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# The Decentralization of Government

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## I. INTRODUCTION

During the past two decades, three concerns have dominated the discussion about reforming fiscal structures: rationalizing tax structures to make them more simple and more compatible with economic development objectives, modernizing the tax administration to increase the rate of revenue mobilization and reduce the compliance cost, and decentralizing the revenue raising powers and the expenditure delivery responsibilities of central governments. This paper is about the third of these concerns, and arguably the one where the least progress has been made, fiscal decentralization.

A reasonable working definition of fiscal decentralization is the delegation of revenue raising powers, expenditure responsibility, and budget autonomy to subnational level governments.[1] In other words, what is the best arrangement of fiscal powers and responsibilities between the different levels of government? This is a question at the center of policy debate in countries around the world (Bird, 1993). It is not an issue restricted to big countries, as many believe. Though it is an important concern in China and the United States, it is also under study in Nicaragua and the Baltics. Nor is it restricted to higher income countries -- it is presently a major concern in Russia, India and the United States. Some countries answer the decentralization question with new policy thrusts, some with newly elected politicians with different views, and some even attempt to solve the issue by

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[1] This should be distinguished from *devolution*, which refers to the central government's delegation of administrative powers to its regional and local arms. Decentralization moves governance closer to the people, but devolution does not.

means of force.

The question of the proper fiscal balance between central and subnational governments is especially important in the developing and transition countries (Bahl and Linn, 1992; Bird, Ebel and Wallich, 1995). These nations are torn between trying to control unstable economies and trying to invest more decision making power in populations that have long been disenfranchised. Interest has been heightened in recent years because of the trend toward popularly elected provincial and local councils, and the improved technical ability of local governments to deliver and finance services. Yet many of these countries, facing budget deficits and pressure on prices, recognize that fiscal decentralization could impose a considerable cost and perhaps even an economic risk.

The next section of this paper provides a brief overview of worldwide trends in fiscal decentralization, and a menu of reasons why it will become increasingly important. In section III we turn to a review of the economic theory of fiscal decentralization, the economic benefits and costs imposed, and the empirical evidence of the success with decentralization. The two major approaches to financing subnational governements, assignment and sharing, are evaluated in sections IV and V. A concluding section summarizes the lessons learned in the past decade.

## II. THE WORLDWIDE PUSH FOR DECENTRALIZATION OF GOVERNMENT

Fiscal Decentralization has long been on the policy agenda, because its logic is irresistible and its politics are right (World Bank, 1988). Shifting powers to provincial and local governments moves decision making closer to the people and serves nation-building purposes; it allows people to choose the services they want and therefore increases their willingness to pay; and it makes local officials more accountable to their constituents and therefore increases the efficiency of local service delivery. Politicians like the ring of an argument that says local people know their needs better than do national bureaucrats. Even academics find the arguments appealing; economists see the efficiency gains from smaller government units, and political scientists see the better link between voters and budget outcomes.

Despite these persuasive arguments, there was no significant worldwide movement toward fiscal decentralization in the 1960's and 1970's. The subnational government expenditure share was about 30 percent in the 1980s and the share in less developed countries was about 15 percent. Moreover, these shares had not changed since the preceding decade (Bahl and Nath, 1986). Indeed, in the mid-1980's it was difficult to point to a developing country where a significant devolution of revenue raising power had taken place.

The 1990s, however, are a new setting and one that is much more conducive to a stronger participation in the fiscal system by subnational governments. One might offer the following propositions in support of the argument that subnational governments will grow in importance in the next decade.

## Economic Efficiency Gains

Economists argue that if people are free to choose a mix of services that matches their preferences, fits their income constraint, and takes relative prices into account, they will be better off. And so long as these services are not characterized by spillover effects, society also will be better off. The process by which this happens is that elected officials interpret the preferences of the voters for the package of services they desire. The smaller the governmental unit, the more likely it is that preferences will be similar. Unless there are local elections, however, these efficiency gains cannot be captured. A provincial governor appointed by the central government will not see local voters as his constituency.

Until recent years, local elections were not the order of the day, especially in the former Soviet block countries and in the developing countries. But the late 1980's saw major changes in this situation, as dictatorships fell and elected local councils became more the rule than the exception. Because of popular elections at the local level, the efficiency gains are more likely to be captured and the case for decentralization is much stronger than in the past.

Ethnic Differences

A major reason for fiscal decentralization and in particular for the federal structure of government, is ethnic, religious or cultural differences in the population that make it difficult for all groups in the country to accept the same degree of central control. Sometimes the differences are too great to be reconciled by local autonomy, a federal system of governance or even by a confederation. The breakup of the former Soviet Union, Yugoslavia and Czechoslovakia are examples.

In most cases, however, it is possible to hold the country together. This solution has the advantages of creating a stronger economic unit by removing barriers to trade, capturing comparative advantage, and eliminating duplication of services. The resolution to the problem of the demand for autonomy by the different ethnic or cultural groups, and the need for a central government, is to create a decentralized fiscal and governance structure where the lower level unit is given a significant measure of control over its own affairs. The debate usually centers around what is significant.

The 1990's is a time when tensions among "different" population groups is a high level. Many countries are searching for solutions that grant regional autonomy but, allow the central government to maintain a viable fiscal position. The most prominent examples are in the former Soviet republics, and in eastern Europe. Work is underway now to find decentralized fiscal solutions in Russia, Ukraine, the Baltics, Bulgaria, and Croatia (Martinez-Vazquez and Boex, 1995). Outside Europe, decentralization is a major agenda item in many diverse countries ranging from China and India to Nicaragua.

The 1990's are also a time when secession movements will force some greater degree of fiscal decentralization. Several of the Russian oblasts (provinces) are in open defiance of the central authority and threaten to break away. Quebec is unhappy with its place in the Canadian federation, and there is a separatist movement in Spain. The Philippines has made special arrangements for governance of the Moslem provinces, and many other countries have set up special fiscal treatments for minority groups. These are just a few examples of situations where fiscal decentralization may be part of a solution.

The 1990's is also a time for unification, and decentralized fiscal structures can provide an assurance to the new members that they will have some degree of autonomy. The absorption of East Germany was made easier because of the federal structure. China plans a special fiscal regime for Hong Kong, decentralized governance is a centerpiece of the new arrangement for the West Bank, and South Africa will be a form of federation (Financial and Fiscal Commission of South Africa, 1995). There are many other examples of unification that could occur in the 1990's.

Does this suggest more decentralization in the next decade? What seems to have happened in the very recent past is that subgroups of the population of countries, who never really got along, now have the wherewithal to break away. One form of "breaking away" is the adoption of a decentralized structure. A reasonable proposition is that more of this will be seen in the coming years.

Deficit Problems and Offloading

Central governments in decentralized systems sometimes attempt to off-load their deficits onto local governments (Martinez-Vazquez, 1994). They may do this by cutting the flow of grants or subsidies to local governments, or assigning local governments additional expenditure responsibility.

The Russian government passed responsibility for safety net expenditures, and for capital expenditures to its oblasts in 1992, but did not pass along additional revenues. The intention clearly was to relieve the pressure on the central budget. The government had to pull back the capital expenditure responsibilities, but the safety net remains an explosive issue. The Chinese reform of 1994 was an attempt to recapture revenue from the local governments to head off what appeared to be a pending central government budget imbalance. The U.S. government is undertaking a similar offloading as it reduces grants to its state governments. Note from these examples that "offloading" is not restricted to countries without a long history of democratic governance.

While local governments refer to this as "offloading", central governments see it as "clawing back." The provincial and local governments in China had increased their share of revenues dramatically since the mid 1980's, creating what the center saw as an imbalance that could not be sustained. The U.S. state and local governments have run an aggregate surpluses at the same time the federal government was running a deficit and passing substantial aid to the subnational sector. These "offloading" strategies can also be seen as attempts to control the growth in local spending.

A constraint to fiscal decentralization, especially in the developing and transition countries, is the extent to which it compromises the ability of the central government to pursue stabilization policy. Offloading and clawing back mitigate against this constraint. The recent success with these strategies may give central governments confidence that they can recontract to "undo" the dangers with decentralized structures in times of macroeconomic pressure. In a perverse way, then, this will make fiscal decentralization a more acceptable policy.

New Technology

Central governments in less developed countries have typically withheld fiscal power from local governments on grounds that local governments are not capable of adequate tax collection or efficient expenditure delivery. The complaints are legion. On the tax administration side, collection rates for local property taxes are often in the 40 percent range, adequate tax rolls do not exist, penalties are not applied and outright evasion is rampant. The problems, it is usually sated, are inadequately trained personnel, inadequate procedures, and little or no computerization. On the expenditure side, local governments often have too little equipment to carry out capital projects, too little resources and technical know-how to maintain them properly, insufficient materials and supplies and materials on hand, and too few trained personnel to deliver most social services adequately.

Recent years have seen a technology explosion which has greatly increased the administrative capacity of local governments. Tax Administration can greatly benefit from computerization, and at least in the larger cities this is a technology that can be absorbed. Relatively little investment in microcomputers can dramatically improve the record keeping systems for tax administration, and can be easily used for maintaining an adequate tax roll, billings, and identification of delinquencies. The inadequate human resource issue can also be addressed with increased emphasis on training.[2] With growing urbanization, the local governments now have a capacity to carry train high quality staff for service delivery, and can justify the capital labor substitution that will improve capital construction activities and maintenance of the capital stock.

If it is correct that the capacity of local governments to absorb new technology and train personnel is correct, then an important constraint to fiscal decentralization will have been removed. Central governments might take this to mean that local governments can carry more fiscal responsibility without raising the fear of declining revenue mobilization and inefficient delivery of basic services.

## II. THEORY AND FISCAL DECENTRALIZATION[3]

There always has been a cry for more decentralization of government, resulting from a combination of people wanting to get more involved in the process of government and the inability of central governments to "get the job done." Yet, many countries around the world have remained highly centralized and have been loathe to relinquish taxing and spending powers to lower level governments. We might call on the theory of fiscal federalism (Oates, 1972) to solve this puzzle.

### The Economic Justification of Decentralization

Efficiency. Economists invoke an efficiency criteria in arguing for smaller local government, i.e., in arguing for fiscal decentralization. If preferences for public services differ across subgroups of the population, and if externalities are not present, then national welfare is maximized if local communities vote their preferences and provide the level and mix of public services that they want. Non-economists might take the same view, but couch it in different terms: getting government closer to the people will lead to more participation in government, will likely provide an outcome that is closest to the preferences of the median voter, and will allow the political process to guarantee a more efficient operation of local government. Either way, the results should be the same:

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[2] In 1994, the Chinese Government created an entirely new system of local tax administration, and passed responsibility for all income tax administration to the local governments.

[3] These arguments are developed more fully in Bahl and Linn (1992), pp. 385-427.

- The mix of services provided will match the demands of the local population.
- Government officials will become more accountable to voters for the quality of services they provide.
- Local populations will be more willing to pay for public services, since their preferences will be honored.

The economic theory of local public goods, on which the efficiency argument is based, is well developed in the U.S. literature (Borcherding and Deacon). A median voter with a preference function (U) and a budget of $O\tilde{X}$ chooses to consume $OG_1$, units of government goods and $OX_1$, units of private goods. Taxes paid are $\tilde{X}X'$. (Figure 1). At this equilibrium (E), the ratios of the marginal utilities are equal to the ratio of the prices and the consumer cannot make a better choice without reducing his welfare. Moreover, the efficiency effects of any movement from E can be evaluated. Relatively little has been done, however, with the measurement of efficiency gains and losses, resulting from changes in relative price, i.e., we cannot say how much is to be gained from a more efficient arrangement of government.

The traditional theory shows that if a larger government with a more heterogeneous population voted for $G'$ or $G''$, and this level of government services was imposed on the residents of this community, a welfare loss would occur for these residents. Decentralized government is the answer to this problem.

However, the theory of local public goods was developed with western industrialized economics in mind and this paradigm may not fit the developing and transition countries. There are at least four reasons.

1. The provincial or local government may not have capacity to deliver services at the level desired by residents. For example, it may be unable to deliver more than $G'$

units of government goods, and this would push the consumer-voter back to a level of utility lower than U in Figure 1. Subnational governments in developing and transition countries often are criticized by the private sector who claim a willingness to pay for more and better services, but also claim that local governments do not have the capacity to deliver the higher level of services.

2. The local government may be restricted to $\tilde{X}X^1$ in taxes, either because it does not have the administrative capacity to collect more, or because it is denied the right to increase the tax rate to $\tilde{X}X_1/O\tilde{X}$.

3. There is no median voter, because the local council and the chief officers of the local government are not elected. This means that the bureaucratic decision process takes into account both the demands of the local population as well as the demands of the higher level (appointing) government.

4. This model can be used to show that intergovernmental transfers, that distort relative prices of public and private goods, result in efficiency losses, that lump sum grants do not, etc. However, in the LDC context where subnational governments are usually unable to reach an initial level of equilibrium, this analytic model breaks down. We cannot judge the efficiency effects of alternative forms of grant systems.

The conclusions we draw from this are, (a) there has been some question about whether local governments in developing and transition countries could capture the efficiency gains that come with fiscal decentralization, and (b) whether the traditional block grant solution can improve matters. (See Figure 1).

<u>Revenue Mobilization.</u> A second argument for fiscal decentralization, not often made, is that it can enhance revenue mobilization. Some taxes are suited to local government in that their

assessment and collection requires familiarity with the local economy and population, and because they are perceived as quasi-benefit charges that finance local services. The property tax and other land based taxes are usually thought of as local government taxes. It is also true that central government value-added and income taxes often do not reach smaller enterprises. Typically, small firms are legally exempt from income tax and VAT for administrative reasons. Workers outside the formal sector often escape individual income taxes because the administrative apparatus cannot find them. Local governments, it could be argued, might be able to capture this untapped fiscal capacity because of their greater familiarity with the local tax base.

The decentralized system of financing in the United States is a case in point. The state governments make use of retail sales taxes that reach even the smallest firms. It is doubtful that the U.S. Treasury could do as good a job with administration of this tax as do the state and local governments. Similarly, the property tax is a local government revenue source in the U.S., and its assessment and collection would be much less efficient as a federal tax. Again the issue is with the advantages of familiarity with the local economy in identifying the tax base.

Optimal City Size. Another potential gain from decentralization is that it enables local governments to charge its residents a price approximating the marginal cost of delivering public services. If a city becomes too congested, the price rises and migration slows, so the theory goes. The result will be a more efficient organization of economic activity and population within the country.

In fact, local governments in developing and transition countries often do not have any control over their user charges and levels of local taxation. The result is that they cannot set "prices" to reflect the cost of providing services. Even if they could, it is not clear that they could tax the in-migrants, who tend to be poorer, in the informal sector, and often outside the tax base.

Even in the industrialized countries where the tax rates can often be adjusted, there is concern about whether the levy of certain taxes, and the provision of certain pro-poor services actually works to hold the poor and drive away higher income taxpayers. And in the case of both developed and developing countries, there is the issue of whether a higher tax price could discourage a significant portion of migration or divert it to smaller urban places.

Conclusions. Given this state of affairs, the situation in a transition country which could give maximum gains from a more decentralized local government structure would include: (a) enough skilled labor, access to materials, and capital to expand public service delivery when desired, (b) an efficient tax administration, (c) taxing power sufficient to capture significant portions of community income increments, (d) an income-elastic demand for public services, (e) popularly elected local officials, and (f) some local discretion in shaping the budget and setting the tax rate. This list suggests two areas where policy might be rethought. The first is to think less about intergovernmental transfers as the route to removing the financing bottleneck for subnational governments, and to think more about investment to strengthen tax administration and expenditure delivery capacity. The second is to recognize that the prospects for effective fiscal decentralization are better in industrialized than in transition and developing in transition and developing countries. Where these conditions are present in lower income and transition countries, it is usually in the wealthier provinces. This suggests that fiscal decentralization initiatives might have their best chance of success in the higher income regions and might initially be limited to such places. This would not likely be a politically popular feature of a decentralization reform movement.

## Advantages of Centralization

The arguments for fiscal centralization, on the other hand, are stronger in transition and developing than in industrial countries (Prudhomme, 1995). History has shown that stabilization policy is an especially important concern in developing economies and in those economies that are in transition to a capitalist system. This argues for central government control of the main fiscal instruments (taxation, spending, and borrowing). Under a highly decentralized system where the local governments have a built-in claim on a share of total revenues raised, the central government will find itself in a difficult position insofar as increasing revenues to reduce the total deficit, or passing structural tax reforms that might be aimed at stimulating savings or reducing imports. By the same token, controlling inflation by limiting government spending may be compromised if local governments have the power to set their own budgets.[4]

A related issue is the relationship between control of the central government budget deficit and intergovernmental fiscal relations. Where the central government has power over all the major fiscal instruments, it can target on an acceptable level of the deficit and control this with either tax increases or expenditure control. And, as noted above, central governments would like the latitude to try and off-load their shortfalls onto local governments by reducing grants or other subsidies. Some countries have installed safeguards against the offloading phenomena. India and Australia, for example, have grants commissions that set the allocations for a period of time, and local shares are constitutionally guaranteed in some countries. The absence of transparency in government allocations to the subnational sector is not in the interest of good governance. Countries with chronic deficit problems would do well to unbundle these two important policy questions: what to do about the central deficit, and what is the right fiscal balance between the central and local governments?

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[4] Gramlich, however, disagrees with this proposition, at least in the context of industrialized countries. " ... since central government fiscal policy has a limited stabilization effect anyway, the time seems right for some new thinking about decentralization strategies" (Gramlich, p. 234).

In transition countries that are undergoing privatization and building a public and industrial infrastructure, the need for a coherent investment policy is also an argument for fiscal centralization. Capital resources are scarce and must be controlled by the central government to maximize returns, and the spellover effects of major capital investments are important. If local governments are given access to major tax bases, they may compete with the central government and therefore limit central revenues. As a corollary, centralization allows the national government to allocate fiscal resources to goods and services with national benefits, whereas local autonomy would inevitably lead to greater expenditures on those services that have more local benefits.

Several arguments for income distribution also support fiscal centralization. The most important is that regional (and rural-urban) disparities in income and wealth may be accentuated by fiscal decentralization because wealthier urban governments will benefit most from greater local taxing powers. Centralization allows the national government more discretion in shaping regional differences in levels of public service and taxation, which is an especially important consideration for governments that intend to use tax and subsidy policy to shape the spatial distribution of economic development.

But the *potential* to use the central budget to redistribute resources among regions is only part of the story. The rest is whether equalization actually takes place. Three interesting cases are China, Russia, and the U.S. are characterized by significant fiscal disparities. China and Russia in particular have faced difficult choices as regards equalization. China was forced to choose between funneling more resources to the lower income provinces or leaving the revenues in the higher income and faster growing coastal provinces. Russia has faced the difficult decision of choosing among equalization, central government fiscal solvency, and appeasing the potential breakaway provinces.

In both cases, the central governments retained control over the fiscal resources and the fiscal systems were not equalizing. The U.S. federal government is in much less of a position to affect a regional redistribution of resources, since it directly collects only about 60 percent of revenues, and about two-thirds of its grants are to persons rather than to places. Still, the U.S. grants system is not equalizing, i.e., significantly more grants do not go to lower income states.

## IV. INSTUMENTS OF DECENTRALIZATION: THE ASSIGNMENT MODEL

One model of fiscal decentralization assigns specified taxing powers to local governments. The other shares centrally-collected revenues with the local governments. There is a great deal of debate about these two approaches. In this section, we evaluate the assignment model and in the next we consider the sharing model.

Under an assignment system, the subnational governments are given the power to set tax rates and in some cases to choose tax bases. In general, we might expect an assignment system to lead to more efficient outcomes as local governments choose their tax prices, but to less equitable outcomes as fiscal capacity is separated from expenditures. In fact, the true results depend on which taxes are assigned to the subnational government level.

There is not uniform agreement among policy makers about which taxes should be assigned to which level of government (Musgrave, 1983; McLure, 1994, Oates, 1993). But three general principals that might guide decisions on this questions are:

- Local governments should be assigned taxes whose burdens are local, i.e., are not easily exported to residents who do not benefit from the local services that are being financed by the revenues raised,

- Local Governments should not levy taxes that cause businesses to adopt methods of doing business that might harm the growth in the local (and national) economy,
- Local governments should not levy taxes that impose heavy administrative and compliance costs.

Value Added Tax

The value added tax is unsuitable for use by subnational governments. It must be a central government tax. A primary reason for this rule is that administration would become hopelessly complicated if each local government were permitted to set its own standards for creditable and non-creditable transactions, set its own tax rates, and follow its own methods of administration. Moreover, local governments would almost certainly attempt to arrange protectionist-type safeguards to keep more of the revenue in the home province. They could do this by placing penalties on purchases from "foreign" suppliers.

Even if the VAT is held to a uniform national rate and base structure, it is not suitable for sharing on a derivation basis, i.e., a system whereby each local government retains all or a share of what is collected within its boundaries. This is because some resource rich and processing areas would benefit greatly while those who export would be in the zero-rated zone and would collect little net revenue (McLure, 1994). China and Russia do share the VAT between the Central and Provincial governments on a derivation basis, but the problems are mitigated because in both countries the tax is collected by a central tax service, and in China, at least, the zero rating credits are paid by the central government. Even so, protectionists policies have arisen in some Chinese provinces.

## The Business Income Tax

Corporate income taxes can be used by sub-national governments, and are in fact used by 41 of the 50 U.S. states. However, this tax fails all the tests of a good local tax: it imposes a high compliance cost, it causes firms to adopt inefficient practices to avoid taxation, and it offers the opportunity for one province to export its tax burden to (non-benefitting)[5] capital owners, workers and residents in other provinces.

The use of a subnational corporate income tax requires that the provinces use a formula to allocate taxable profits among the provinces where the corporation operates. This introduces enormous administrative and compliance costs, and if states have different tax rates, it opens the door for transfer pricing to reduce overall tax liability. In many developing and transition countries, the problems of formula allocation have not yet arisen because enterprises tend to operate in a single province. Russia, China and the Eastern European countries are examples. But as multi-province operations begin to emerge, the practice of separate accounting for each enterprise location will no longer be possible, and the complexities that plague the provincial level company income tax will become apparent (Bahl, 1994a).

The appeal of the corporate income tax is that it can yield significant revenue, though in Russia and China it has dwindled as a revenue source (Hofman, 1993; and Bahl and Wallace, 1994). It is a particularly difficult revenue source for transition countries because the process of privatization and the switch to a market-driven economy may compromise enterprise profits

[5] That is, residents of other states who do not directly or indirectly benefit from the services provided in the taxing state.

significantly. Moreover, the corporate income tax can be quite cyclical in its flow of revenues, and this is undesirable if local governments are responsible for essential public services.

The Individual Income Tax

The individual income tax meets most of the tests for a good provincial (or local) level tax. First, it can be relatively easy to administer to the extent it focuses on payroll employment, and it can be linked to the central government income tax bases. Most of the American states use an individual income tax, and choose the same definition of gross income as does the federal government. There is cooperation between the two levels of government in the administration of the tax, though administration is separate. Second, the individual income tax is resident based, and therefore the burdens may be thought to fall mostly in the levying jurisdiction, i.e., there is a correspondence between where the tax is paid, and where the benefits from the public services financed by this tax are received. An advantage of the individual income tax, of course, is that it can yield quite a significant amount of revenue. It is the principal source of subnational government revenue, in the Scandinavian countries. In addition, it is more stable in yield than is the company tax.

All would not agree with the conclusion that the individual income tax is a proper source of revenue for local governments. The following are among the criticisms most often levied:

- It is often seen as an instrument that may be used to shape the distribution of income. Income distribution is a central and not a local responsibility, and therefore this instrument should be left to the central government. Anyway, local governments may choose tax rate structures that will offset some of the progressivity intentions of the central income tax. Some former eastern bloc countries overcome this problem by having a uniform rate and base structure that is centrally determined, but revenues that are shared with the local governments.

- The individual income tax is an effective instrument of stabilization policy, i.e., it can be cut in times of recession to stimulate economic activity, etc. Local governments are notorious for behaving in a countercyclical way to cover deficits, and their use of the individual income tax may compromise central government policies. This has created problems in the United States where state and local governments regularly raise tax rates during periods of economic contraction.

- There is not always a perfect correspondence between where one pays taxes and where one receives public service benefits. In the United States, commuters into the central city often reside in another taxing jurisdiction. To compensate for this, U.S. cities often have a local income tax on both commuters and residents. In Russia, the individual income tax is returned 100 percent to the local governments, but all to the place of employment and none to the place of residence. As labor mobility increases and housing becomes less dear, this will become a significant problem with the individual income tax sharing in Russia.

- There are major administrative problems with taxing the self employed. In transition countries the tax is usually collected by the enterprises as withholdings, and small businesses are not easily identified and audited. Most developing and transition countries are forced to live with this exclusion from the tax base, which creates a revenue loss and a significant source of unfairness in taxation.

- In transition countries, central decisions about wage rates and other limitations on the compensation of employees may compromise the yield of the individual income tax.

<u>Foreign Trade taxes</u>

There is little disagreement but that taxes on international trade should assigned to the central government (McLure, 1994; Musgrave, 1983). Local governments should never be allowed to set tariffs or export tax rates or to decide on exemptions. Sharing on a derivation basis would likewise be inappropriate, because the revenues would accrue to the Port cities. There are few examples of local governments having any significant claim on revenues from international trade taxes.

<u>Retail Sales Taxes</u>

The flat rate ad valorem tax on retail sales, commonly used by state and local governments in the United States, also meets the tests of a good local tax. The burden mostly falls in the taxing jurisdiction (most business purchases are exempt), and administration is relatively straightforward. The revenue yield is quite significant. In 1992, retail sales taxes accounted for 14 percent of all state and local government revenue in the U.S.(ACIR, 1994). The elasticity of the retail sales tax remains near unity, i.e., revenues grow about in proportion to personal income.

But there are problems with the retail sales tax as a local government revenue source, especially in the transition and developing countries. The most important problem is administration. Where there is a proliferation of small shops, whose books of account are irregular, and where modern cash register equipment is not present, collection and audit are difficult. Second, the coverage of the retail sales tax is narrow and in the United States most services are not taxed. This is because of the difficulties of tracking interstate transactions, the difficulties of separating business input purchases from individual purchases, and of course politics. It leads to an erosion of the tax base and a horizontal inequity as regards the treatment of those with different consumption patterns (Snell, 1993).

User Charges

Clearly, subnational governments should rely more heavily on benefit and user charges (Shah and Qureshi, 1994). Charges for locally provided services are efficient, and they are relatively easily administered. Revenues can be significant. In the United States, user charges accounted for about 14 percent of total state and local government revenues in 1992 (ACIR, 1994).

The problem with user charges in transition and developing countries is that essential services -- where user charge potential is greatest -- are often provided at subsidized rates. In China and Russia, public transit, utilities and housing are not self-sustaining and in fact are part of national wage policy. The same is true in most developing countries where the low income population is substantial, and where affordability (and politics) are major problems. Bird (1993, p. 212) notes that "The potential for improved user charge finance as a means of financing local government thus remains more potential than reality.

Property Tax

The residential property tax is the ideal local tax in many ways. It is a rough form of benefit charge since land owners are primary beneficiaries from most local services. It is a tax best administered by local governments since it requires identification of each parcel of land, identification of each new improvement, and identification of changes in ownership. Clearly the tracking of such changes is well beyond the reach of the central government. The property tax accounted for 18 percent of all state and local government revenue in the United States in 1992, but 30 percent of the revenues of local governments in the same year (ACIR, 1994).

On the other hand, few countries in the world approach this intensity of use of the property tax. And there are good reasons for this. Administration of the tax is difficult, especially in the transition countries where the identification of property ownership is difficult. Moreover, there is a major problem with valuation of property, especially where the tax base is defined to include improvements as well as land. Finally, many if not most governments are loathe to strictly enforce the property tax by seizing property. The result is that the yield of the property tax is rarely more than one percent of total national revenues.

Even in the United States the property tax is widely unpopular and has been the source of a taxpayer revolt. In most states it is subject to limits on its growth, and many wonder if it can continue to be the mainstay of education finance in the U.S. (Snell, chapter 9).

Borrowing

There is a strong case for local government borrowing to finance capital projects. These projects have a long life, hence it is reasonable that they be paid for as they are used up. Not to allow this form of financing is to introduce a bias against capital spending and in favor of consumption spending, which is not likely a policy in the interest of most local governments in low income or transition countries. Moreover, the wealthier local governments have an ability to repay loans, either through taxes or user charges, and it seems reasonable to substitute loans for grant-financed capital projects.

## Conclusions

The assignment of revenue sources to local governments presents difficult choices. It has been made more difficult by the growth in the VAT as the major source of government revenue around the world. The VAT is not suitable for local governments, as a local source revenue or as a derivation shared revenue. Neither are foreign trade taxes, commercial ventures, or the business income tax. Arguably the best sources of local government revenue are the individual income tax, the property tax and user charges. Retail sales taxes can also work, but only in more industrialized countries that possess the administrative infrastructure necessary to assess and collect the tax. Higher income local governments should be given borrowing powers for capital project financing.

# V. THE SHARING MODEL

An alternative approach to fiscal decentralization calls for central government collections and a sharing of the revenues with subnational governments. In general, this preserves the revenue control by the central government and it can be equalizing, but it's efficiency properties are weak because the link between tax burdens and expenditure benefits is broken. However, the actual effects depend largely on the specific type of transfers used.

Transfer systems have two dimensions: the method of determining the size of the divisible pool and the method of determining the distribution among subnational governments. The former is usually thought of as the "vertical balance" dimension, and the latter as the "horizontal balance" dimension. To understand and evaluate a transfer system, it is necessary to consider both horizontal and vertical equity.

## Vertical Equity

The current practice in developing countries suggests three basic approaches: a specified share of national government tax revenues, an ad hoc decision (such as an annual appropriation voted by a parliament), or reimbursement of approved expenditures.

The shared tax approach does not necessarily resolve the problem of an imbalance between the total amount of expenditure responsibility that has been allocated to local governments and the total amount of revenue that is being passed to them to finance these responsibilities. It depends on the share of the national tax that is being allocated. There are other characteristics of the shared tax approach that are worth noting:

- It provides a degree of certainty to local governments and therefore encourages better local fiscal planning.
- It might be legislated and therefore not easily reversed by the central government, therefore it may compromise the flexibility of the central government to use fiscal policy.

The second approach to vertical balance is an ad hoc decision. That is, parliament decides each year how much the local government sector should receive. This has the potential to resolve the vertical balance problem because the Center can evaluate the true level of needs, and may adjust these each year. On the other hand, Parliament also decide to reduce transfers to the local level based on new priorities. The ad hoc approach is the least transparent approach, and the most susceptible to political interference.

The third approach is cost reimbursement, and is based on a recognition that the local governments may not be able to handle the financing of a particular service form their own resources. Usually it is a service that has been assigned national importance, e.g., education or highways. The Center will simply reimburse the local sector all or part of all expenditures on the designated service. The advantage of this approach, from a central point of view, is that the funds are designated for a specific object, and moreover, the Center can insure national standards, e.g., specifications for road and bridge construction, classroom size, hospital facilities, etc. Still this addresses only the vertical balance issue with respect to a few functions and vertical inequity may still exist.

Horizontal Equity

Once the amount of the pool is determined, allocations among local governments are typically made in any of four ways: by returning shares to the jurisdictions from which the taxes were collected (i.e., using a derivation principle); by formula; ad hoc; or by reimbursing costs.This two-way classification suggest many different combinations of vertical and horizontal equity allocators. In the sections below, we review a few of the most important ones.

The Shared Tax. The purest form of shared tax requires that some proportion of the amount collected in the jurisdiction of a local government be returned to that local government (i.e., that a *derivation* principle of revenue sharing be applied). The national or regional government deducts a fee for collection, usually a specified percentage of total receipts. Under this system, the local government has no control over the determination of rate and base. Type A is thus an intergovernmental transfer and not a local tax.

Why would a shared tax be used instead of an outright grant or a local tax? There are at least three reasons. First, the national government may be pursuing a bona fide program of fiscal decentralization, intent on guaranteeing the subnational government some share of locally generated revenues. Brazil designates shares of the value added tax (VAT) for state and local governments; Colombia shares beer tax revenues with Bogota and the departments; Malaysia has shared excise taxes on petroleum with the states; the Chinese central, provincial, and local governments share the revenues from income and sales taxes; and the Russian federal and subnational governments share income and value added taxes. Second, the national government may see the need to mobilize more resources from local tax bases, thinking that local governments do not have the administrative capacity or political will to carry it off. Third, the government may want--through shared taxes rather than independent local taxes--to keep open a line of fiscal control while quieting somewhat the calls for a better vertical fiscal balance.

There are three important advantages to pure shared taxes (type A). First, by comparison with allocation by formula or ad hoc arrangement, the amount of transfer to the local unit is certain and the fiscal planning of local governments is improved by this certainty. If ad hoc (type D) methods of distributing earmarked national tax shares are used, there is much room for debate over the proper method of allocation; and for cost-reimbursement allocations (type C), the national government may make ad hoc changes in the conditions under which costs may be covered. Second, pure tax sharing might give local governments access to an income-and inflation-elastic revenue base, such as consumption or production, and thereby improve the adequacy of revenues raised by local governments. Third, if conditions are not imposed on the use to which the funds are put, local fiscal autonomy might increase significantly under a pure shared tax. This third advantage, of course, depends on the national government's willingness not to tamper with the vertical fiscal balance once it is created. From the point of view of the national government, sharing arrangements tend to be inflexible, because it is politically difficult to change the earmarked percentages and, because it is difficult to make year-to-year adjustments in the total budget allocation to specific local governments. Such flexibility is important in economics that are exposed by external events (e.g. rising energy costs, declining world prices for minerals, typhoons) to economic uncertainty.

An even more important problem with the pure shared tax is that it is not equalizing. The return of revenues on the basis of point of collection will further enrich the higher income urban communities. The fact that this form of national assistance is effectively a local area tax over which the local government has no control creates other advantages and disadvantages. The advantage is that the lack of local control frees local officials from having to make unpopular decisions about increasing tax rates and enforcing collection. This feature probably makes the tax more productive than would be the case if it were an independent local tax. However, the potential disadvantage with any form of national assistance is that the separation of the pleasure of the benefits of expenditure from the pain of taxation means that local governments are given less incentive to operate more efficiently, to reallocate expenditures among functions, and to increase the total level of spending or tax effort. The shared tax is better than the other forms of grant assistance on this count, and the greater the percentage of the tax to be retained, the more incentive local residents will have to comply. The issue here is the extent to which local taxpayers perceive the shared tax as being "kept at home" to finance local services.

Formula Grants. An alternative to the pure shared tax is to distribute the grant pool among eligible local units on the basis of some formula. The formula used for allocating the pool among local governments varies widely, but seems to reflect some combination of the desires to equalize fiscal capacity (or to reduce disparities in levels of public service) and to encourage local governments to mobilize resources. Although the idea of giving more funds to poor jurisdictions is straightforward, the practice is disappointing. The problem is finding an operational measure for making an equalizing allocation. Measures of personal income are commonly used for this purpose in industrialized countries, but such data are rarely available on a regular basis below the national level in developing and transition countries.

Some countries have attempted to build measures of tax effort directly into the formula in order to stimulate local resource mobilization. The Korean system in the past was one effort to try to hold tax rates at or above their present level; if a city drops below the standard tax rate, there is a built-in penalty in the form of a lower allocation. Other programs are more aggressive and try to reward higher tax efforts in the allocation. For example, India's Plan Grants include a measure of tax effort in the formula, as does the Nigerian formula for sharing national revenues with the states. Few countries can follow this practice, because they do not have adequate measures of local personal income. Moreover, there is little evidence that such incentives work to increase local revenue mobilization.

Grants to Reimburse Costs. A third way to transfer resources to local governments is to reimburse costs for a specified government expenditure.

An important issue is whether reimbursement is full or partial. The choice suggests quite different consequences. Full reimbursement of costs amounts to national government financing of a locally administered service; hence, no incentive is given to the local government for improved efficiency in the delivery of the service. Moreover, full reimbursement is likely to be accompanied by a rigid national government approval process, and local government fiscal choices may be minimized if not eliminated.

National governments have attempted to overcome the problem of incentives by subsidizing less than 100 percent of costs, i.e., by requiring a match from the recipient government. Such grants are meant to stimulate the tax effort of local governments on behalf of the aided function. Despite its merits, this type of grant imposes important costs on the residents of recipient communities, and perhaps on society. The stimulation of expenditure induced by the grant will distort the local budget in favor of the aided service and against other services that local residents might have chosen. Another potential cost is that such grants may be counter- equalizing because many of the takers will be those financially able to put up the match (Winkler, 1994).

Ad Hoc Grants. Perhaps the extreme case of centralization in grant design is an ad hoc program in which the size of the divisible pool is determined annually by the national government and the distribution is made on some subjective basis. Examples include: (1) open-ended construction grants that require approval of each project, (2) any grant allocated on a discretionary basis by the state or national government, and (3) supplementary grants allocated for special purposes during the fiscal year. The great advantage (and disadvantage) of ad hoc grants is that they give the national government maximum flexibility to redirect resources.

## V. CONCLUSIONS: LESSONS AND GUIDELINES

What lessons from the experience with fiscal decentralization might be learned from the international experience. The following are six principles that might be considered by fiscal planners in thinking through the development of the new system.

1. *There is no one best intergovernmental system.* Many different divisions of powers and responsibilities among levels of government, and many different kinds of transfer payment systems, can work effectively. Everything depends on how the government weights its

objectives. If investing decision-making power in the provincial governments is of paramount importance, then it is essential to give them autonomy to form budgets and set tax rates. It is also essential to give them political autonomy as regards election of local councils and appointment of local officers. If on the other hand, national objectives such as macroeconomic stability or equalization are most important, then the tilt should be toward more centralization and less toward, local government taxing and spending autonomy, powers to borrow, and direction of investment. The latter is the strategy that most transition and developing countries follow.

2. *Fiscal Decentralization is a system, and all of the pieces must fit together.* The system that any country designs must take into account, in some consistent way, the following:

- the assignment of taxing and spending powers and responsibilities,
- local government autonomy in setting tax rates, determining tax bases, and setting budgets,
- the degree to which local councils are popularly elected, and the degree to which local councils appoint and dismiss the chief local operating officers,
- whether the number and salaries of local government employees are determined by the local or the central government,
- whether, and how local governments will be able to borrow for capital purposes,
- the structure of intergovernmental transfers.

If an intergovernmental system is designed without considering all of the pieces, it is not likely to accomplish the objectives that the government has set for it.

3. *The place to begin in designing a proper fiscal balance between levels of government is with the expenditure side.* Until the assignment of expenditure responsibilities is decided, it is not possible to decide on the proper division of local taxing and borrowing powers, and the

"right" level of transfers. Policy makers should "run the numbers" associated with any particular expenditure assignment to determine revenue needs. (Martinez-Vazquez, 1994).

4. *Recognize that intergovernmental systems are always in transition, and plan for this.* Among the reasons for instability in systems of federalism are that;

- regional balances in economic power shift over time;
- ethnic differences take on more importance, either because of changing political power or because of civil unrest; and
- politicians change and bring new views and biases with them.

What can a country do to protect itself against the disruptions caused by these circumstances? One possibility is to set up commissions, as in India and Australia, to periodically review the intergovernmental system. Another is to put in place a data system that will enable a careful tracking of the fiscal performance of subnational governments, and the evaluation of the impact of changes in the federal system on these governments.

5. *It should be recognized that the age of VAT means that there is much less room for assignment of revenues to local governments.* The value added tax is not suitable as a local government revenue source, and it is not suitable as a shared tax on a derivation basis. This suggests that grants allocated on a basis other than derivation will play an increasing role in the intergovernmental fiscal structures in many countries. The individual income tax has many characteristics that make it suitable as a local government tax. Other good prospects are the local property tax and user charges.

6. *There is an intraprovince dimension to intergovernmental fiscal relations and this should be taken into account in planning the system.* If the central government worries only about the distribution of resources among the provinces, it may miss the more important issue of how resources are distributed among the rich and poor local governments within the province. Oftentimes, the disparities in income and wealth within a province are much greater than those among provinces.

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**Figure 1**

Defining an Efficient Level of Output For Local Public Goods in Developing Countries