2004

Fiscal Decentralization: Twelve Implementation Rules

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Otherwise, implementation will not be locally directed, and services may be delivered as directed by the centre. Other necessary conditions for fiscal decentralization are a significant set of expenditure responsibilities and a significant amount of taxing powers, budget making autonomy, transparency and a hard budget constraint. The latter forces local government to live within their means, and local officials to be accountable for hard choices that they must make.

BOX: CONDITIONS FOR A SYSTEM OF FISCAL DISCENTRALISATION

Necessary Conditions

- Elected Local Council
- Locally Appointed Chief Officers
- Significant Local Government
- Discretion to Raise Revenue
- Significant Local Government Expenditure Responsibilities
- Budget Autonomy
- A Hard Budget Constraint
- Transparency

Desirable Conditions

- Freedom from Excessive Central Expenditure Mandates
- Unconditional Transfers from Higher Level Governments
- Borrowing Powers

All fiscally decentralized systems will not look the same and some would give more autonomy to local government than others.

Not everyone follows the advice that design should be comprehensive. Some countries (and international agencies) think of a fiscal program no more than a revenue sharing system, or an upgrading of the property tax administration. Some ignore the fiscal issues completely and think of decentralization only in terms of the local election system, and planners very often focus exclusively on getting inputs from local population groups included in the project selection discussion. The "one dimension" approach may not produce successful decentralization because other elements crucial to capturing the benefits may not have changed in a supportive way, or may even work to yield offsetting results. There are many examples of problems with piecemeal reform from which we might draw:

- Russia has reformed its intergovernmental fiscal system to replace ad hoc grants with a formula-based transfer, but has not removed its extensive system of expenditure mandates. Clearly there were gains in transparency, but these were not accompanied by increased local discretion as to the expenditures of these monies.

(continued)

- South Africa has assigned significant non-property taxing powers to sub-national governments, including a payroll and turnover tax, and has granted local governments some borrowing powers. However, the government still has not put in place a hard budget constraint for local governments to force efficient use of these instruments.

- China's 1994 fiscal reform dramatically changed the national revenue sharing system, gave local governments more control over the administration of locally assigned taxes, and changed the balance of revenue availability between the two levels of government. However, no commensurate changes in expenditure assignment were made.

Rule 2: Finance Must Follow Function

The second rule is to get the correct order of reform. First should come the assignment of functional (or expenditure) responsibility to local governments, and then the assignment of revenues should be determined. This is an important rule, for two reasons. The first is that the government must establish expenditure needs at each level of government before tackling the question of revenue assignment. The second is that the economically efficient assignment of revenues requires knowledge of expenditure assignment. For example, services that may be priced (public utilities, buses) should be largely financed by user charges; general services with a local area benefit zone (roads, parks) should be financed with local taxes; and goods characterized by significant externalities should be financed from region-wide taxes and intergovernmental transfers. Governments must settle on the assignment of expenditure responsibilities to local governments, at least the assignment that will hold for the near term future, before it can choose an efficient mix of taxing.

Unfortunately for good policy, most countries begin the business of intergovernmental reform on the revenue side: Some would see this as a not-too serious policy mistake. One justification for this "back-end" approach is that the expenditure needs of, local governments are so great that feasible intergovernmental revenue reform programmes do not typically make a big dent into the service level and infrastructure backlog. In such a case, it matters little where one begins. The other, and probably more important reason is that revenue reform is a more manageable issue, and more likely to yield visible, short-term results. The assignment of expenditure responsibility is a much more politically charged issue. Giving local government's significant control over the expenditure budget reduces the control that can be exerted by the line ministries and shifts the balance of power away from the centre. Moreover, once decentralized to local governments, expenditures are not so easily controlled or "called back". Revenue assignment, as practised in most LDCs, is a less permanent proposition: local tax rates can be limited or subject to approval, intergovernmental transfers to local governments might not be delivered as promised, and all borrowing might be subject to central government approval.

Rule 3: There Must be a Strong Central Ability to Monitor and Evaluate Decentralization

Lesser developed countries (LDCs) are for the most part characterized by very centralized systems of government and are likely to remain centralized for quite some time. A "controlled" and gradual process of fiscal decentralization will require central government leadership on matters such as the imposition of a uniform system of financial accounts, audit rules, disclosure requirements for borrowing, determining when to relax spending mandates, how to adjust grant distribution formulae, and how to impose proper limits on borrowing. There is also the need for technical assistance to local governments, in several areas. Especially the smaller local governments require assistance in areas such as accounting, treasury, tax administration, data processing and project evaluation.

A problem arises because most developing and transition countries do not have a strong ability to monitor the development of local government finances. The two ingredients necessary are (a) a fiscal analysis unit, probably located in the Ministry of Finance, with staff adequate to continuously monitor local government finances, and (b) an extensive data system that will allow quantitative monitoring and evaluation.

With respect to the former, many of the talented analysts have been hived off to other "more important issues" with the result that many countries do not have such a fiscal analysis unit. There also are problems with the availability of a comprehensive data system to support the work of the fiscal analysis unit. It is not common in developing countries to have an up to date information system that describes the finances of sub-national governments in detail. Rarer yet is a forecasting or fiscal analysis model that is used to track the performance of local government finances.

Rule 4: Fiscal Decentralization Must Begin With the Larger Local Government Units

Many countries believe that there must be a uniform intergovernmental fiscal system under which all sub-national governments must operate. However, this may not be a necessary condition for effective decentralization. In fact, a better route may be to begin fiscal decentralization with the larger local government units and to let the smaller ones "grow into it".

Sub-national governments have very different capabilities to deliver and finance services, and certainly different capabilities to borrow. It may be necessary to set up a system where these differences are explicitly recognized, i.e., where different local governments are given different financing powers and expenditure responsibilities. Places in the lower tier could rely more heavily on grants; at the same time those that are more developed could rely more heavily on local taxation, and could borrow to finance capital outlays. Countries that choose this route, must have a clear set of rules about when a local government graduates from one status to another. It is not at all uncommon to see such gradations, e.g., the Kenyan cities, large cities in American states, and many national capital districts are given special fiscal powers.

Rule 5: Fiscal decentralization Must Provide Local Government with Significant Taxing Powers

Voters will hold their elected officials more accountable if local public services are financed to a significant extent from locally imposed taxes, as opposed to the case where financing is primarily by central government transfers.

The tax must be visible to local voters, large enough to impose a noticeable burden, which must not be easily exported to residents outside the jurisdiction. Minor taxes and nuisance taxes will not do the trick. What bases can regional and local governments tax?

The VAT is probably a bad choice for sub-national governments in most LDCs and transition countries. The taxation of international trade is one major obstacle, another is administrative concerns. Corporate income taxes are flawed as sub-national government taxes as well, even though they are often used for sub-national finance.

The individual income tax is a good choice for sub-national governments. It is not easily exported, and it can be easily administered. To achieve the advantages of decentralization, the local government need not set the base of the tax. It would be sufficient for the local government to choose an add-on to the central government tax rate. Certainly a local income tax meets the test of a good local tax in that its burden falls largely on local residents.

Excises can be an appropriate revenue source for sub-national governments, but not for goods where there is some sort of natural monopoly. In this case, the tax burden would be exported and there would be an incentive for local governments to overspend. Retail sales taxes are not possible in many developing countries because of the administrative difficulty of tax collection from small vendors. Some countries do not use retail sales taxes at the local level, but target these on "big ticket" luxury items. Other countries face up to the problem of administrative inability to get at the retail sector by taxing gross sales by businesses (e.g., The Philippines and South Africa).

Motor vehicles are potentially an excellent revenue choice for local governments. Motor fuels, restricted licences, unrestricted licences, tolls, and parking taxes all meet the test of being not easily exported and being administratively feasible. The motor fuel tax offers the greatest potential for revenue, but is likely to be an unpopular choice with central governments who typically depend heavily on this tax.

The use of a local government motor fuel tax, where the local government has some ability to set the tax rate, has some appeal on efficiency grounds. If the use of this tax is restricted to urban areas it may impose a higher tax price on urban motorists, and therefore they would be charged the higher marginal cost associated with the congestion and pollution they generate, and the road services they use.

The property tax is a most appropriate source of local government revenue, which is used by local governments in most countries in the world. It is suitable for local-level governments because local government services tend to benefit property owners and occupants, hence it is a kind of benefit tax; the burden of the tax is not easily exported (except for part of the non-residential share); it is a tax on wealth and is highly visible in the local area; and local assessors have a- comparative advantage in identifying local property wealth. Potentially, the- property tax can be a major revenue producer, but it rarely produces significant revenue.

There are other problems with the property tax as applied in developing countries - it is administratively difficult and expensive, and it is politically unpopular. For the latter reason, the effective tax rates tend to be kept low, and the property tax yields relatively little revenue in most countries.

User charges should be urged on local governments. Many local government services (for instance, local public transportation) can be priced and are amenable to full cost recovery or privatization.

Borrowing should be used by the larger sub-national governments in developing countries, and they should be given an incentive to make more use of this source. The advantages are clear. Capital assets are long-lived and should be financed by bonds whose maturity approximately matches the asset life. Pay-as-you-go financing provides a bias in favor of consumption expenditure. Pushing larger local governments to make more use of bonding may free up grant monies for use in subsidizing the budgets of poorer local governments. However, it is necessary for the central government to put a proper regulatory framework in place.

Rule 6: Central Governments Must Keep the Fiscal Decentralization Rules that they Make

Central governments design fiscal decentralization programmes. In most countries, this strategy involves the centre actually giving up power, and in some cases constitutional changes are made to guarantee the transfer of power. While fiscal decentralization will surely mean a step away from a paternalistic approach to intergovernmental fiscal relations, it is the central government that will make the rules by which the new system will operate. Very often, these rules take the form of implementing regulations, rather than laws or constitutional imperatives.

But the central government does not always keep the rules that it makes. There are many examples of this:

- The imposition of unfunded expenditure mandates on local governments;
- The under funding of transfer programs;
- The reassignment of expenditures without commensurate reassignment of revenues, and
- The abolition of local taxes.

Local governments recognize this and in many countries believe fervently in a "flypaper effect of revenue sharing, i.e. the money will stick where it hits. Rules or no, the belief is that the center will not hand the money over when times are hard, nor will they always honor the, pledge to grant local autonomy.

If decentralization is to have a chance, the central government must keep the rules it makes. This rule for successful fiscal decentralization should be carefully heeded when the central government is designing its program. If the centre intends to make local government finance a low priority -- the first cut when times are hard -- then it should not develop a "law" that guarantees a particular revenue flow. And if local government expenditure autonomy depends o n a central judgement as to whether the "right" choice is made, then it is better not to promise the autonomy in the first place. Transparency in the rules is not enough. There must also be adherence to the rules.

Rule 7: Local Government Administrative Systems must be kept simple

Local government administrative systems often cannot handle complicated intergovernmental fiscal arrangements. The same may be said of the central government systems necessary to monitor and evaluate intergovernmental fiscal arrangements. Simple fiscal decentralization structures will require the local governments to allocate fewer resources to administration, and will lower the monitoring and evaluation cost facing the central government. Complication is often introduced by well meaning policy analysts, without regard for the capability of the administrative system to handle these refinements. The following is a list of complications often found in intergovernmental systems, that are better avoided:

1. Complicated grant allocation formulae that cannot be supported adequately by existing data. Sometimes data are not necessary to support the formula, and "imputations" or other estimation methods are required. In many cases the data may be available for one period, but cannot be updated, and again some sort of imputation is required. This raises major problems of administrative cost, lack of transparency and an erosion of confidence in the system.

2. Local taxes that are structured to accomplish other goals than revenue raising. For example, property taxes are sometimes structured to control building height, local sales taxes may carry an extensive list of exemptions to promote economic development, etc. The complications do not come in the levy of the tax but with fine tuning the rate and base to achieve effects other than revenue raising. This imposes an administrative cost, and it diverts the efforts of the tax administration away from ifs main purpose, the collection of revenues.

3. Conditional, grants that require a monitoring of the use of the funds. Conditional grants require local governments to report on the use of funds, and perhaps to set up special accounts. Or, they may be induced to create schemes to avoid actual compliance with the central mandate, e.g., reclassifying expenditures, changing accounting procedures.

Decentralization is a grass roots movement, which means that voters and elected politicians, including the President, will be the natural champions. But, if decentralization conflicts with macroeconomic stabilization policy, the President's support will be less firm. Hyperinflation or recession offers far more of a threat to re-election chances than does the absence of a good decentralization programme.

Parliament will embrace programmes that voters embrace, and therefore is a potential champion of decentralization. However, members of Congress are most interested in how programmes benefit their own constituency, hence will be less enthusiastic than policy analysts about the need for transparency. The local governments will favour decentralization, but the rich and poor will have very different views about the best version of decentralization. The more well-off local areas will favour increased fiscal discretion and a laissez faire approach to fiscal decentralization while the poor will opt for a redistributive system based on a guaranteed revenue flow.

Finally, some of the external donors and advisors will champion fiscal decentralization. The World Bank sees decentralization as part of a development strategy that will lead to a more satisfactory and balanced growth, and promote decentralization as a country strategy. USAID is also an advocate of decentralization, but is heavily influenced by the democracy aspects. The IMF take a more cautious and qualified view because of their concern with any policy that might promote fiscal instability. But the external advisors play an important catalytic role. When they bring funding as the carrot, they often catch the attention of government officials and stimulate the government to begin to look harder at the decentralization issue. But unless the government itself is enthusiastic, the harder look will not lead to meaningful policy reform and in fact will be quickly forgotten when the money is exhausted. Thus the implementation stage is never reached.

There are three major detractors of fiscal decentralization policy the Ministry of Finance, the Ministry of Economy or Economic Planning and line ministries. The Ministry of Finance, the keeper of the tools to address instability, will not want to give up control over these tools. If this Ministry is on record as favouring decentralization, it will tend to be a very controlled form. One might look for the following features in such a programme:

- Limited freedom for local governments to set tax rates for any major taxes;
- Strictly controlled borrowing powers;
- Budget approval by higher level government, or stringent expenditure mandates;
- An ad hoc system of intergovernmental transfers, that would give the central governments some flexibility to withhold full distributions in hard times; and
- Centrally controlled wage and salary rates for local government employees.

Typically, the Ministry of Finance will be more in favour of an ad hoc than a transparent regime.
The Ministry of Economy could be a significant opponent. This Ministry will be interested in a system that allows central rather than local direction of investment. If investment decisions are decentralized to any significant extent, the result will be will compromise national planning on the distribution of capital expenditures by function and by location.

The line ministries often will oppose decentralization on grounds that seem more paternalistic.

Their view is that the local governments do not have the technical capacity to deliver services or to plan resource allocations, hence there must be strong central direction. Line ministries, if they are persuaded on fiscal decentralization will be more comfortable with conditional grants and mandated expenditure requirements.

Conclusion

Fiscal decentralization has been held back. The advantages of centralization and the political power of the centralists have been too strong. But the world has changed, and the case for decentralization is becoming more irresistible. It may be slowed by an unstable world economy, as most new policies will be, but its time may have come. Governments around the world are increasingly elected, and increasingly on a platform of citizen participation in governance; economic development has eroded some of the arguments in favour of fiscal centralization; and the service delivery capabilities of local governments have improved dramatically. Moreover, much of the world has come to see that granting some form of local autonomy is better than separatism as a policy direction. The enemy now is poorly conceived decentralization policies. Design must match objectives, and implementation must face up to the many dimensions of decentralization. This paper is an attempt to stimulate that discussion.