false assumption that central officials have better information and sharper incentives than subnational officials. Such approaches distort expenditure management processes and impede the ability of local governments to innovate. Above all, micromanagement and second-guessing blur the lines of accountability between tiers of government.

Local capacity. Subnational governments need the capacity to develop strong processes for managing expenditures for cost-effective service delivery. In deciding how far to decentralize responsibility for public spending, central governments need to

TABLE 5.4 Do EA5 Countries Meet Conditions for Effective Decentralization of Expenditure Management?

	China (1980)	Indonesia (2001)	Philippines (1992)	Thailand (1999)	Vietnam (1994–96)
Clear assignment of responsibilities	○	●	●	●	●
Matching of resources to responsibilities	○	●	●	●	●
Matching of authority to responsibilities	●	●	●	○	○
Local capacity	●	●	●	○	●
Local accountability	○	○	○	●	○
National accountability	●	○	○	●	○

Source: Authors' assessment.

Note: ● = high, ○ = medium, ○ = low. Start date of decentralization in parentheses.

assess local capacity. Nevertheless, substantive capacity is likely to develop only through “learning by doing,” in which subnational governments are given some budget to manage. Central government has an important role to play in creating such an environment, as well as in mentoring and training local officials.

Local accountability. If subnational expenditure management is to translate into cost-effective services, local governments need to be accountable to citizens and their institutions. Such accountability includes external auditors and representative local assemblies, public interest bodies and civil society, and individuals with concerns and grievances. Analysts often argue that boosting the share of local expenditures financed by own-revenues enhances local accountability (although this argument has deficiencies in countries where only a small proportion of citizens pay direct taxes).

National accountability. Because subnational administrations draw on transfers and deliver services with national impacts, central governments must find a way to hold them accountable but stop short of micromanagement. Toward that end, central and local governments could create multiyear “contracts” covering both expenditure and revenue assignments that include performance criteria and minimum service standards.

Assessing East Asian Countries

To what extent have EA5 countries established these conditions for success? Once again we reviewed

published and unpublished reports on expenditure decentralization. At present, as table 5.4 shows, none of the EA5 countries score highly on any of these conditions. Assignment of responsibility is often fuzzy. Resources and authority over those resources are often poorly matched with responsibilities. Local capacity and accountability—to both local people and central government—are often limited.

The following sections elaborate on this assessment.

Clear Assignment of Responsibilities. A lack of clarity in assigning responsibilities is a common problem in the EA5. In Indonesia, these problems are due mainly to hasty implementation of sweeping changes and the inexperience of reformers. This experience illustrates the difficulty of applying theoretical concepts of decentralization. Based on the subsidiarity principle, the decentralization law (Law 20) of 1999 gave all “authorities” to local governments except those specifically assigned to the center and regions. However, since “authorities” are broader than functions, the result is much confusion over who is responsible for what, from legislation to planning to implementation. Further confounding the assignment of responsibility is the fact that central line ministries still account for a significant amount of local spending. Adding to the confusion and disputes, Law 22 of 1999 called for adjusting sectoral laws and regulations to conform to the new decentralization framework—in effect setting aside the functional responsibilities and operational

TABLE 5.5 Distribution of Expenditures and Revenues in China, by Administrative Level
(percent)

1999	Expenditures					Revenues				
	China	Hebei	Gansu	Hunan	Jiangsu	China	Hebei	Gansu	Hunan	Jiangsu
Province	28.2	26.4	32.8	31.6	25.8	21.2	20.6	16.5	13.6	16.2
Prefecture	30.2	23.7	19.5	22.4	34.7	35.4	23.4	24.9	27.8	43.8
County ^a	41.5	39.2	34.3	37.8	39.5	43.4	35.8	39.9	35.2	40.0
Township		10.7	13.4	8.9	0.0		20.2	18.7	23.4	0.0
Change since 1994/95 (in percentage points)										
Province	1.8	6.8	0.5	5.6	5.8	4.1	0.9	-1.4	-0.4	11.3
Prefecture	-1.1	-1.6	-2.6	1.1	0.1	-5.6	-1.9	-3.0	3.3	-1.8
County ^a	-0.6	5.9	0.2	-2.4	-5.9	1.5	2.5	0.6	0.8	-9.5
Township		-11.0	1.9	-3.8	0.0		-1.5	3.8	-3.6	0.0

Source: World Bank 2002a, table 8.

a. County figures for China include townships.

details that sectoral and ministerial decrees usually contain. Legal battles have ensued, as some central ministries sought to exempt their agencies from decentralization laws, at least until local governments were ready to take on the functions.⁶

In China and Vietnam, the lack of clarity stems from a second dimension of the assignment problem: how to distribute functions among levels of government in a multitiered administrative setting. In both countries, the administrative systems operate as nested hierarchies, in which the central government sets rules only for provinces, which set rules for districts and communes.⁷

China's 1994 Budget Law spells out in broad principles the division of functions between central and subnational governments, but is silent on the division of labor between tiers of subnational government. This leaves essentially all decentralized functions as concurrent assignments for the various subnational tiers. In practice, China typically assigns the responsibilities based on economies of scale and the subsidiarity principle. For example, provinces operate universities and large hospitals, while lower-tier governments run primary and middle schools and small hospitals and health clinics.

This approach has led to two undesirable outcomes in China over the past decade. First, expenditure assignments are murky, with a good deal of uncertainty about which level of subnational government is responsible for what. With all subnational levels jointly responsible, no one is account-

able. Second, this murkiness has worsened the fiscal status of the lowest tiers and adversely affected service delivery. This has been evident in rural provision of basic education: provinces, prefectures, and counties have done little or nothing to help rural townships that lack the resources to implement the national policy of providing nine years of free education.

Table 5.5 shows what happens in the absence of formal rules. For China as a whole, and for three of the four provinces in the sample, counties and townships together lost expenditure shares from 1994 to 1999, indicating that they had fewer resources to finance their responsibilities, which did not change. These trends confirm the complaint in many localities that each administrative level tries to capture more revenues by redefining how to share "local" taxes with the level below. Since the county and township levels together provide the bulk of basic services, including 70 percent of total public expenditures on education and 55 percent of expenditures on health, this trend could significantly undermine services, especially in rural areas. Provinces, in contrast, have gained significant expenditure shares even though they are not directly involved in providing services or redistributing income.

A third result of the lack of clear assignments occurs when central ministries and departments resist giving up their authority under decentralization. In Vietnam, the roles of sectoral ministries and provinces in prioritizing expenditures are

unclear. Ministries establish unrealistic service norms that provinces largely ignore. This phenomenon is common in China and the Philippines as well. In fact, national standard setting on civil service wages and salaries, and even nationally mandated wage increases, are common in all EA5 countries to varying extents. This is extremely disruptive to local budgeting, given the large share of local expenditures absorbed by personnel costs (see chapter 7).

The realities of service delivery are often such that simplistic assignment of complex services to a single level of government is not practical. Most countries have overlapping assignments. However, clarifying responsibility for regulation, financing, implementation, provision, and maintenance of assets is still important, as is ensuring that these assignments are clear to all, including the public. Most of the EA5 countries have considerable scope for improvement in this regard.

Matching of Resources to Responsibilities. The literature on fiscal federalism implicitly assumes that local governments are largely financing their own services—hence the choice between high-tax, high-service packages and low-tax, low-service packages across localities. The reality is that there is no *a priori* reason why, under a well-designed intergovernmental system, the expenditure needs of subnational governments will match their ability to generate own-revenues to meet those needs. Thus, intergovernmental transfers play a crucial role, both vertically (in determining whether local governments have the resources to perform their assigned responsibilities) and horizontally (in keeping interregional disparities to acceptable levels).

All the EA5 countries face problems coordinating the decentralization of revenues and expenditures, albeit for different reasons. In Thailand, the transfer of revenues has outpaced the transfer of responsibilities. In principle, the laws provide local governments with minimum transfers, but the central bureaucracy has been slow to decentralize commensurate functions. As a result, in mid-2003, local revenues were about 22 percent of national revenues, while the country has decentralized only about 4 percent of expenditures.

In Indonesia, even though central authorities scrambled to decentralize expenditures to avoid

huge deficits, they devolved more than enough revenues in 2001 to match expenditure responsibilities. In the Philippines, decentralization has also transferred more resources than responsibilities to the *barangays* (fourth tier), specifying that they can levy a tax of up to 1 percent of gross receipts on businesses and collect fees, but without specifying that they perform any significant duties (Azfar et al. 2000).

China reveals the opposite mismatch: subnational governments account for a much larger share of expenditures (70 percent) than revenues (45 percent). Central transfers—which finance about 45 percent of subnational expenditures on average—fill the vertical fiscal gap. However, the transfer system is not equalizing, often giving more to rich provinces than to poor ones (see chapter 4). Thus, resource gaps emerge in poor regions with inadequate self-financing, and at lower tiers of the administrative hierarchy such as counties and townships. Since fiscal capacities vary greatly across localities—reflecting the uneven distribution of economic activities—the result has been large and growing service disparities between urban and rural areas, and between regions.

As interregional disparities in spending have risen sharply since the mid-1990s, public services have gradually deteriorated in poor regions (World Bank 2002a). In Yunnan Province on China's southwestern border, 106 of 127 counties were reportedly unable to meet budgeted expenditures in 1995. In neighboring Guizhou, the poorest province in China, many counties could not meet payroll (Dai Xiaoming 1997). In the Liangshan Yi minority Prefecture in Sichuan Province, this led to the elimination of free medical care and epidemic prevention programs, among other services. Many clinics and health stations closed, and epidemic diseases thought to have been wiped out reappeared. In 1996, only 40 percent of Yi children attended school, a figure that dropped to 10 percent in poorer villages (Heberer 2001). With ambitious mandates for many public services, local governments must raise their own funds off-budget, relying heavily on user charges to finance primary education, and on the sale of medicines, supplies, and other assets to finance public health.

Fiscal pressures have also reduced the resources available to local governments in the Philippines. With revenues falling from 18.7 percent of gross

BOX 5.1 The Backdoor Route to Decentralization in China

While straining under diminishing fiscal resources but facing growing demands for services, local governments in China have turned to a plethora of fees and levies on local constituents to bridge the budget gap. These include education surcharges, traffic safety fees, family planning fees, and contributions to National Day celebrations and preparation for the Olympic Games. The central government sanctioned these efforts, and encouraged and even urged local governments to “find local solutions.”

Today local governments depend on extra-budgetary resources to finance nearly half their expenditures, on average.^a In 1998, for example, the budget financed an average of only 53 percent of China’s expenditures in education; tuition, fees, social contributions, and profits from school-run enterprises provided the rest. In the health sector in 1999, budgetary appropriations provided only 11 percent of total operating revenues in public hospitals and clinics, while out-of-pocket payments by patients accounted for 59 percent.

A 1999 survey in China’s Shanxi Province illustrated the dominance of fees over taxes in some sectors and localities. The survey found

that annual fee payments averaged almost ¥ 11,000 in the nine cities surveyed, while taxes were less than ¥ 1,500. The ratio of fees to taxes ranged from a high of 13 to a low of 4, with the highest in smaller cities. These fees were almost entirely outside the purview of the budget, as different departments collected and used the fees until public expenditure management reforms implemented since 2002. Once authorized, the reporting requirements for fees were lax, and finance departments were often unable to track total collections and how they were used. Expenditure management reforms are attempting to bring these extrabudgetary revenues under tighter supervision, but resistance is reportedly widespread.

These extrabudgetary funds provide a backdoor route to decentralization in China, as they give local governments real autonomy on both the revenue and expenditure sides, which they lack under the formal budget. However, these funds are not transparent, and the user charges from which they are financed are often highly regressive.

a. Wong 1998; Fan 1998; and World Bank 2002a.

national product in 1997 to 14.6 percent in 2001 and continuing to fall through 2003, the resulting budget deficits and rising interest costs have squeezed social spending and the ability of local governments to fulfill their responsibilities. The decline is exacerbated by budgetary inflexibility at the sectoral level. For example, in education, the ratio of personnel costs to the total recurring budget rose to 92.4 percent in 2001, severely limiting room to maneuver (World Bank 2003e).

None of the EA5 except China has assigned local governments significant revenue bases, and China did so through the “backdoor”—that is, largely off-budget (see box 5.1).

Matching of Authority to Responsibilities.

Another significant shortcoming in the institutional framework and incentive environment for subnational expenditure management has been frequent mismatch between authority and responsibility. Local governments and service providers

often have functional responsibility without the authority to manage related public expenditures. This undercuts the promised benefits of both devolution and delegation strategies (see box 5.2).

One dimension of this problem is a lack of local authority regarding sectoral spending allocations. Directives by the central government often tie a significant proportion of revenues and resources transferred to local governments to specific sectors, functions, or services.

In Vietnam, for example, provincial finance departments must allocate their budgets in accordance with norms specified by central line ministries. However, budgets allocated to provinces have not enabled them to meet all the obligations imposed by the center. Provincial finance departments, in consultation with the People’s Committee and People’s Council, have therefore used their discretion in allocating funds between sectors and spending units. A new State Budget Law, which took effect in January 2004, consolidated this

BOX 5.2 China: Devolution by Default Rather Than by Design

During China's transition to a market economy, decentralization has occurred more by neglect than by design. Subnational expenditures have risen from about 45 percent of the total on the eve of transition to around 70 percent today. However, this increase reflected changes in the composition of expenditures and relative prices rather than a major change in expenditure assignments.

As in other Soviet-type economies, in China the central government was responsible for national defense, economic development (capital spending, research and development, industrial policy, and universities and research institutes), and national institutions such as the judicial system. The central government had delegated to local governments responsibility for day-to-day public administration and social services, such as education (except universities), public safety, health care, social security, housing, and other local and urban services. A large portion of central spending focused on making capital investments and financing state-owned enterprises. When the transition began, the transfer of financing for state-owned enterprises

from the budget to the banking system reduced central spending, while wage increases pushed up the cost of labor-intensive services, which were mostly local. Safety net expenditures—also local responsibilities—rose rapidly with retrenchment in the state-owned enterprise sector, which entailed unemployment stipends, early retirements, and pension payouts. As a result, local expenditures grew relatively.

Behind these numbers, real decentralization had in fact occurred. While local governments are performing largely the same functions as before, under the planned economy they had acted as agents in fulfilling deconcentrated functions of the central government, which bore the costs through revenue-sharing arrangements. During the transition, however, incremental changes in revenue-sharing arrangements weakened and then severed the link between retained revenues and expenditure needs, and local governments became responsible for financing their assigned functions from own-revenues. This devolution had occurred without fanfare in the mid-1980s and was later codified in the Budget Law of 1994.

de facto discretion. Recognizing this reality in law will help clarify accountability and strengthen local transparency. But some constraints on provinces remain. They must spend 15 percent of their budgets on the national priority sector of education by 2000, 18 percent by 2005, and 20 percent by 2010. They must also spend 2 percent of their budgets on science and technology.

In China, a multiplicity of laws stipulating spending increases in certain sectors and regions constrain local governments. For example, the central government required education expenditures to rise to 4 percent of GDP by 2000, that agricultural spending must grow faster than revenues, and that spending on propaganda and culture should be no lower than overall revenue growth. The center also required that spending on science and environmental protection each rise to 1.5 percent of GDP by 2000, and that health care spending keep pace with revenue growth, with per capita spending rising from ¥ 2.6 to ¥ 4 by 2000.

Reconciling all these constraints and unfunded mandates is almost impossible for local govern-

ments. These constraints have contributed to China's backdoor decentralization, whereby local governments have moved more and more funds outside the purview of the budget and fiscal authorities.

In Indonesia, the central government continues to enforce regulations that determine spending on certain items, including the Education Law, which calls for providing nine years of education to all, with free primary schooling. Government regulations 109 and 110 of 2000 also regulate the ceiling for spending by the head of a region and the provincial representative assembly, but these regulations are widely ignored.

Another common problem is a lack of authority transferred from the central or local finance function to local service providers, which have little discretion in using resources. In Vietnam, provincial finance departments required spending units to agree to every detail in their budgets and obtain formal approval before reallocating spending. However, recent decrees have gradually delegated greater budgetary flexibility, within a fixed block

BOX 5.3 The Block Grant Experiment in Ho Chi Minh City

In 1999, the Vietnamese government authorized a pilot to introduce block grant budgeting in 10 administrative units (districts and departments) in Ho Chi Minh City. An early World Bank–sponsored assessment found that the pilots had made significant progress in meeting their objectives:

Restructuring departments and streamlining administrative procedures. In most pilot agencies, restructuring and streamlining had already begun. The pilot gave a further boost to this, although centrally prescribed functional obligations limited the scope for restructuring.

Reducing administrative costs. Reported gross financial savings in the first year of the pilot ranged from 13 percent to 29 percent, based on administrative economies as well as staff reductions. Because departments used the savings to supplement salaries, as planned, net savings were zero.

Reducing overstaffing. Most agencies cut their staff by around 15 percent compared with their quota, and some made bigger cuts. However, most staff were transferred rather than retired or retrenched.

Raising incomes of employees by reapplying savings. Departments used gross savings to raise incomes, with 70 percent going to salaries, 20 percent to a bonus fund, and 10 percent to a staff welfare fund.

Increasing transparency. Departments launched various initiatives to monitor service delivery standards and customer satisfaction. No evidence suggests that service quality declined in the pilot agencies.

Source: Bartholomew et al. 2005.

grant, to spending and service delivery units.⁸ Units will have the freedom to shift resources between recurrent budget lines and—crucially—to use savings from staffing cuts or lower operational costs to finance salary supplements. Selected spending units in Ho Chi Minh City have piloted this approach over two years, and a recent World Bank–sponsored assessment concluded that the pilots may have resulted in significant staffing reductions and savings (Bartholomew et al. 2005). (See box 5.3 for further details on this experiment.)

Nominally decentralized expenditure management regimes involving high levels of central control are likely to be both inefficient and ineffective. Such regimes will tend to make the allocation of resources overly rigid and encourage compliance with rules and red tape rather than a focus on responsiveness and service outputs and outcomes. Such regimes also remove incentives among service providers to find savings, because officials cannot transfer savings within expenditure items or subitems to other categories but must forfeit them to the treasury. Above all, micromanagement and second-guessing blur the lines of accountability for results between the finance function and the spending unit.

Nevertheless, central governments need to manage the passing of budgetary authority to

subnational governments carefully. Checks and balances need to be in place if the move away from line-item budgeting is not simply to replace one form of inefficiency with another. As they lift line-item budget constraints, central governments need to create alternative mechanisms such as stronger capacity and greater ex post accountability for the use of resources and service performance. Strong financial management systems are essential for preserving fiscal discipline. We turn next to issues of capacity, accountability, and reporting.

Local Capacity. Local capacity for managing fiscal resources varies greatly, not only across administrative tiers but also within each tier. As the Ho Chi Minh City block grant experiment suggests, the administrative capacities of large cities may sometimes be equal to those of the central government. That story also clearly reveals that mobilizing these capacities to improve resource allocation and service delivery depends critically on establishing appropriate incentives and constraints.

For the most part in the EA5, however, local governments typically have weaker capacity in expenditure management skills, such as planning, budgeting, execution, audit, and procurement. In China, local public expenditure management is extremely poor. Budgeting is passive and

input oriented rather than results oriented. Budget formulation is almost totally inertia-driven, as it adds incrementally to past year's allocations without focusing on goals, outcomes, or performance. Accounting standards are lax, and waste of resources is common (World Bank 2002a). That these problems persist after more than two decades of economic decentralization suggests that their root cause lies elsewhere. The inefficiencies of local expenditures can be explained by the bifurcated Chinese fiscal system: local officials are often not interested in improving financial management of budgets over which they lack real control; they focus instead on developing extrabudgetary resources over which they exercise near-total control.

Another dimension of the problem is that countries have sometimes made "wrong assignments" by devolving responsibility for providing services to levels of government that do not have the resources and administrative capacity to respond. Again, China provides a good example. Throughout the history of the People's Republic, rural basic education has been the responsibility of township governments, which average 27,000 in population, and their antecedent, agricultural people's communes.⁹ Under the collective economy, public funds of the collectives financed rural education, with teachers mostly paid in "work points," or shares in the collective's net income. Under that system, the level and quality of education varied among collectives, depending on their resources and allocative choices. Through the 1980s the government imposed rising standards on rural schools and teachers, and by the late 1980s directed that all rural teachers be upgraded to the status of public employees. This greatly raised the cost of providing rural education, as the average salary for teachers in state-run schools was several times that of teachers in rural "community" schools.

Expenditure pressures on townships rose further when the government introduced a Compulsory Education Law calling for nine years of Universal Compulsory Education (UCE) by 2000—a level that far surpassed provision in most rural areas. Townships—primarily agricultural units—have no significant tax base, except for the lucky ones in coastal provinces, where township and village enterprises thrive. For them, education is by far the largest budgetary outlay, which even in the early 1990s absorbed 40–60 percent of the total. Despite

pressure from upper levels to comply with UCE, townships in poor regions have not met targets (Wong et al. 1995).¹⁰ At the same time, the strain of trying to do so has led townships to impose escalating fees and involuntary contributions on rural residents, spawning a rising tide of collective protests through the 1990s.¹¹ Thus, decentralizing basic education to townships has hindered the priority national program of universal compulsory education while imposing high tax burdens on local populations.

Local Accountability. Institutions for managing expenditures focused on effective and responsive service delivery are likely to evolve only if institutions also hold local governments accountable for the way they use resources. As previous sections make clear, however, local governments cannot be held accountable for nonperformance if they have not been given clear assignments, if they do not have the resources and authority to respond, or if their assignments and capacities are poorly matched.

One of the key assumptions of decentralization is that local governments are more responsive because they are "closer to the people." The literature on fiscal decentralization tends to emphasize bottom-up mechanisms of "voice" (elections) and "exit" (mobility), both exercised by the electorate. In the nascent democracies of Indonesia and Thailand, these mechanisms may take time to develop. Even in the Philippines, where grassroots democracy began a decade earlier, a 1999 study found that a lack of information limited popular influence on local decision making—citizens generally knew less about local government than about national government. While citizens rely on the media for information on the national government, they rely largely on local officials and personal contacts for information on local government, as the media tend to focus only on "big news." In turn, local officials have little awareness of the preferences of local citizens, although municipal officials were more aware than provincial officials. In the Philippines, decentralization also does not seem to have improved civic discipline despite the democratic setup. Measured corruption remains high and has grown under decentralization (Azfar et al. 2000).

Analysts also often assert that local taxing authority enhances local accountability: when local citizens

are paying directly for public services, they devote more attention to local politics and officeholders. However, this assertion lacks empirical justification anywhere in the world, is conceptually suspect to the extent that it elides citizens and taxpayers, and is particularly questionable in the EA5, where only a small proportion of citizens pay direct taxes.

The exit option is not an effective mechanism for holding local governments accountable in countries where government is the sole provider of many services. This is true in China and Vietnam, where private providers are just emerging in vital services such as education and health care, and where government monopolies and administrative restraints hinder the development of many services. In these countries, people's option of moving to another jurisdiction ("voting with the feet") is constrained. Political culture also hinders the responsiveness of local governments and service providers. Officials who are used to responding to rules and regulations will need time to become more client oriented.

National Accountability. The transition economies of China and Vietnam, and to some extent the other countries in the EA5, also have top-down mechanisms to hold local governments accountable. A study of transition economies in Eastern Europe and the former Soviet Union found that intermediate levels of government tended to respond to higher levels of government rather than to local people (Wetzel 2001).

In China and Vietnam, through the *nomenklatura* system of appointing the top officials, the Communist Party continues to wield control over senior civil servants. In China, the government relies on elaborate systems of evaluation and performance bonuses for top officials at all levels of government to induce compliance on priority goals such as growth, family planning, and prevention of social unrest. These mechanisms have been spectacularly successful in ensuring that local officials promote growth and invest in basic infrastructure. Judging from the remarkable record of high and sustained growth rates over the past two decades, China is arguably a successful case where the central government gets more of what it wants by giving incentives to local governments to fulfill the central agenda. This is the argument of the so-called "market-preserving fiscal federalism" school. That approach

has been far less successful in meeting other targets, however, such as exerting aggregate fiscal discipline, ensuring the delivery of vital services to all citizens, and protecting vulnerable social groups.

Although Vietnam remains a one-party state, the National Assembly is growing in importance, reviewing government plans, budgets, and implementation and exercising its constitutional authority as the highest organ of the state. The bureaucracy sees the National Assembly as a significant source of authority and a potential arena for independent criticism of government performance. However, the People's Councils at provincial levels and below have yet to emerge in all but the major cities as significant checks on the executive. The memberships of the People's Councils (the legislature) and the People's Committees (the executive) often overlap, and their capacity is often limited.

Given the fragile nature of local democracy in EA5 countries, the central government plays an important role in managing decentralization. It must have strong capacity to monitor and evaluate decentralization, and it must set up mechanisms to hold local governments accountable in fulfilling their responsibilities. But central governments must balance these imperatives against the need to give local governments autonomy and incentives, and the need to guard against micromanagement and the reassertion of authority.

The availability and timeliness of information on subnational governments is weak for most countries in the world, and the EA5 is no exception. Improving local transparency and information flows is vital to building subnational accountability to both citizens and higher-level governments.

Conclusion

Building sound public expenditure management processes at the subnational level in the EA5 is a large and daunting program. The success of that program will depend on establishing appropriate institutions and incentives. In other parts of the world, expenditure management processes and the supporting institutions and incentives evolved over decades and even centuries. The East Asian experience is still unfolding. Nevertheless, a number of preliminary conclusions emerge from this review of the region's early experiences in decentralizing public expenditures.

First, expenditure management processes at the subnational level are generally weak. Planning processes are disconnected from fiscal planning and budgeting processes, and poorly coordinated with planning at other levels of government. Budget formulation suffers from major delays and is fragmented, with parallel budgets for investment projects and recurrent expenditures managed by separate institutions. Budget execution is slow, with long delays in effecting appropriations, significant divergences between approved appropriations and outputs, and corruption in procurement. Monitoring and accounting systems often produce data that are neither timely nor accurate. Auditing is typically weak and evaluation almost nonexistent.

Part of the explanation is that countries such as Indonesia, Thailand, and Vietnam are just beginning to decentralize expenditures. However, time does not automatically solve these problems: China and the Philippines are still struggling to build the needed institutions despite starting one and two decades ago. There is no regional panacea: every country will need to find its own way forward. Nevertheless, all the EA5 countries clearly need to prioritize strengthening core expenditure management processes at subnational levels as part of wider decentralization programs. In so doing, countries need to devote attention to budget formulation and execution, and focus on “getting the basics right” rather than attempting to jump to any perceived world “best practice.”¹² Most EA5 countries should pay early attention to coordinating subnational planning and budgeting, integrating extrabudgetary resources into the budget process, and strengthening information on financial management.

Second, none of the EA5 countries score highly on the institutions and incentives needed to manage subnational expenditures effectively. Assignment of responsibilities is often fuzzy. Resources and the authority to manage those resources are often poorly matched with responsibilities. Local capacity and accountability to both local people and central government are often limited. Although EA5 countries can take immediate steps to strengthen expenditure management processes, governments cannot expect healthy local institutions to develop organically until they have addressed these structural issues. Over the longer term, central governments need to assign functions

clearly and match resources and authority to responsibility. These efforts should go hand in hand with strengthening capacity and accountability institutions at both local and central levels.

Third, decentralizing expenditure appears to have yielded some benefits. In particular, given flexibility and the right incentives, local governments have shown significant capacity to innovate, both in responding to local demands and conditions and in achieving cost savings. Innovations in service delivery associated with flexibility given to frontline service providers by subnational governments in Vietnam and China are cases in point. Such innovation has occurred despite imperfect conditions for decentralization and its incomplete nature. However, major distortions have emerged as well. In particular, inequalities in service provision have often grown. EA5 governments need to pay greater attention to the impacts of decentralized management of public expenditures and service delivery on poverty reduction and equity. The process for learning through local innovations must be formalized. Both positive and negative experiences need to be analyzed, compared, and disseminated, and both local and central authorities must respond flexibly to facts on the ground. Central governments—as well as regional groups such as the Association of South East Asian Nations (ASEAN) and international organizations such as the World Bank—have an important role to play in capturing and disseminating such lessons.

Fourth, perhaps the defining challenge in EA5 countries is to balance the need for bottom-up local discretion with the need for top-down direction in subnational expenditure management. In country after country, central ministries continue to overplay their role by creating unfunded mandates and impinging on the necessary discretion of local governments. At the same time, central governments play an important role in guaranteeing minimum service standards, transparency, and accountability; in transferring resources between regions; in ensuring coordination between central and local initiatives as well as between local initiatives; and in creating incentives for developing local expenditure management capabilities. This is particularly the case given the weaknesses of local democracy in EA5 countries. Efforts to decentralize public expenditures need to focus on redefining the role of central ministries as well as developing new roles for local agencies.

Endnotes

1. Our study does not include Cambodia.
2. The study sample included countries for which subnational budgetary data were available from the International Monetary Fund, the World Bank, the Organisation for Economic Co-operation and Development, and other sources.
3. Bahl's regression results (2002) showed a "decentralization effort" of 2.6 for Vietnam, 1.4 for China, 1.0 for the Philippines, 0.9 for Indonesia, and 0.6 for Thailand. The author measured decentralization as the ratio of actual subnational expenditures to "predicted" expenditure share.
4. In the cases of China and Vietnam, we drew on our own interactions with central and subnational governments. We also benefited from conversations with colleagues in the World Bank's East Asia and Pacific Region.
5. The classic formulation of this can be found in Oates 1972.
6. Examples include the ministries of Land Management and Investment Approval (World Bank 2003a).
7. Russian-educated Vietnamese often refer to this nested hierarchy as the "Matrouchka" system.
8. Government of Vietnam, Decision 192/2001/QS-TTg: 17, Decision of the Prime Minister on the Expansion of the Pilot Block Grant Scheme, 2001; Government of Vietnam, Decree 10/2002/NS-CP, Decree Regarding Financial Regulation of Service Delivery Agencies Whose Operation Generate Revenue, 2002.
9. Townships were traditionally units of rural government. They were replaced by people's communes during the period of collective agriculture. When the communes were disbanded in 1983, townships were restored as units of government.
10. At year-end 2000, the deadline for reaching the targets, 500 of China's 2,100 counties had not yet achieved UCE, and another 600 counties needed help in shoring up their UCE status. In Gansu province in the northwest, 35 of 86 counties had not achieved UCE. Among them, 6 counties were not yet providing even six years of primary schooling (World Bank 2002a).
11. Responding to these protests, in 2001 the government introduced a major reform program to eliminate all rural fees, and is incrementally addressing excessive decentralization to rural townships of key functions such as basic education and health.
12. On the case for "getting the basics right" in public expenditure management, see Schick 1998.

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