

CENTRALIZATION, INTERGOVERNMENTAL STRUCTURE, AND REFORM IN THE MIDDLE EAST AND NORTH AFRICA*

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INTRODUCTION

THERE HAVE BEEN SIGNIFICANT DECENTRALIZATION efforts in developing countries in recent decades. These efforts led to an extensive literature on the causes and consequences of both centralization and decentralization. Despite these good reasons to study government structure in the Middle East and North Africa (MENA) region, there is surprisingly sparse literature on the region. While recent studies followed a comparative perspective and showed similarities and differences between the decentralization efforts in a variety of developing countries, the MENA countries are left out of those comparisons (Bardhan and Mookherjee, 2006).

McLure (2001) argues that tax assignment over different levels of government depends on history, and has been subject to change through economic evolution. MENA countries have relatively more centralized government structures compared to other developing countries due to the evolution of their public administration system under Ottoman Empire subjugation. MENA countries, particularly Egypt, Lebanon, Algeria, and Yemen, have based their government organization on the administration structure of the Ottoman Empire. The Ottoman taxation system was a centralized system of taxation. It included elements from Islamic taxation as well as from taxation law and practices of Roman, Byzantine, Mongolian, Turkish, and pre-Islamic Persian civilizations (Lewis, 1979). It emerged as a clash between competition and rigidity in institutions (Cosgel, 2005). For example, while the Ottomans changed the tax system in the conquered lands to collect revenue in the most efficient way, they were faced with local institutional constraints (Cosgel, 2005). Hence, this explained the substantial regional variation in taxes throughout the empire.

Ottoman tax administration changed from a strong decentralized system to a weaker but cen-

tralized system around the end of the 16th century (Lewis, 1979). There had been a consolidation of tax collection at the center with the stagnation and decline in the Empire after the 16th century. In places such as Egypt, more government centralization took place in accordance with heavier European influence (Hanna, 1995). In this centralization trend, we see a change from the Timar system (strong center with decentralized military expenditures) to Iltizam or Tax-Farming System (weaker center with more centralization of military and more decentralization of other government services at the district level) towards the end of the 16th century. Some of the reasons were as follows: Sipahi cavalry becoming less important due to introduction of new war technologies, higher demand for full-time regular troops, changing patterns of trade, influx of Spanish silver from America, and subsequent inflation leading to a sharp decrease in real income (Lewis, 1979; Barkey, 1994). Barkey (1994) argues that the Ottoman state was able to overcome (global) economic distress without any significant rebellions throughout the empire. She explains that this was mainly due to the success of the state in aligning officials at different levels of government with the objectives and success of the central government.

There have been few sporadic efforts to change the centralized government structure in the Ottoman Empire. For example, Saliba (1978) explains in detail efforts and achievements of Midhat Pasha to decentralize political and fiscal powers when he served as governor of the Syrian province. Such efforts faced strong opposition from the central government in Istanbul and were mainly approached with suspicion as the Empire was experiencing significant loss of territories. Reform efforts during the Tanzimat or Reorganization period in the 19th century aimed at creating a more centralized government structure (Ortayli, 2006). This was thought to be a way to save the Empire from total collapse.

In summary, we see that the taxation system was not as centralized in the early period (until the end of the 16th century) of the Ottoman Empire

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as it was in the later period. Centralization gained momentum particularly during the Tanzimat (Reorganization) period in the 19th century when the empire was declining rapidly and consolidation of power at the center was seen as a solution to prevent total collapse. Centralization that started in the 16th century is, by no means, unique to the Ottoman Empire. In fact, Europe started its transformation from small, decentralized city-states to large and centralized territorial states at the end of the 15th century.¹ It was also argued that European influence in the Middle East and North Africa fueled more government centralization (Hanna, 1995). Aside from a few courageous attempts at decentralization, the region inherited a heavily centralized system of taxation and public administration from the Ottoman Empire and other European States.

In this paper, we examine decentralization and intergovernmental relations in the Middle East and North Africa (MENA), a region that has lagged behind other developing regions in decentralization. The region has unique socioeconomic and political characteristics. First, there is economic dependency on oil revenues particularly in Gulf Cooperation Council (GCC) countries. Second, the MENA region has one of the highest population growth rates in the world. This demographic explosion has led to young population structures throughout the region. Third, the region is ridden with both internal and external conflicts that impact economic and political performance of the countries. Finally, democracy and democratic institutions are either lacking or not functioning properly in the MENA countries.

Our goal in this paper is to combine descriptive and empirical analyses to provide a comprehensive picture of decentralization and the reasons behind its slow progress. We also discuss some reform options. The paper is structured as follows. In the next section we provide a comparison of the intergovernmental structure in five MENA countries, Iran, Egypt, Tunisia, West Bank/Gaza, and Yemen. In the third section we explore the determinants of strong centralization in the region in a regression analysis. We discuss the intergovernmental reform options and policy recommendations in the final section.

CURRENT INTERGOVERNMENTAL STRUCTURE IN SELECTED MENA COUNTRIES

In this section, we examine the intergovernmental structure in a selected number of MENA

countries to demonstrate the centralized features of local government systems in the region. Our selection includes five countries representing both Maghreb and Mashreq regions. These are Egypt, Iran, Tunisia, West Bank/Gaza, and Yemen.

Local Government Systems in the Selected Countries

Overall, local government systems in the MENA region can be characterized as a form of deconcentration rather than one of devolved local self-government. In general, the public administration system is highly centralized, equipped with an elaborate system of deconcentrated field offices of line agencies. Decisions for the most part, especially service delivery decisions, are made by the central government and the role of subnational authorities is largely confined to carrying these out.

In the region, the general trend is to have two distinct types of local government units: deconcentrated and decentralized (municipal) units (see Table 1). The operations of these two types of local governments are subject to totally different rules. In all countries, the deconcentrated units of the central government provide a big chunk of public services, including health and education, under strict guidance of the central government. Whereas, decentralized units (generally municipalities) perform a limited number of functions such as street paving and maintenance, construction of local roads, street lighting, garbage collection, library and park services, and issuing permits for constructions.

Table 1 shows that countries differ in their deconcentrated systems. While West Bank/Gaza and Tunisia have only provincial or governorate level governments, Iran, Yemen and Egypt have a variety of sub-provincial level governments. In all five countries, governors are appointed by the central government and/or the president. On the other hand, they have relatively decentralized systems at the lower level of government. Municipalities are run by elected officials in West Bank/Gaza and Tunisia. In Iran, representation of people is partial and indirect. First, there is involvement of the Ministry of Interior (MOI) in both urban and rural municipalities. Second, people elect city or village councils which in turn appoint mayors jointly with the MOI.

Expenditure Responsibilities of Local Governments in the Selected Countries

Subnational deconcentrated governments have a very limited number of "own" responsibilities.

Table 1
Decentralization and Decentralization Systems in MENA Countries

	<i>Iran</i>	<i>Yemen</i>	<i>Egypt</i>	<i>West Bank/Gaza</i>	<i>Tunisia</i>
Central Government Ministry	Ministry of Interior (Mol)	Ministry of Local Administration (MoLA)	Ministry of Local Development (MoLD)	Ministry of Local Government (MoLG)	Ministry of Interior
	<i>Decentralized System</i>				
Province	30 provinces (Ostān)	22 governorates	26 governorates	16 governorates	24 governorates
District	318 districts (Shahrestān)	332 districts	180 districts (markaz)		
County	854 rural counties (Bakhs)		213 cities (madina) 74 districts (hay) 1164 rural villages (qariya)		
Appointed by	Provincial governor (Ostāndar) is appointed by the President District Governor (Farmandar) is appointed by Mol Rural county administrator (Bakhsdar) is appointed by the Ostāndar	Governor is appointed by the President District governor is appointed by the Prime Minister	Governor is appointed by the President Chief of Markaz is appointed by the Prime Minister City and district chiefs are appointed by the minister of MoLD Village chief is appointed by the governor	Governor is appointed by the President.	Governor is appointed by the central government
Council	Provincial Planning and Development Council (Chair: Ostāndar; Line Ministry reps) District Planning Committee (Chair: Farmandar; Line Ministry reps)	Governorate council directly elected by people District council directly elected by people	There are two councils at each local government level: Elected People's Council and centrally appointed local Executive Council. Executive council is composed of representatives of central government ministries and departments.		Regional assembly is made up of members of the Parliament of the region, municipal mayors, and other appointed members.
	<i>Decentralized System</i>				
Urban Municipalities	More than 1000 municipalities (Shahr)	N/A	N/A	119 municipalities	262 municipalities
Rural Municipalities	More than 68,000 rural municipalities (Deh/Roosta)	N/A	N/A	251 village councils 49 joint service councils	
Elected by	Mayor of an urban municipality (Shahdar) is jointly appointed by the Mol and City Council, which is directly elected by the people. Mayor of a rural municipality (Dehyar) is jointly appointed by the Mol and Village Council, which is directly elected by people.	N/A	N/A	Municipal mayor and council members are directly elected by the people. Village councils and joint service committees are appointed by the MoL.G.	Municipalities are governed by an elected municipal council that elects its mayor within its ranks.

Source: Authors' compilation.

Most of the local expenditure responsibilities can be classified as “delegated” expenditures as opposed to “own” expenditure responsibilities.² Central government ministries make decisions on most services that are traditionally provided by local governments in other countries (see Table 2). In almost all countries in the MENA region, the assignment of expenditure responsibilities between central and local governments does not conform to generally accepted principles for setting the right incentives for efficient and equitable delivery of public services. In contrast, intergovernmental expenditure responsibilities have been assigned largely according to static bureaucratic and administrative considerations. Delegated responsibilities are those transferred to the decentralized central government departments only for the actual delivery of services while all decisions on budgeting and financing remain at the central level. Some of the delegated responsibilities, such as primary education, health, and public security have high local public good characteristics and in many countries are not delivered by locally elected governments.

Table 2 shows the expenditure assignments in five MENA countries and also includes the worldwide practice. Expenditure assignments are indicated as central government (C), provincial government (P), and municipal government (M). Assignments are shown for Social Services, Transportation, Utility Services, and Other Services, and are also broken down by Macro Policy and Oversight, Financing, and Provision. To show that MENA countries have significantly more centralized expenditure functions compared to the worldwide practice, we assigned points to central, provincial, and municipal government involvement in expenditures. Accordingly, we assigned 1 point to C, 2 points to P, and 3 points to M. In addition we assigned 1.5 points to C,P; 2.5 points to P,M and 2 points to C,P,M. We gave 1 instead of 0 to central government assignments since the worldwide practice shows that some central government involvement is probably desirable to facilitate decentralization.

Table 3 presents total expenditure assignment scores and average scores for the selected MENA countries and worldwide practice. The average score for MENA in all sectors is below the worldwide practice, which indicates centralized structure service delivery in the region. However, West Bank/Gaza is an outlier among the selected

countries. The average scores for countries across government services and government involvement show that West Bank/Gaza has the most decentralized expenditure system among the group followed, in order, by Egypt, Iran, Tunisia, and Yemen. This reflects the realities of Israeli occupation. In the absence of a sovereign state, Palestinian local governments have had to fend for themselves in providing services to local communities.

Revenue Sources of Local Governments in the Selected Countries

Subnational governments in the MENA region have two main types of revenues: locally collected taxes and fees and intergovernmental transfers. Tables 4 and 5 show revenue assignment and transfer characteristics, respectively. Subnational governments have almost no independent source of revenues in Egypt, Iran, and Yemen. The rates and bases for all revenue sources—the property tax, fees, charges, intergovernmental grants, and borrowed revenues—are delineated by the central government. In Tunisia, municipal governments have the right to set the rate according to laws, but they don’t practice this right in general. The only truly decentralized revenue system is the one by West Bank/Gaza (WBG). In WBG, the Law on Local Authorities of 1997 grants a degree of autonomy to municipal governments over revenue sources. They have to obtain the approval of the central government in setting the tax rates and defining the revenue bases. Mostly within the confines of the centrally defined tax and fee bases, assessment strategies, and rates, the local governments are provided with revenue sources such as property taxes, building permits and utility revenues.

Intergovernmental transfer is the most important revenue for local government in the MENA region, as it is in other regions. However, the lack of predictability and criteria for allocation are the prominent characteristics of intergovernmental transfer system design in the region. Intergovernmental transfer systems in many countries in the region lack transparent criteria and are conducive to *ad hoc* bargaining and *ex post* gap filling which encourage subnational governments to understate their own revenues and to increase their commitments on expenditures and to run deficits in the expectation that their financing gap will be filled by the central transfer. Table 5 shows that allocation rules for transfers to local governments are

Table 2
Expenditure Assignment in MENA Countries

<i>Macro Policy/Oversight</i>						
<i>Function</i>	<i>Iran</i>	<i>Yemen</i>	<i>Egypt</i>	<i>WBG</i>	<i>Tunisia</i>	<i>Worldwide</i>
Social Services¹						
Social Welfare	C	C	C	C	C	C
Hospitals	C	C	C	C	C	C
Public Health	C	C	C	C	C	C,P
Universities	C	C	C	C	C	C,P
Secondary Education	C	C	C	C	C	C,P
Primary Education	C	C	C	C	C	C,P
Housing	C	C	C	C	C	C,P
Transportation²						
Urban Transportation	C,P,M	C,P	C,P	C,P,M	C	C,P,M
Railroads	C	C	C	N/A	C	C,P
Airports	C	C	C	N/A	C	C,P
Ports and Navigable Waterways	C	C	C	N/A	C	C
Urban Highways	C,P,M	C,P	C,P	C,P,M	C,P	C,P,M
Interurban Highways	C	C,P	C,P	C,P,M	C,P	C,P
Utility Services³						
Electricity	C	C	C	C	C	C,P,M
Waste Collection	M	P	M	M	M	M
Water and Sewerage	P,M	C,P	P,M	M	C,P	M
Other Services⁴						
Fire Protection	C	C,P	M	C,P,M	C	M
Heating	C	N/A	N/A	N/A	N/A	M
Irrigation	C	C,P	C,P	C,P	C,P	M
Police	C	C	C	C	C	C,P,M
<i>Financing</i>						
<i>Function</i>	<i>Iran</i>	<i>Yemen</i>	<i>Egypt</i>	<i>WBG</i>	<i>Tunisia</i>	<i>Worldwide</i>
Social Services¹						
Social Welfare	C	C	C	C	C	C
Hospitals	C	C	C	C	C	C,P,M
Public Health	C	C	C	C	C	C,P,M
Universities	C	C	C	C	C	C,P,M
Secondary Education	C	C	C	C	C	C,P,M
Primary Education	C	C	C	C	C	C,P,M
Housing	C	C	C	C	C	C,P,M
Transportation²						
Urban Transportation	C,P,M	C,P	C,P,M	C,P,M	C,P	C,P,M
Railroads	C	C	C	N/A	C	C,P
Airports	C	C	C	N/A	C	C,P
Ports and Navigable Waterways	C	C	C	N/A	C	C
Urban Highways	C,P,M	C,P	C,P,M	C,P,M	C,P	C,P,M
Interurban Highways	C	C,P	C,P	C,P,M	C,P	C,P
Utility Services³						
Electricity	C	C	C	M	C	C,P,M
Waste Collection	M	P	M	M	M	M
Water and Sewerage	P,M	C,P	P,M	M	C,P	M
Other Services⁴						
Fire Protection	C	C,P	M	C,P,M	C	M
Heating	C	N/A	N/A	N/A	N/A	M
Irrigation	C	C,P	C,P	C,P	C,P	M
Police	C	C	C	C	C	C,P,M

Table 2
Expenditure Assignment in MENA Countries (Continued)

<i>Function</i>	<i>Provision</i>					
	<i>Iran</i>	<i>Yemen</i>	<i>Egypt</i>	<i>WBG</i>	<i>Tunisia</i>	<i>Worldwide</i>
Social Services¹						
Social Welfare	C	C	C	C	C	C,P,M
Hospitals	C	C,P	C	C	P	C,P,M
Public Health	C	C,P	C	C	C	C,P,M
Universities	C	C	C	C	P	C,P,M
Secondary Education	C	C	C	C	P	C,P,M
Primary Education	C	C	C	C	P	C,P,M
Housing	C	C	C	C	C	C,P,M
Transportation²						
Urban Transportation	C,P,M	C,P,M	C,P	C,P,M	C,P	C,P,M
Railroads	C	C	C	N/A	C	C,P
Airports	C	C	C	N/A	C	C,P
Ports and Navigable Waterways	C	C	C	N/A	C	C
Urban Highways	C,P,M	C,P,M	C,P	C,P,M	C,P	C,P,M
Interurban Highways	C	C,P,M	C,P	C,P,M	C,P	C,P
Utility Services³						
Electricity	C	C	C	C	C	C,P,M
Waste Collection	M	P	M	M	M	M
Water and Sewerage	P,M	C,P	P,M	M	C,P	M
Other Services⁴						
Fire Protection	C	C,P	M	C,P,M	C	M
Heating	C	N/A	N/A	N/A	N/A	M
Irrigation	C	C,P	C,P	C,P	C,P	M
Police	C	C	C	C	C	C,P,M

Source: Authors' compilation.

C: Central Government P: Provincial Government M: Municipal Government N/A: Not applicable

¹These services are national in scope, the central government has a role in correcting fiscal inefficiencies and regional inequalities, it should also provide some financing to cover spillovers.

²The overriding concern is the efficient provision of services. If the benefits accrue to local jurisdictions, it should be financed by local residents. If the benefits of the service spillover to other jurisdictions, the service is national in scope and the cost of service should be realized by nonresidents as well.

³These services are local in scope; if the services are financed by national revenues, nonresidents bear the cost of services. In that case, inefficient allocation of resources is a major concern. However, preservation of internal common market might be an area of concern; central government might have a role in regulatory function to ensure efficiency and equitable provision of some of these services.

⁴The primary beneficiaries of these services are local residents and they are most efficiently provided by local governments.

also mainly ad-hoc, except in Tunisia and West Bank/Gaza.

DETERMINANTS OF CENTRALIZATION

Measurement Issues and Review of the Literature

Decentralization is difficult to measure. Despite the popularity of decentralization as a research topic in recent literature, there are serious problems

with the measurement of decentralization. Ebel and Yilmaz (2003) note that this is mainly due to data imperfections, particularly in the IMF's Government Finance Statistics (GFS). Problems with data availability and quality get worse in the case of the MENA countries. Hence an empirical investigation of decentralization in the MENA region is difficult due to aforementioned data problems. As so many other studies did before us, we rely on data from the GFS. We have realized however

Table 3
Expenditure Assignment Scores*

<i>Macro Policy</i>					
<i>Country</i>	<i>Social Services</i>	<i>Transportation</i>	<i>Utility Services</i>	<i>Other Services</i>	<i>Average Score**</i>
Iran	7	8	6.5	4	1.28
Yemen	7	7.5	4.5	4	1.21
Egypt	7	7.5	6.5	5.5	1.39
West Bank/Gaza	7	6	7	4.5	1.53
Tunisia	7	7	5.5	3.5	1.21
Worldwide Practice	9.5	9.5	8	11	1.90
<i>Financing</i>					
<i>Country</i>	<i>Social Services</i>	<i>Transportation</i>	<i>Utility Services</i>	<i>Other Services</i>	<i>Average Score**</i>
Iran	7	8	6.5	4	1.28
Yemen	7	7.5	4.5	4	1.21
Egypt	7	8.5	6.5	5.5	1.45
West Bank/Gaza	7	6	9	4.5	1.66
Tunisia	7	7.5	5.5	3.5	1.24
Worldwide Practice	13	9.5	8	11	2.08
<i>Provision</i>					
<i>Country</i>	<i>Social Services</i>	<i>Transportation</i>	<i>Utility Services</i>	<i>Other Services</i>	<i>Average Score**</i>
Iran	7	8	6.5	4	1.28
Yemen	8	9	4.5	4	1.34
Egypt	7	7.5	6.5	5.5	1.39
West Bank/Gaza	7	6	7	4.5	1.53
Tunisia	11	7.5	5.5	3.5	1.45
Worldwide Practice	14	9.5	8	11	2.13

Source: Computed by the authors.

* Expenditure assignment scores are determined as follows:

Central Government (C) = 1 point

Provincial Government (P) = 2 points

Municipal Government (M) = 3 points

C,P = 1.5 points

P,M = 2.5 points

C,P,M = 2 points

** Average score is calculated by dividing the sum of total scores for each country in the table by the total number of services listed in Table 2.

that data on conventional fiscal decentralization measures such as share of local governments in total government expenditures or revenues is simply nonexistent. That left us with using data on total central government expenditures relative to an economic base such as gross domestic product (GDP). Thus, we use a centralization measure defined as total budgetary central government expenditures as share of GDP of the country. While this measure captures mainly the size of the

central government, it will also be closely related to the degree of delegation of central government powers to lower levels of government. A reduction in the size of the central government can be seen as one avenue for decentralization. In the absence of better data, our objective is to compare results to other studies and note similarities and differences.

There is considerable literature on the effects of fiscal decentralization on economic growth.

Table 4
Revenue Assignment in MENA Countries

Country	Revenue Assignment
Egypt	There is a national tax sharing system combined with local tax and fee surcharges. Rates are set nationally and the central government collects a portion (25-50 percent) of local taxes into special national funds. Popular participation (down payments of citizens) is the most important local revenue under the discretion of local governments.
Iran	All local levies are required to be consistent with the government's annual budget and the National Five Year Development Plans and to be in line with the capacity to pay as determined by the Ministry of Interior (ceiling for local tax/local income ratio). With adoption of the Law on Tax Amalgamation (2003), revenue collection has been effectively recentralized and almost all taxes are collected by the central government. One of the main locally collected fees is the land use change and density increase tax.
Tunisia	LGs can set and administer local taxes on developed real estates, but this right is rarely exercised. Other taxes, fees, and charges are introduced by central government decrees and managed by central agencies.
WBG	Of all the MNA-8 countries, the WBG regulatory framework provides the greatest autonomy to the LGs. While LGs have a right to set taxes or create new ones, they can do so through initiating amendments to the tax law. Many taxes and fees are collected and administered locally by LGs.
Yemen	Central government sets both tax rates and base, LGs can make proposals for taxes and fees. Apart from the religion tax ("Zakat") most taxes are not collected in many districts particularly in rural areas.

Source: Authors' compilation.

Determinants of fiscal decentralization received less attention. Two recent papers provide theory and empirical evidence on the determinants of the decentralization process in a wide variety of countries. Panizza (1999) builds on the work by Alesina and Spolaore (1997) on the number and size of nations by introducing different levels of government. Panizza's theoretical model shows negative correlations between fiscal centralization and country size, income per capita, taste differentiation, and level of democracy. He finds empirical evidence supporting these theoretical correlations. Panizza also compares his results to two other cross-sectional or panel studies by Oates (1972) and Wallis and Oates (1987) and finds similarities particularly in regards to country size and income per capita. Arzaghi and Henderson (2005) examine the determinants of fiscal decentralization using panel data on 48 countries over the period 1960 to 1995. They show that the Middle East and North Africa region has the highest share of central government and the lowest federalism index.³ They also show that the Middle East and North Africa lags behind all other regions in the

democracy index. Arzaghi and Henderson follow Panizza's approach to model decentralization first and then empirically test hypotheses derived from the theoretical model. Their empirical findings mainly confirm previous findings on the determinants of decentralization (or centralization). They find that past colonial experience and initial constitutional provisions matter in the decentralization process.

Empirical Analysis

We started with a group of 14 MENA countries but eventually reduced our sample to 9 countries due to lack of government expenditure data.⁴ We are using an unbalanced panel with a study period broadly from 1975 to 2004. As mentioned above, we use total budgetary central government expenditures as share of GDP as our dependent variable. Our choice of explanatory variables is based mainly on the theoretical and empirical analyses by Oates (1972), Wallis and Oates (1987), Panizza (1999), and Arzaghi and Henderson (2005). We use *GDP per capita* and *Population* to capture the effects of the size of the economy and the size of the

Table 5
Transfer Characteristics and Allocation Rules in MENA Countries

	<i>Transfer Characteristics</i>	<i>Source</i>	<i>Allocation Rules</i>
Egypt	General development grants: mutual plus earmarked (service & development, land, housing, cleanliness, road).	National budget.	No rule-based allocation nor formula. Discretionary grants and donations.
Iran	Transfers to urban LGs appear to be negligible, particularly, in the larger cities. Development transfers: 60% earmarked 30-40% discretionary.	Oil revenues.	No formula. Allocation rules decided annually by the Parliament.
Tunisia	Earmarked: operating grants through LG Common Fund (FCCL), development grants managed by Fund for Loan and Support for LG (CPSCL); sector-based transfers; Regional Development transfers.	National budget.	Formula based – 10% flat rate, 45% size of LG, 45% according to average property tax.
WBG	Current transfers and grants for transport fees are not earmarked. Discretionary/emergency transfers are channeled to specific projects.	Transport fees and a separate account assigned for discretionary/emergency transfers.	A formula for the pool and distribution of transport fees exists on paper (1997 Local Government Law). Yet, the formula is only partially applied. Discretionary/emergency transfers are ad hoc.
Yemen	30% of grants from extra-budgetary funds are earmarked, others are not.	Shared revenues from 28 taxes, mainly – Zakat.	No formula, but Council of Ministers uses nonbinding guidelines – population density, financing gap, degree of deprivation, performance in revenue collection.

Source: Authors' compilation.

country, respectively. Oates (1972), Panizza (1999), and Arzaghi and Henderson (2005) all found that these are negatively correlated with centralization. If decentralization is a normal good, we would expect a negative relationship between income per capita and centralization (Panizza, 1999). Wallis and Oates (1987) argue that smaller states may benefit more from centralization as economies of scale may not be exhausted due to small population size at decentralized levels. Wallis and Oates also argue that population concentration in urban areas increase the benefits from decentralization. Hence, we would expect a negative relationship between urbanization and centralization. We use *Share of Urban Population* to find the effect of population concentrations. Both Panizza (1999)

and Arzaghi and Henderson (2005) point to the importance of democracy and other institutional factors in decentralization. In Panizza's model, the level of democracy is inversely related with the willingness of the central government to extract rent and ignore the preferences of the median voter, which imply a negative correlation between democracy and centralization. We use *Democratic Environment* and *Quality of Governance* as two types of institutional variables. These come from the International Country Risk Guide (ICRG, 1984-2003) published by the PRS Group.⁵ *Democratic Environment* is the average of the following political risk components law and order, democratic accountability, military in politics, and religion in politics. *Quality of Governance* is the

average of law and order, bureaucratic quality, and corruption.⁶ Finally, we add two other variables that were not specifically used by the literature mentioned above. First, we have *Trade Openness*, traditionally defined as the ratio of the sum of exports and imports to GDP. Rodrik (1998) argues that more open countries have larger governments to stabilize the economy against external shocks. To the extent that the stabilization role is undertaken by the central government we would expect a positive relationship between openness and centralization. The second variable we introduce is *External Conflict*. This may be an important factor in centralization especially in the MENA region. Tosun and Sen (2007) show that the MENA countries have more major conflicts such as war, on average, than other developing countries. They find evidence of significant spatial spillovers from regional conflicts. Alesina and Spolaore (2003) present a model with conflict and size of nations. They show that external shocks give a strong incentive to form larger jurisdictions. We draw a parallel and further argue that external shocks may legitimize greater central government budgets since national defense is a function of government undertaken by the central government. Alesina and Spolaore also address the interaction between democratization and conflicts showing that democratization becomes a less important factor in reducing the size of countries when there are major conflicts. We also examine how the impact of democratization changes when external conflict is introduced into the empirical analysis. Data on *External Conflict* also comes from the ICRG dataset. We adjusted this variable, however, to have higher points representing worsening in conflicts.⁷

Empirical Results

We provide the summary statistics on the variables described previously in Table 6. We now turn to regression results in Table 7. In addition to the explanatory variables, we also include country fixed effects in our regressions. Hence, country characteristics such as land area, being an oil producer, and all time invariant institutional factors are captured by the fixed-effects estimation. We also see that serial correlation of errors is a serious problem in our data. We run AR(1) fixed-effects regressions to correct for the serial correlation problem.

We find that the coefficients of the size variables GDP per capita and population have the expected negative sign but not statistically significant in all four regressions. The coefficient of the share of urban population is positive, significant, and robust across all regressions. This finding is counter to the argument by Wallis and Oates (1987). We see in columns 1 and 2 that both institutional variables have the expected negative sign and statistically significant with lower significance for the quality of governance. Column 3 shows that external conflict has a significant positive effect on centralization, which is also expected as we argued in a previous section. When we include both institutional variables and external conflict in the same regression in column 4, we see that external conflict still has a positive and significant effect, while democratic environment loses its significance and the coefficient of quality of governance turns positive. Hence, external conflict is the only robust factor among the institutional and conflict variables. Similar to the implications of the theoretical model of Alesina and Spolaore (2003), we find that democratic environment loses its importance when external conflict is added to the analysis. Finally,

Table 6
Summary Statistics for the Regression Analysis on the Determinants of Centralization
in MENA Countries

	<i>Number of Observations</i>	<i>Mean</i>	<i>Standard Deviation</i>	<i>Minimum</i>	<i>Maximum</i>
Total central government spending (% GDP)	206	35.4667	15.95837	16.2249	211.1821
GDP per capita (constant \$)	356	4732.248	5354.927	443.06	27114
Population	417	1.39E+07	1.80E+07	224000	7.26E+07
Share of Urban Population	420	64.10119	20.50635	14.8	98.28
Trade Openness	361	82.50733	36.57866	13.7724	251.14
Democratic Environment	253	3.167987	0.795095	0.75	4.75
Quality of Governance	253	2.790474	0.677695	0.666667	4.333333
External Conflict	253	3.802806	2.923239	0	12

Table 7
Determinants of Centralization in MENA Countries

	(1) <i>Total Central Government Spending (% GDP)</i>	(2) <i>Total Central Government Spending (% GDP)</i>	(3) <i>Total Central Government Spending (% GDP)</i>	(4) <i>Total Central Government Spending (% GDP)</i>
Log of GDP per capita	-0.109 (0.133)	-0.028 (0.132)	-0.113 (0.138)	-0.035 (0.118)
Log of population	-0.154 (0.129)	-0.085 (0.130)	-0.167 (0.132)	-0.158 (0.120)
Log of Share of Urban Pop.	1.543 (0.559)***	1.101 (0.543)**	1.414 (0.570)**	1.193 (0.501)**
Log of Trade Openness	0.146 (0.088)	0.118 (0.090)	0.222 (0.090)**	0.262 (0.087)***
Democratic Environment	-0.088 (0.028)***			-0.065 (0.046)
Quality of Governance		-0.055 (0.029)*		0.086 (0.044)*
External Conflict			0.026 (0.007)***	0.035 (0.008)***
Constant	-0.028 (0.222)	0.063 (0.244)	0.038 (0.195)	-0.021 (0.246)
Fixed Effects	Yes	Yes	Yes	Yes
Rho (AR1)	0.452	0.417	0.522	0.365
R2 (within)	0.64	0.60	0.68	0.65
Observations	125	125	125	125
Number of panels	9	9	9	9

Standard errors in parentheses

* significant at 10 percent; ** significant at 5 percent; *** significant at 1 percent

trade openness is significant only in regressions (3) and (4). With a positive and significant coefficient, results for openness in columns 3 and 4 support Rodrik's argument.

In summary, our main findings show that improvements in the institutional variables have some negative effect on the centralization but these do not seem to be as important as the strong positive centralization effect of external conflicts.

INTERGOVERNMENTAL REFORM OPTIONS AND CONCLUSIONS

The most striking feature of the public management system in the MENA region is the degree of centralization. All countries in the region have a

highly centralized administrative structure with very limited decision-making power assigned to local governments. For a variety of reasons (e.g., tradition, history, culture), responsibilities assigned to local governments have not been as extensive as those in many other parts of the world. In their efforts to reform local government sector, governments should recognize that decentralization requires sharing of fiscal roles and responsibilities between central and local governments accompanied by a robust capacity to deliver services both centrally and locally. The challenge is to determine how to sort out the responsibilities and financing among different types of local governments. It is important for the decision makers in the region that decentralization reforms may be asymmetric.

They can set criteria to classify local governments into different categories that have asymmetric taxing and spending responsibilities and borrowing privileges. This would give impetus to the decentralization reform process by which regional governments (governorates) and local governments might be empowered with increased autonomy in expenditure and revenue decisions. However, they should keep in mind that there is a need for systematically reviewing legal and regulatory standards for “sorting out” rules and responsibilities among different types and levels of governments.

Decentralization is a dynamic process where the intergovernmental relations system needs constant adjustments. The governments in the region should consider establishing a multilevel government coordinating body to launch decentralization reforms. This coordinating body would be a mechanism for the central government to (1) improve the design and gauge the direction, pace, and extent of decentralization, and (2) disseminate information, provide training, and directly engage municipal governments in the decentralization process. This body would be instrumental in developing institutions for intergovernmental cooperation and dialogue. It would be especially central to increasing local public expenditure efficiency in areas of concurrent expenditure responsibilities and creating strong incentives (financial and legal) to promote cooperative arrangements among local governments for service delivery.

Despite data difficulties, our empirical analysis gives us interesting insights into determinants of the central government’s role in the economy. Regression results suggest that improvements in the democratic environment in the region would help in the decentralization process. A more striking result is the significant role of external conflicts in centralization. It seems external conflicts set a major obstacle in decentralization. This would lend itself to another recommendation that countries in the region and other related countries should work together to remove this obstacle. As Tosun and Sen (2007) suggest, regional conflict prevention is an international public good and a collective provision of this public good would ease the burden on central governments of individual countries. This will, in turn, release resources from the grasp of central governments that are currently charged wholly with the provision of this public good and make it available to the local governments.

In the long run, the governments in the region need to devolve expenditure responsibilities further to local governments while making them fully accountable before their respective constituencies for policy results, in terms of their effectiveness and efficiency in delivering quality public services. To this end, they should consider strengthening local government accountability mechanisms by systemic collection, analysis, and dissemination of information about local fiscal performance and compliance with financial and policy goals. Such information is essential both to informed public participation through political process and to the monitoring of municipal performance by the central government.

In reforming local government, systems the most challenging task for the governments in the region would be restructuring the overall revenue system in a manner that provides local governments “fiscal space” to strengthen their own revenue and expenditure arrangements. The governments should first make sure that adequate steps are taken to establish accountability mechanisms, then boost revenue autonomy by giving local governments adequate decision-making powers on tax rates and the determination of some tax bases in order to improve budgetary predictability. They should gradually lift central government controls on local fees and taxes after making sure that local revenue mobilization is maintained.

In delivering public services, the governments should explore the private sector participation in both financing and delivery of public services to improve the overall efficiency of local government expenditures. Outsourcing public service delivery to the private sector might be a means in overcoming inefficiencies associated with small scale. More importantly, the governments should study rationalizing the transfer system so as to make it a more effective instrument for the implementation of policies of national interest at the local level and reduce horizontal fiscal disparities. This would include an examination of conditional and unconditional (e.g., equalization) transfer systems alike. They should establish transparent rule-based transfer systems with explicit formulas for equalization. They should explore ideas for a combination of unconditional and matching open-ended types of grants that would force municipal governments to exploit their revenue bases.

Last but not least, central governments in the region should credibly commit to and then enforce hard budget constraints for local governments. This

may mean letting some local governments fail first and then be subject to centrally led financial restructuring rules.

Notes

- ¹ Alesina and Spolaore (2003) note that French invasion of Italy in 1494 marks the beginning of the period of absolutism in Europe. They argue that the main reasons behind the centralization trend were the need for institutions and larger domestic markets caused by growing economies in Europe, and rising costs of war and public administration.
- ² Delegated responsibilities are those transferred to the deconcentrated branch units of the central government for delivery of services while the actual decisions on budgeting and financing are carried out at the central level.
- ³ Their evidence on MENA is based on only a few countries in the region due to problems with available data on fiscal decentralization.
- ⁴ These are Bahrain, Egypt, Iran, Jordan, Kuwait, Morocco, Oman, Syria, and Tunisia.
- ⁵ Note that higher risk points correspond to an improvement in the institutional variable.
- ⁶ This was recently used as a measure of governance quality by Knack (2001). Components of these institutional variables, particularly corruption in government, were used in many other studies including Tanzi and Davoodi (2000), Mauro (1996) and Knack and Keefer (1995).
- ⁷ We have also tried a variable on internal conflicts but that didn't turn out to be a significant factor in any of the regressions.

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