Decentralization and quality of government

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Introduction

The results of empirical work addressing the relationship between decentralization and quality of government do not prove conclusive due to mixed theoretical suggestions (Breuss and Eller, 2003). On the one hand, decentralization has many dimensions, each of which may have different impacts on the quality of governance; thus, for example, Schneider (2003) distinguishes among administrative, fiscal, and political decentralization, and Treisman (2002) considers structural, decision, resource, electoral and institutional decentralization. On the other hand, good governance is also a multifaceted concept; thus, for example, Kaufmann et al (2006) consider six dimensions governance (voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law and control of corruption) and La Porta et al. (1999) classify good government performance variables into five different groups (interference with the private sector, efficiency, output of public goods, size of public sector and political freedom). Last but not least, much of the apparent impact of decentralization on government efficiency disappears when basic structural variables such as economic development and political regime are incorporated into the analysis (Dwyer and Ziblatt, 2006).

 As an alternative to these broad approaches and while remaining aware that many aspects of the quality of government are non-economic, other more functionalist concepts of quality can be used in order to facilitate policy design and implementation. In the European Commission (2004), quality of public finances concerns the allocation of resources and the most effective and

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efficient use of those resources in relation to identified strategic priorities. Priorities can be related to the academic functions of government, such as stabilization, allocation, distribution and other public administration goals (Afonso et al, 2003) or based on a concrete agenda such as the Lisbon strategy for growth and employment (European Commission, 2002).

The Lisbon agenda has recently been reviewed to include cohesion policy in order to concentrate most resources on a few areas with a high impact on efficiency (as described in section 2). After discussing the international guidelines to measure public sector efficiency (section 3) and some practical proposals to measure it in practice (section 4), this paper presents some evidence from the intense decentralization process undertaken in recent decades in Spain (section 5). This evidence corroborates the idea that performance measures need to be review to capture the different causes and effects of each decentralization process and to take into account the complementarity between the different tiers of government.

The alignment of cohesion policy with the Lisbon objectives

The European Commission has recently launched a revised Lisbon Strategy characterized by a new three-year governance cycle and greater focus on a few areas with a high impact on efficiency: investment and work, knowledge and innovation as well as more and better jobs. The starting point of the cycle is the *Integrated Guidelines for growth and jobs 2005-2008* adopted by the Council on the basis of the Commission's proposal. Based on these guidelines, the Commission presents a *Community Lisbon programme* which covers the activities to be undertaken at Community level, and the Member States draw up *National Reform Programmes (NRPs)* describing their priorities and policies according to the Lisbon strategy. Finally the Spring European Council reviews the progress and gives new policy orientation on the basis of an annual *Commission report* assessing the progress identified by Member States and the proposals to update the initial guidelines.

Regional policy has always contributed, albeit indirectly, to growth and employment, but it was not until the 2007-2013 Cohesion program, when the National Strategic Reference Frameworks (NSRFs) , were expressly committed to taking into account of the Lisbon goals. A few of the first NRPs (2005) and half of the NRP implementation reports (2006) presented sufficient explanation of how NSRF priorities are related to NRP ones.

In this context, the Committee of the Regions (CoR) has expressed its concern about the lack of consultation of regional and local authorities in the preparation of the NRPs as revealed by a 2005 CoR survey. As a result of that concern, the CoR has delivered a clear message to the European Council on the need for Member States to consult their regional and local authorities in order to improve the deficient regional dimension of the NRPs and at the same time launched a Lisbon Monitoring Platform at the 2006 Territorial Dialogue meeting.

The 2006 Spring European Council has welcomed the initiatives taken up by the Committee of the Regions and has asked for summary reports in support of the Partnership for growth and employment in early 2008. More recently the European Commission has expressly recognized that the involvement of local and regional authorities in the European strategy for jobs and growth is absolutely vital.

Guidelines for measuring public sector efficiency

Governance (government performance) indicators can be conceptualized at different levels depending on what is being measured (Shuders & Nahem, 2004). The annotated bibliography concerning Institutions and economic performance of Malik (2002) or the forty-seven data sets used by different projects on measuring governance reported by Besançon (2003) are a few examples of the vast literature on governance indicators and of the broad scope of the subject (See an updated list of general literature in UNDP Oslo Governance Centre).

Measures of governance can be broadly categorized as process and performance measures (Knack and Manning, 2000), the former capturing the institutional arrangements associated with better government performance, whereas the latter assesses government effectiveness (Malik, 2002). Institutional performance in turn falls into three categories: economic, political and cultural, which in some sense can respectively be related with efficiency, distribution and beliefs (La Porta et al, 1999)

The economic efficiency of an organization is given by the equation Productivity = Output/Input and its measurement requires the homogeneous valuation of both output and incomes. The standard guidelines are provided by the System of National Accounts (SNA), the current version of which was approved in 1993 by the United Nations Statistics Commission at the proposal of the five major international bodies (UN, EU, IMF, OECD and WB, 1993): "Market prices are the basic reference for valuation in the System. In the absence of market transactions, valuation is made by reference to market prices for analogous goods or services (services of owner-occupied dwellings) or according to costs incurred (non-market services produced by government)". (SNA93 §2.68). Since "there are no markets for collective services such as public administration and defence (and), even in the case of … services provided to individual households, suitable prices may not be available …(given the) differences between the types and quality of services provided, and also to ensure that the various non-market services produced by government units and NPISHss are valued consistently with each other, they are all valued in the System by the sum of the costs incurred in their production: that is, as the sum of Intermediate consumption, Compensation of employees, Consumption of fixed capital, Other taxes, less subsidies, on production. The net operating surplus on the production of non-market goods or services produced by government units and NPISHs is assumed always to be zero". (SNA93 §6.90 y 6.91).

When writing this paper a full set of 44 consolidated recommendations, made by the Advisory Expert Group (AEG) for the update of the SNA 93 and prepared by the Intersecretariat Working Group on National Accounts (ISWGNA), has

been adopted by the UN Statistical Commission at its 38th session held in March 2007. The initial ISWGNA document included additional considerations on five controversial issues and after considerable effort consensus has emerged in all of them, except in the "Other non-market producers: cost of capital of own assets" issue. A majority of countries and AEG members are in favour of including an estimate of the return to capital in the measurement of non-market outputs as in the market sector. In fact, the preliminary draft of chapter 6 of the SNA93 Rev.1 states that (6.125) "The value of the non-market output provided without charge to households is estimated as the sum of costs of production, as follows: a. Intermediate consumption; b. Compensation of employees; c. Consumption of fixed capital; d. A return to fixed capital e. Rent on land used in the production, if any; f. Other taxes". However, many other countries, mostly European State members concerned by the impact on GDP which is the balancing resource of the EU budget, point out that the required estimates of capital stock are not well developed, such that even an estimation of consumption of fixed capital is difficult, and inappropriate rates of return may hamper comparability among countries. Finally the ISWGNA proposal to the Statistical Commission was that more research should be undertaken and in the meantime, the updated 1993 SNA will recommend that countries continue with the current 1993 SNA recommendations regarding the estimation of non-market output. (The same as the European System of National and Regional Accounts, ESA 95)

The consolidated recommendations made by the Advisory Expert Group (AEG) also included a postscript concerning five clarification items that involve some degree of change in the existing SNA text, mostly regarding harmonisation with other statistical systems. One is "the measurement of the volume of non-market output". On the basis of a proposal prepared by François Lequiller from the OECD, the AEG is considering including in the corresponding section of chapter 16 on price and volume measures some of the suggestions put forward by the 2005 Atkinson report based on the experience of the United Kingdom's National Statistical Office, the 2001 OECD Manual on Measuring Productivity and the

2001 Eurostat Handbook on Price and Volume Measure. The 2001 Eurostat Handbook recommendations were embodied in the European Commission Decision of 17 December 2002 to further clarify the principles for the measurement of prices and volumes contained in chapter 10 of ESA 95, in order to improve the comparability between the Member States in the data for changes in real Gross Domestic Product (GDP). Basically the regulation recommends the output approach as the best method to measure the volume of individual services and the input approach as the second best method to measure the volume of collective services, while activity and outcome approaches should be avoided.

A recent proposal by the ISWGNA to present an initial volume of the 1993 SNA update, with only the chapters representing the SNA central framework in terms of accounting conventions, leaves the controversial issues open to further discussion until a second volume is published in 2009.

In the meantime a number of countries are developing direct volume measures of government output, although only a few (the United Kingdom, Australia, Italy, the Netherlands or New Zealand) cover a significant portion of it, such that cross country studies use somewhat crude measures of government efficiency.

Measuring the relative efficiency of public expenditure in practice

Over the last ten years several methods have been proposed to measure relative efficiency of public expenditure. In two recent European Central Bank working papers, Afonso, Tanzi and Schuknecht (2003, 2006) employ a performance indicator as a proxy for output, comprising about a dozen indicators grouped by activities (administration, education and health) and outcomes (allocation, stabilization and distribution), and use total government expenditure as a ratio of GDP as a proxy for input. With these two variables they calculate the input and the output oriented efficiency coefficients, as the horizontal and vertical distances with respect to the efficiency frontier. As noted in the conclusion of the papers "the results have to be seen as indicative and

need to be interpreted with great care" until further developments provide more specific insights and lessons. Thus, for example when the European Union efficiency frontiers are used as a reference (Figure 1) it might be deduced that the governments of the 12 new member states (white points) are much more efficient than the governments of the 15 older members, or that Spanish government efficiency fell sharply after the incorporation of Cyprus or Lithuania. Some of these misleading results might be partially avoided by using more sophisticated techniques, such as stochastic frontier analysis instead of data envelopment analysis (Crawford et al, 2003), although it remains clear that further conceptual research is still required.

Figure 1. The enlargement of the UE government efficiency frontier
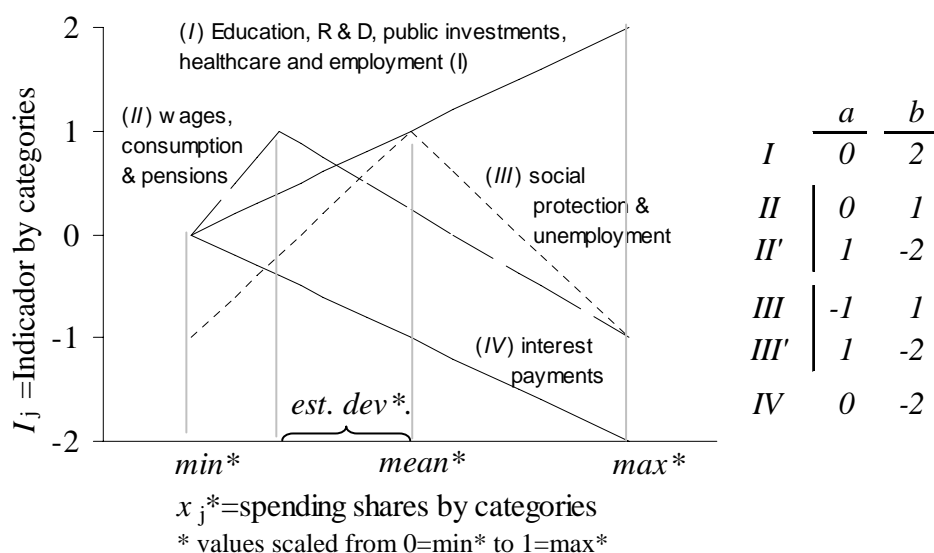Data from Afonso et al. (2003, 2006)
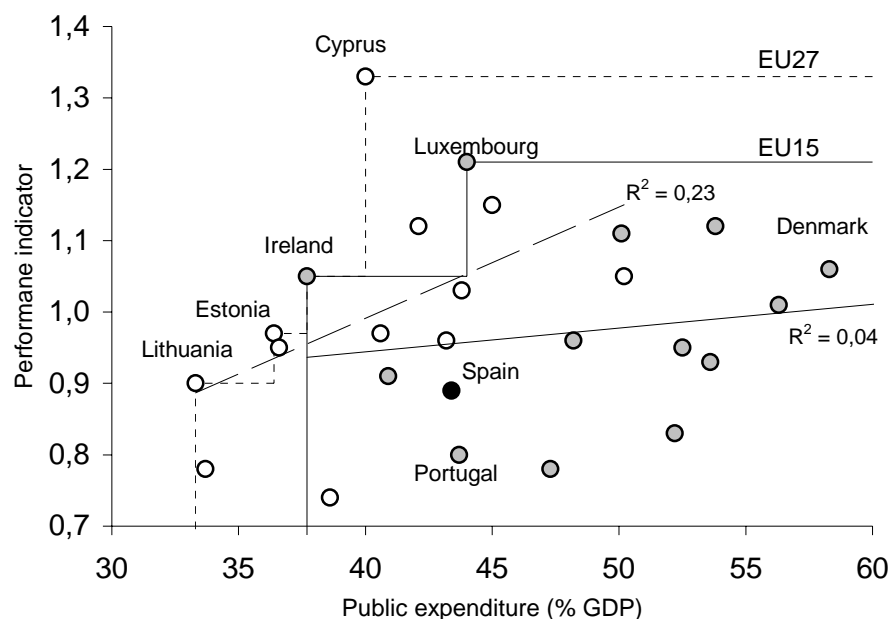
A different approach consists of relating the composition of government expenditure to achieving certain previously defined strategic goals, as proposed in the European Commission (2002), where a synthetic indicator is developed on the basis of previous research into the impact of different expenditure categories (inputs) on long-term growth (outcome). According to the literature reviewed and the preferences of EU policy-makers evidenced in Council conclusions or Commission proposals, the different categories of public spending are classified into four groups, depending on their assumed efficiency-

enhancing nature. The comprehensive expression used in the European Commission (2002, 107) can be simplified as follows:

$$I_i = \sum_j a_j + b_j \, x_{ij}^*, \qquad x_{ij}^* = \frac{x_{ij} - n_j}{m_j - n_j} \qquad [1]$$

where the indicator I of country i depends on the shares x of the specific components j in total spending, scaled from 0 to 1 by subtracting the minimum value and dividing by the range (maximum-minimum) with respect to the sample of countries. The a and b parameters take the values shown in figure 2 where, for the sake of simplicity, the same range is assumed for all categories.

Figure 2. The impact of public expenditure on efficiency
(as assumed by the European Commission: 2002)

	a	b
I	0	2
II	0	1
II'	1	-2
III	-1	1
III'	1	-2
IV	0	-2

x_j*=spending shares by categories
* values scaled from 0=min* to 1=max*

Decentralization and government efficiency in Spain

The historical trend toward increased fiscal centralization reached a peak during the second half of the twentieth century in the industrialized countries and in Europe the current process of downward devolution is occurring together with upward devolution to Community institutions. As concluded by Oates (1999),

while the existing literature in fiscal federalism can provide some general guidance on these issues, … we still have much to learn!

The economic role of decentralization is to reveal preferences on local goods and to introduce institutional competition in order to improve efficiency and accountability. However economic principles are often secondary to historical and political considerations. As concluded by Rodden (2004), decentralization and federalism do not easily translate into gains in efficiency and accountability as predicted by the first generation of theory, and subsequent empirical studies should consider that different types of decentralization have different causes and effects. Despite the difficulty in translating the experience of one country to another, Joumard and Kongsrud (2003) have highlighted a few general trends and common lessons on the basis of OECD economic surveys. First, the observed growth of sub-national spending does not necessarily reflect greater power, due to the increase in grants, norms, standards and other rules imposed by central governments. Second, on-going assessment of the local nature of the activities assigned to local administrations is required. And third, while own resources do not match spending responsibilities, the design of intergovernmental grants and transfers is critical and a better alignment of policy objectives between donors and recipients remains the main challenge in this respect.

In the second half of the 1970s, Spain initiated a democratization process followed by rapid advances in social and public services. In just a decade, from 1975 to 1985, non-financial general government expenditure rose sharply by 17 percentage GDP points (Figure 3). During this period an intermediate tier of government was developed by constitutional mandate and in the mid 1980s, at the same time as Spain joined the European Community, a rapid and sweeping process of power and resources transfer from central government to the seventeen new regional authorities was initiated. In two decades, from 1985 to 2005, regional expenditure increased by 10 percentage GDP points (Figure 3) and today accounts for some 40 per cent of general government expenditure, whereas the share now controlled by central government is only 20 per cent

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(social security and local government have remained at around 30 and 10 per cent respectively). As pointed out by López-Laborda et al (2006), what was a rigidly centralized country has emerged as one of the most decentralized in the world.

Figure 3. Non-financial revenue and expenditure as a share of GDP
(Eurostat and MEH data)
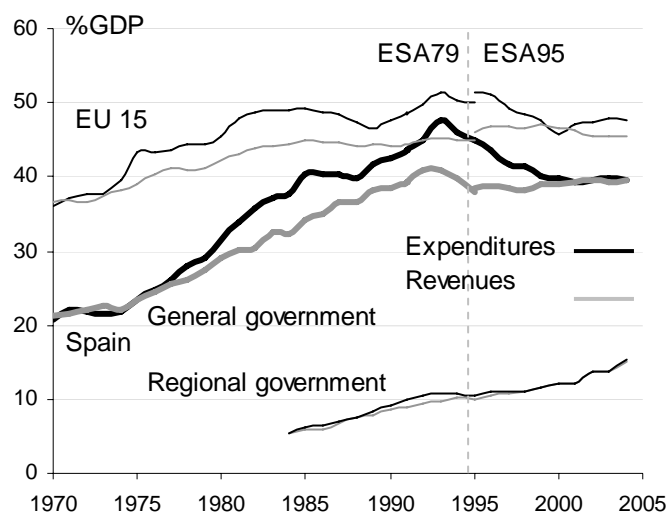
For historical and political reasons the current Spanish decentralization process is characterized by certain asymmetries (Viñuela 2000 and García-Mila and Mcguirre, 2007). With regard to the revenue side, two regions (The Basque Country and Navarra) were granted "special status" with almost full fiscal autonomy being conferred, while the other fifteen with a "common status" have gradually been assuming an increasing degree of co-responsibility and certain legislative capacity. As regards expenditure, the 1978 Constitution designed two different ways to accede to self-government (Molero, 2001), the two special regions and five of the common regions (Andalusia, The Canary Islands, Catalonia, Galicia and Valencia.) known as the "fast track" regions assumed most of their spending responsibilities in an initial wave of transfers, while the other ten regions have had to wait before claiming a similar level of expenditure, after assuming recently education and health care which accounts for more than a half of regional budgets. (see Figure 4). The ongoing revision of the financing system aims to align the increasing tax autonomy with spending

responsibilities in order to enhance accountability and, as pointed out by the last OECD Economic Survey of Spain (2007), "to evaluate the quality of public policies is a promising idea for comparing the management methods of the various government agencies and boosting efficiency"

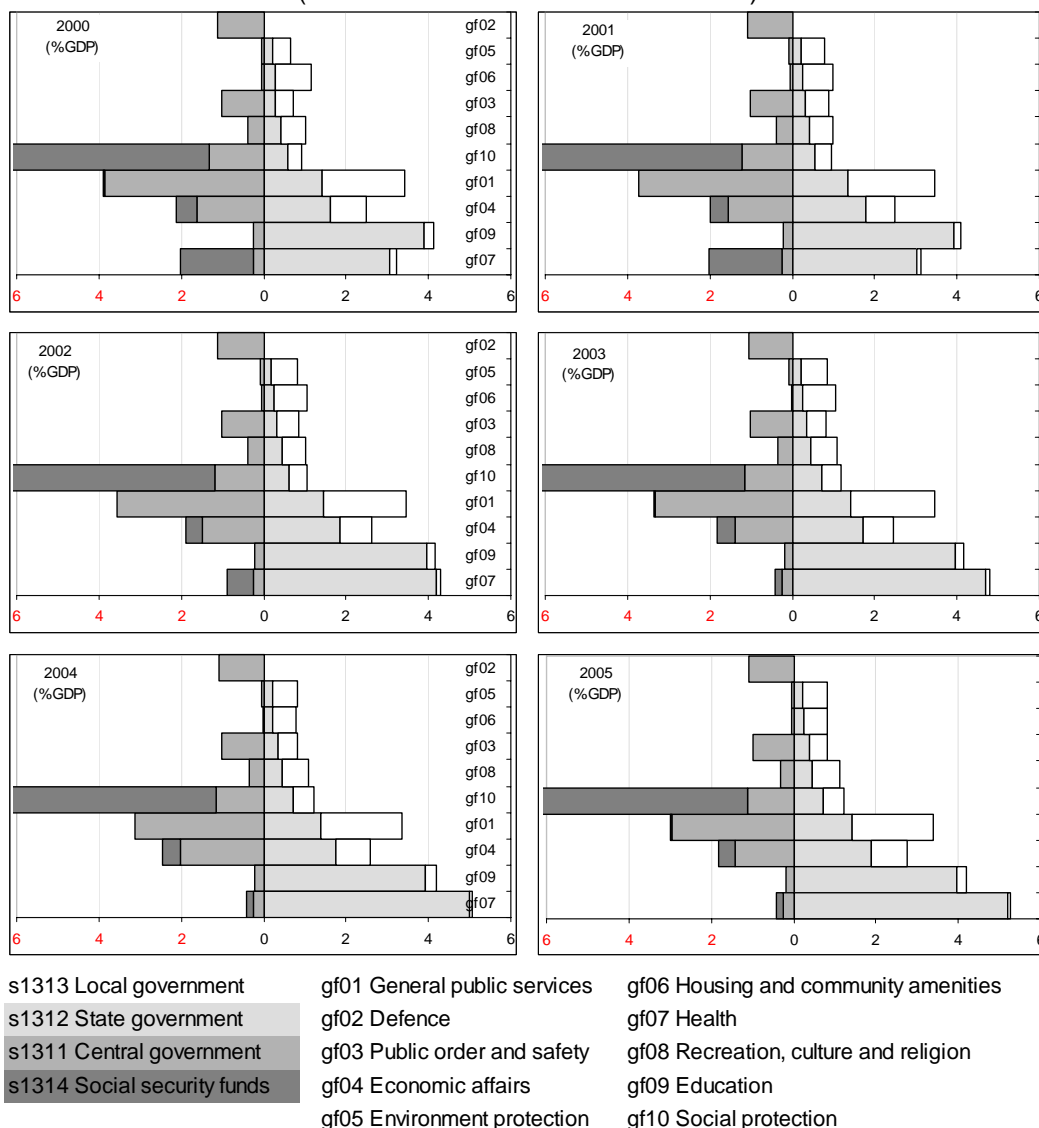*Figure 4. Regional budgets in Spain. 1985-2005.*
(MEH and INE data)

Non financial **expenditures** & revenues
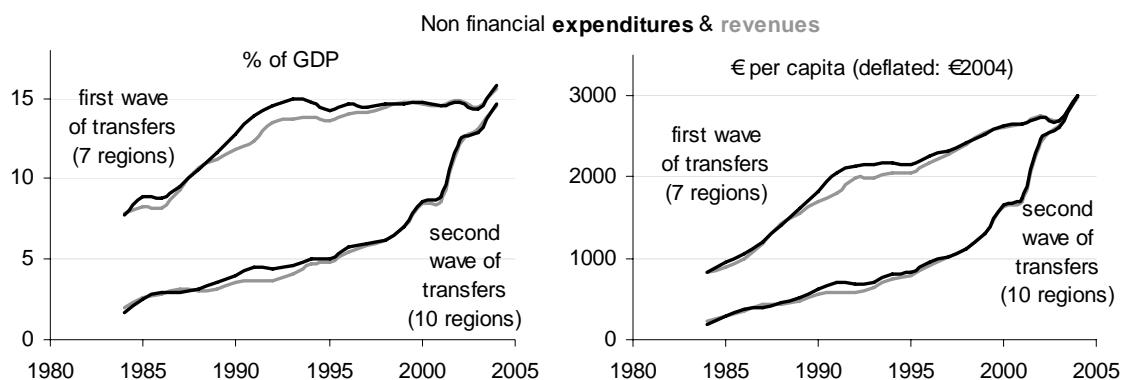
Despite the importance of the Spanish decentralization process, there is little evidence on its overall economic impact and the few available results are controversial. While Carrion et al (2006) have found "a positive relationship between the decentralisation process undertaken in Spain and overall Spanish growth", the results of Pérez and Cantarero (2006) "do not support the hypothesis that revenue decentralization contributes to regional growth and although expenditure decentralization seems to have had something of a positive impact, this is not robust". The international empirical literature predicts more controversial results when accountability, corruption, quality or stability, are considered instead of just growth, or when various shade of decentralization are taken into account (Rodden, 2004). Even if only budgetary matters are concerned, the process of decentralization is something more that just one share.

The recent evolution of Spanish public expenditure by functions and tiers of government (figure 5) can be used as an illustration to show that the performance of a sector of government cannot be assessed without taking into account the behaviour of the other sectors.
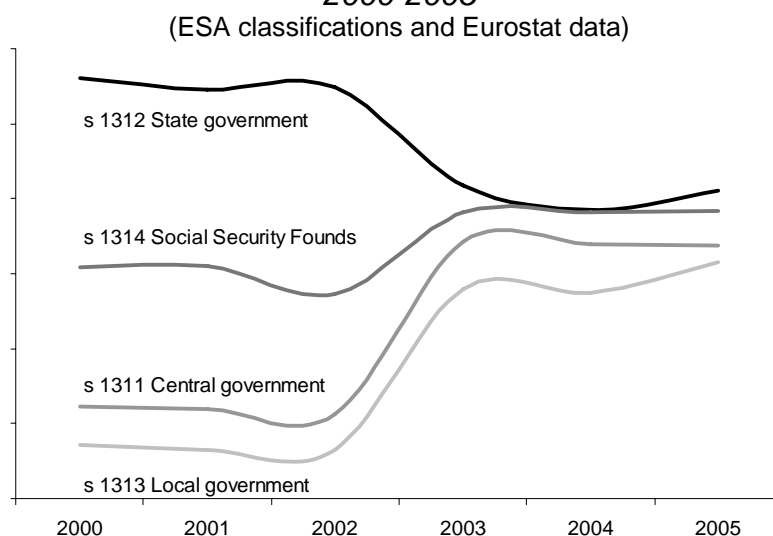
Figure 5. Public expenditure by function and sector. Spain 2000-2005
(ESA classifications and Eurostat data)

s1313 Local government
s1312 State government
s1311 Central government
s1314 Social security funds

gf01 General public services
gf02 Defence
gf03 Public order and safety
gf04 Economic affairs
gf05 Environment protection

gf06 Housing and community amenities
gf07 Health
gf08 Recreation, culture and religion
gf09 Education
gf10 Social protection

Let us suppose the following correspondence between the classification of functions of government (COFOG) used in Figure 5 and the categories of the Figure 3. As in European Commission (2002) health and education are included in the category *I*, for which there is no crowding out effect. The first five COFOG functions are considered as collective services with positive effects for low expenditure shares (category *II*). Finally category *III* comprises the remaining functions, housing, recreation and social protection, with the top impact at intermediate levels of spending.

By now using equation (1) a relative composite indicator of quality is calculated for each of the Spanish government sectors. As can be seen from Figure 6, the relative performance of the different administration levels has converged in recent years. Contrary to what might appear at first glance, this convergence is not due to a poorer behavior of the regional tier of government (S1312), as might be understood when the process of decentralization (Figure 4) and the composition of the transfers (Figure 5) are taken into account.

Figure 5. Relative quality of public expenditure by function and sector. Spain 2000-2005
(ESA classifications and Eurostat data)

s 1312 State government

s 1314 Social Security Founds

s 1311 Central government

s 1313 Local government

2000   2001   2002   2003   2004   2005

Conclusion

The quality of European governments has been measured by relating the composition of their expenditure to the Lisbon Strategy. European regions wish to participate in the alignment of the Cohesion Policy and the Lisbon objectives, provided that the specific regional circumstances are taken into account. International guidelines to measure public sector efficiency are open to further discussion and the practical proposals to measure it remain imprecise. Evidence from Spain suggests that assessments of regional governments might prove misleading if the complementarity between the different sectors of government and the nature of each decentralization process are not taken into account.

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