

The Relevance of the Decentralization Literature for Fiscal Policy Design

Muhammad Zilal Hamzah*

ABSTRAK

Tujuan kajian ini adalah untuk mengkaji sejauh mana peranan kerajaan dalam ekonomi Islam mengimbangkan antara kepentingan peribadi dan kepentingan sosial untuk mengekalkan peraturan ekonomi. Kajian dijalankan mengikut dua zaman iaitu zaman khalifah dan zaman kini. Zaman khalifah menggunakan pendekatan pengeluaran zakat merupakan kewajipan kewagnan melepaskan sebahagian daripada nilai harta berdasarkan syarat-syarat tertentu. Selain itu cukai juga digunakan untuk neingkatkan dan memperbaiki pendapatan negara berdasarkan kepada pemerintahan sesebuah kerajaan dimana perbincangan mengenai penyebab desentralisasi, kebaikan desentralisasi, kekurangan disentralisasi, keadaan mencapai desentralisasi, disentralisasi fiskal yang mengandungi perancangan pendapatan dan perancangan perbelanjaan. Selain itu perangkaan sistem disentralisasi fiskal yang mengandungi perbelanjaan, pendapatan, pertukaran antara kerajaan dan pinjaman/hutnag sub-kerajaan.

ABSTRACT

The main purpose of this study research how to manage the state in an Islamic economy plays can be realized by settling the balances between private interests and social interests to maintain the economic. The research followed Caliph Era and Recent Era. Caliph era perform this obligation is through the zakah (tithe) institution, which is an inseparable part of out faith. Therefor, tax to improve and broaden the revenue base on any criteria. Therefore, recent era theoretical argument for decentralization, disadvantages of decentralization, important conditions for successful decentralizationfiscal decentralization which are assignment of revenues and assignment of expenditures. Therefore, design of fiscal decentralization system which is expenditures, revenues, and inter-government transfer to the discussion.

Keywords: loan loss provision; capital management hypothesis; earning management hypothesis

INTRODUCTION

During the past three decades, several countries have been working continuously to reform their governments into more democratic forms, known as decentralized government. This reform brings a new interest in the decentralization process. It has been proven in a number of the third world countries, especially in Africa, in South Pacific, and in Latin America. They embark on some transfer of power from the central to sub-national governments. It has been reported by Manis (1999) those 45 countries in the world or so had delegated their government's authorities during this past three decades.

The delegated power can be seen (in ways of delegation, deconcentration, or devolution)¹ in several aspects: politics, government administration, and economic. In economic aspect, the execution of delegated authority takes more serious attention from the economists, especially in the aspect of fiscal decentralization. They argue that fiscal decentralization may effect on the macroeconomic. Furthermore, the prior studies such Cheema and Rondinelli (1983), Conyers (1983), Hyden (1983), Smith (1985), Wasylenko (1987), De Valk (1990), and Oates (1993) also argues that decentralization can promote national economic and development objectives.

Therefore, in this discussion we will highlight prior studies that explore some issues, which can be separated, into several following questions. First, why do we need to decentralize the governments' authorities? Second, what are the advantages and disadvantages from this decentralization system and what are the important conditions of successful from decentralization agenda? Third, since fiscal aspect is one of the decentralization programs. Therefore, how do the local governments acquire and create their own revenues and how do they design their expenditure priority? And fourth, how do they design the fiscal decentralization system. This prior will separate into the caliph era and the recent era.

THE CALIPH ERA

Historically, the state in an Islamic economy plays a positive role, i.e. a moral obligation. The positive role can be realized by settling the balances

between private interests and social interests to maintain the economic rule to keep running on the system. Islam also encourages its followers to work and earn their living to fulfill their needs. At the same time, the followers also need to fulfill the obligation to meet the needs of others (as utterance by Allah in al-Quran, Surah Al Sajadah (32:16) and Surah Al Baqarah (2:274). Prophet Muhammad SAW also affirmed that "He or she is not a real Muslim when he or she eats fully while his/her neighbor is hungry (Al-Bukhari, al-Adab al-Mufarad, 1379H. p 52:112). Abu Ubayd (1353H) in al-Amwal, (784:1909) stated that Ali as the fourth caliph said: "Allah has obliged the rich people to release from their wealth an amount for impecunious people. If those impecunious people are hungry, or have no clothes, or have some difficulties, it is caused by the rich peoples. Hence, it is proper for God to calculate and punish them.

One way to perform this obligation is through the *zakah* (tithe) institution, which is an inseparable part of our faith.² Technically, *zakah* is financial obligation of a muslim to release from the net value of her wealth. It shows that *Zakah* become an important revenues of state and Prophet Muhammad SAW said "Anyone who does the prayers, but pays no *zakah*, his prayers are useless (story Abu 'Ubayd, in al-Amwal 1353 H (492-919)). Abu Bakar, the first caliph, after Prophet Muhammad SAW passed away, declared war to those who refused to pay *zakah*.

In addition Islam also ask the muslim communities to pay tax to improve and broaden the revenue. The tax system, as suggested by Ibnu Khaldun (2001) should have the following three criteria: first, tax is used to realize the Islamic goals (*Maqashid asy-syari'ah*) i.e. human welfare (*al-falah*) and humankind (*al hayat thayyibah*) in *syariah* context (namely the belief/faith, life, mind, generation, and property).

Second, the tax burden should not be too heavy and should be redistributed fairly among the communities who are unable to pay. This criteria was practice by several caliphs, such as Umar, Ali, and Umar bin Abdul Aziz. They emphasized that taxes must be collected fairly and voluntarily and could not higher then the ability for communities to pay. The tax system also should not effect for the communities to fulfill their basic needs. And third, the utilization of those public money should be clearly classified.

As a guidance, Haykal (1964) produces an evidence that Caliph Thahir bin Al Husin directed his son (as an governor) on how to collect and redistribute the public money. The former clearly said this "so, collect and redistribute the public money to all communities fairly and naturally, distribute fairly to everyone without distinguishing them based on self-

esteem and wealth and also do not give exception to your employees or for the family of the Palace or for your clans. And never oblige someone with the tax if he or she is unable to pay it".

With the expansion of the Islamic empyar, Baghdad become the centre of international trade and also the centre of science during the Caliph Harun ar-Rasyid. The increasing trend in trade transaction that cover several merchandise goods such as grist, barley, rice, fruit, olive, jewel, valuable metal, and gold, has increase the state revenues. As a result, *Baitulmal* become an important institution to manage the revenues from the trade. According to Ibnu Khaldun (1961), all of the state's income (around 7,500 million each year) will be brought to *Baitulmal*. This income will be used to fund the expenditures for food and drink of the prisoners. So, even though the revenues from trading and others were saved in *baitulmal*, actually they were used for all communities.

The evidence in several studies (Ibnu Khaldun 1961; MA. Sabzuari 1984; Kadim as Sadr 1989; M. Nejatullah Siddiqi 1996) prove the *baitulmal* collect the money from the local and redistributed that public money from local to the local.

THE RECENT ERA

As reported in Faquet (1997), the modern theoretical argument for decentralization program started in the 17th and 18th Centuries. He mentions that philosophers such as Rousseau, Mill, de Tocqueville, Montesquieu and Madison argue that central governments are distrusted and small, democratic governments are seen as the principal hope to preserve the liberties of free men. Unfortunately, in the early 19th century, we get no more clarification about the study on this program. The studies about this program take many focuses since the mid-1950s.

However, the periods from the mid-1950s to the early 1960s prove the establishment or strengthening of local level governments in a number of countries. Most of these countries were under colonial jurisdiction. After the 1970s, a renewed interest in decentralization was initiated by these governments to become the independence state.

The decentralization programmes in the mid-1950s to the early 1960s were closely associated with the transtition from colonial status to political independence and it was witness in several Anglophone Africa like: Ghana, Kenya, South Africa, and Tanzania. Meanwhile, the decentralization programs after the 1970s were mainly related in Latin

America, Africa and other developing and developed countries. In Latin America, the tendency to decentralize the central authority is caused by the failure of central governments to ensure the regional equality, economic union, an independent central bank, a stable macroeconomic environment or local autonomy. While, in Africa, the inherited highly centralized systems of governance geared toward command and control with little concern for citizens' preferences.

REASONS OF DECENTRALIZATION

As briefly, from several studies below (among others: Maddick 1963; Rondinelli 1981; Conyers 1983; Mawhood 1983; Bennet 1990; Bird, Ebel, and Wallich 1995; Wildasin 1997; Ebel 1998; Bird and Vaillancourt 1998; and Rodden 2002) we can conclude several reasons of decentralization that are: (i) To reduce central government and provincial burden in providing public goods and services with delegate the larger authority to zakah official member in local area (in the the caliph era); (ii) To increase popular participation in the planning and implementation of development programmes (in some Latin America and Africa countries); (iii) The desire of newly independent governments to demonstrate that they were more concerned with achieving democracy, meeting local needs and to increase the effectiveness of local development programmes by making them relevant and responsive to local needs and conditions (in third world); (iv) To escape from central government failures in securing national objectives and to escape from the traps of ineffective and inefficient governance, macroeconomic instability, and inadequate economic growth (in less developed countries); (v) To reorganize the government for the cost effective provision of public goods and services in the post welfare state era (in the western world); (vi) The interest as the part of international development agencies, bilateral aid donors and academic circles (in Europe, North America and Australia).

ADVANTAGES OF DECENTRALIZATION

Several important advantages is: first, *political advantages*. The political advantages of decentralization are related to power sharing between the centre and locality and to the promotion of democracy. Second, *economic advantages*. The economic advantages can be divided into two efficiency advantages (Wolman 1990): allocation and production efficiencies. The

classical definition identifies the fiscal functions of government as distribution, stabilization and allocation (Musgrave & Musgrave 1984). This distribution of functions and collaboration in allocation between central and local government is named as the *Tiebout – Musgrave layer cake model* of the public sector in the literature. A governmental structure must take into account the demand for public services and the conditions under which public services are supplied for allocation efficiency (Bird 1980). Third, *administrative advantages of decentralization*. Tresch (1981) argues that while central government could efficiently provide local goods and services, but they are too far distanced from local needs and preferences.

DISADVANTAGES OF DECENTRALIZATION

Although, it can be seen that the decentralization system is successful in bringing several advantages but authors like Bahl and Linn (1992), Prud'homme (1995), McLure (1995), Sewell (1996) and Tanzi (1996), identify the following disadvantages: macro-economic instability, less economic growth, inefficiency, inequality, reduce economic scale, weak administrative or technical capacity at local levels, weak administrative responsibilities and political instability.

IMPORTANT CONDITIONS FOR SUCCESSFUL DECENTRALIZATION

In practice, the successful application of decentralization programs has not proven to be simple. Bahl and Linn (1994), Proud'homme (1995), Bird and Vaillancourt (1998) and Bahl and McMullen (2000), identify five important conditions for successful decentralization; (i) the decentralization framework must link, at the margin, local financing and fiscal authority to the service provision responsibilities and functions of the local government so that local politicians can bear the costs of their decisions and deliver on their promises; (ii) the local people must be informed about the costs of services and service delivery options involved and the resource envelope and its sources so that the decisions they make are meaningful. Participatory budgeting, is one way to create this condition; (iii) there must be a mechanism by which the community can express its preferences in a way that is binding on the politicians so that there is a credible incentive for people to participate; (iv) there must be a

system of accountability that relies on public and transparent information, which enables the community to effectively monitor the performance of the local government and react appropriately to that performance, so that politicians and local officials have an incentive to be responsive and (v) the instruments of decentralization, the legal and institutional framework, the structure of service delivery responsibilities and the intergovernmental fiscal system are designed to support the political objectives.

FISCAL DECENTRALIZATION

Fiscal aspect is one of the decentralization programs. Fiscal is a tool to change from inefficient to efficient public sector and improve the emulation between the local governments for more efficient in public service. Fiscal decentralization is also used to achieve a certain degree of fiscal autonomy and responsibility given to sub-national governments. Hence, the central government has to transfer the public resources and responsibility to different level of sub-national government and the sub-national government are needed to set up a budgeting system that are able to get the revenue and to allocate them. The fiscal resources should be derived from local own resources and grant from central government.

The above findings suggest that the local government has to acquire and create their own revenues (either through collecting taxes or non-taxes) and has to design their expenditure priority.

ASSIGNMENT OF REVENUES

In fiscal decentralization, taxation is the most important single source of revenue: it determines the volume of proper financial resources which can be used by the member states and regencies/municipalities themselves away from financial transfers, thus the extent of their financial independence. Some kinds of taxes: value added tax (VAT), business income tax, individual income tax, foreign trade taxes, retail sales taxes, property tax, and user charges.

Other source of revenue is borrowing and intergovernmental transfer. There are many ways to design a grant system. The grant could be distributed based on a formula (population, land area, etc.); based on derivation (where the money is collected); based on cost reimbursement (how much is spent for roads, etc.); or even on a political basis.

ASSIGNMENT OF EXPENDITURES

The optimal division of competencies between the levels of government is of course never definitive and the question of which tasks should be assigned to which level of government has never been finally answered. It may be explained in terms of subsidiary and centralization. Yet, decentralization of public expenditures does not imply decentralization of public competencies. The fundamental principle in the distribution of tasks between the various levels of government is subsidiary.

DESIGN OF FISCAL DECENTRALIZATION SYSTEM

Legal and constitutional framework, as well as institutional structure of the public administration system in each country has a bearing on the outcome of fiscal decentralization application.

In designing the fiscal decentralization system at one country, the institutional factors, such as political, social, legal, and economic conditions play an important role. The institutional context of fiscal decentralization depends upon overall economic growth, the nature of the legal system, the ongoing process of economic and political reform, the organization of monetary and financial institutions, and minimization of tensions arising from ethnic, religious, or economic differences (Wildasin 1997; McLure 2001).

According to World Bank (2002), the key function of institutions are: (i) to pick up signals about needs and problems; (ii) to balance interest by negotiating change, forging agreements by avoiding conflicts and stalemates; and (iii) to execute and implement solutions by credibly following through on agreements.

Finally, the design of a decentralized system requires sorting-out of public sector responsibilities among different types of governments and the process of sorting out entails transfer of some decision-making powers from central to sub-national governments (Ebel 2000). Ideally, to achieve the relevant policy objectives, intergovernmental fiscal system should be designed based on each country's specific circumstances. The policy objectives should include not only the public finance goals of efficiency, transparency, and accountability but also should aim at maintaining national integrity and political stability and being equitable to different people and places. As such a design is based on four pillars: expenditure assignment, revenue assignment, intergovernmental transfers/grants and sub-national debt/borrowing (Bird 2000).

EXPENDITURES

Expenditure assignment is the first step in designing an intergovernmental fiscal system. Designing revenue and transfer components of a decentralized intergovernmental fiscal system in the absence of concrete expenditure responsibilities would weaken decentralization process (Martinez-Vazquez 1998). In Latin America and Eastern Europe, many countries have focused only on the revenue side of decentralization and neglected a clear assignment of expenditure responsibilities, which led to weak decentralized systems and fiscally overburdened central governments (Ebel & Yilmaz 2001). The lack of clarity in the definition of sub-national responsibilities has a negative impact on three important respects. First, if the responsibilities are imprecise, the necessary corresponding revenues will remain poorly defined. Second, without clear responsibilities, sub-national government officials might prefer to invest in populist projects which benefit them in the short run rather than in projects with long term impact on the region's economy (such as infrastructure, education, etc). Third, there will be confusion whether sub-national expenditures represent local priorities or centrally determined programs.

The assignment problem is the most fundamental issue in designing an intergovernmental fiscal system. The theory provides broad guidance in delineating expenditure responsibilities among various levels of governments. However, the key to the success of a decentralized system is matching expenditure responsibilities with the objectives of service assignment.

REVENUES

Revenue assignment is the second step in designing an intergovernmental fiscal system. The essence of decentralization is that sub-national governments have the authority and responsibility to own-finance local services. Complete fiscal autonomy over revenues requires that in principle local governments can change tax rates and set tax bases.

The general principles of revenue assignment to different levels of government are listed in fiscal federalism and local government finance literature as (Oates 1972 & Bird 2000): (i) the tax base assigned to sub-national governments should be immobile in order to allow local authorities some freedom to vary rates without the base vanishing. Inter jurisdictional mobility of tax base makes taxation of mobile factors difficult to sub-national governments; (ii) Redistributive taxes should be assigned

to the central government. Taxes imposed on mobile factors for redistribution purposes might result in inefficient jurisdictional allocation of the factors of production. Uniform redistributive taxes minimize location distortions of economic activities; (iii) Services provided by sub-national governments should to the extent possible be financed through user charges and other local fees and taxes that are related to benefits. Efficient allocation of resources requires sub-national governments recover their expenses from the beneficiaries of their services. Examples of benefit related revenues include taxes levied on motor vehicles and fuels and construction fees; (iv) Taxes that are subject to important economies of scale in collection efforts should be centralized; (v) Taxes subject to cyclical fluctuations need to be protected by a system of counter-cyclical rate adjustments in order to avoid sub-national governments exploitation of fiscal power; (vi) Taxes levied on tax bases that are unevenly distributed should be centralized. Uneven distribution of tax bases among sub-national governments forces the residents of one sub-national area bear the economic burden of taxes imposed by another jurisdiction. Taxation of natural resource is the best example of this type of taxation practice; (vii) The revenue yield should be stable and predictable over time; (viii) The revenue system should be easy to administer efficiently and effectively; (ix) Sub-national taxes should be visible to encourage sub-national government liability.

INTERGOVERNMENTAL TRANSFER

Intergovernmental transfer assignment is the third step in designing an intergovernmental fiscal system. The revenue and expenditure assignments give rise to vertical and horizontal imbalances within a nation's intergovernmental finances. In fact, every intergovernmental transfer system has two dimensions: (i) the vertical dimension, concerned with the distribution of revenues between central and local governments; and (ii) the horizontal dimension, concerned with the allocation of financial resources among the recipient units. At least 30 percent of the sub-national governments' revenues come from intergovernmental transfers in all regions. A horizontal imbalance occurs when own fiscal capacities to carry out the same functions differ across sub-national governments. In all countries, these imbalances are handled through a variety of transfer mechanism in order to allow sub-national governments to perform their assigned functions.

There are three key factors in the design of intergovernmental fiscal transfers: the size of distributable pool, the basis for distributing transfers,

and conditionality (Bird 2000). Determining the distributable pool has an important impact on the stability of the intergovernmental fiscal relations system. Sharing a fixed percentage of all central taxes is a better way of establishing transfer system rather than sharing on an ad hoc basis. Sharing must be based on the basis of a formula. Discretionary or negotiated transfers are unstable and unpredictable in nature. The formula for revenue sharing should take needs and capacity into consideration. Once the first two factors have been sorted out, the last question is whether the transfer should be made conditional on a measure. Expenditure conditionality ensures that the transfer amount is spent on a specified service. On the other hand, performance conditionality links transfers to a performance criteria.

SUB-NATIONAL BORROWING/DEBT

Sub-national borrowing/debt assignment is the last step in designing an intergovernmental fiscal system. There are three primary reasons why sub-national borrowing can be considered as an appropriate tool for sub-national public finance: (i) Intergenerational equity. The benefits of certain investment projects, such as infrastructure and education, are spread over time, which means that not only present residents of a locality, but also future residents will consume the services provided by the projects. Therefore, the benefit principle of taxation suggests that future residents should also contribute the cost of investment. For this purpose borrowing is an appropriate tool that offers a means through which payments for capital projects can be spread over the life of the project so as to coincide more closely with the stream of future benefits (Oates 1972); (ii) Economic growth. Delaying infrastructure investments might have a negative impact on sub-national economic performance. Such a negative impact will have a direct effect on residents' life in terms of less employment opportunities and decline of earning levels. Therefore, borrowing is an appropriate tool for sub-national governments in investing on infrastructure projects to stimulate regional economy; (iii) Synchronization of expenditure and revenue flows. Access to financial tools offers an opportunity to sub-national governments to synchronize expenditures incurred and revenue collection. For a variety of reasons expenditure incurred and tax intake may not be fully synchronized for a particular year. In such a situation, borrowing provides sub-national governments to smooth out the mismatch and provide services without disruption.

CONCLUSIONS

Legal and constitutional framework, as well as institutional structure of the public administration system in each country has a bearing on the outcome of fiscal decentralization implementation. The success of fiscal decentralization reforms is inextricably tied to the question of sorting-out public sector responsibilities among different levels of government. There is no prescribed set of rules for sorting-out that apply to all countries.

Although specific aspects of fiscal decentralization process can be worked out in the context of each individual country, the common components of designing a decentralized system of intergovernmental fiscal relations in all countries are assignment of responsibilities for governmental functions, assignment of the power among levels of government to tax people and collect revenues, the nature of intergovernmental transfers system and ability of sub-national governments to borrow.

The failure to design these interrelated components in a consistent way may lead to undesirable results. However, the issue of designing an effective intergovernmental structure is not limited to these components. It involves electing local government officials, having approved budget locally, absence of mandates on local governments as regards to employment and salaries, keeping adequate books of account and monitoring, and monitoring progress towards an effective fiscal decentralization.

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NOTES

- * Post Graduate Student of Economic and Business Faculty, UKM.
- 1 Decentralization is known as a broad term encompassing several arrangements of intergovernmental affairs. There are three basic variants: delegation, devolution, and de-concentration. Delegation is intermediate between devolution and de-concentration. Through delegation, central governments transfer responsibility for decision-making and administration of public functions to sub-national governments. But the powers still belong to the center. Lower levels of government act as agents of the central government.

Delegation is a more extensive form of decentralization. Devolution is the most complete form of decentralization: independently established sub-national governments are given the responsibility for delivery of a set of public services along with the authority to impose fees and taxes to finance those services. Devolved governments have considerable flexibility to select the mix and level of services to provide to their citizens. Devolution is used most frequently in federal countries. On the other hand, de-concentration refers to the decentralization of central government ministries. In most unitary countries are known as regulation. There are two kinds of de-concentration. De-concentration with authority means that regional branches of central offices are created with some ability to make independent decisions. De-concentration without authority occurs when regional offices are created with no independent capacity from the center. All deviations from normal practice must be approved by the center.

- 2 *Zakah* literally means purification (*thaharah*), growth (*nama'*), grant from above (*barokah*) and praise (*madh*) and *zakah* is included in one of Islamic pillars (Abu Ubayd, in al-Amwal 1353H p: 492-912).

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Islamic Economics and Finance Research Group
Faculty of Economics
Universiti Kebangsaan Malaysia
43600 UKM Bangi
Selangor Darul Ehsan
Malaysia
Fax: 603-8921 5760
e-mail: mhd_zilal_hamzah@hotmail.com