

ScholarWorks@GSU

Implementation Rules for Fiscal Decentralization

Authors	Bahl, Roy W.
Citation	Bahl, Roy W. "Implementation Rules for Fiscal Decentralization," in Poverty, Development and Fiscal Policy: Essays in Honor of Raja Chelliah, 253-277, edited by Govinda Rao, Oxford University Press, 2002.
Download date	2026-04-18 00:29:34
Link to Item	https://hdl.handle.net/20.500.14694/4745

Development, Poverty, and Fiscal Policy
Decentralization of Institutions

Edited by
M. Govinda Rao

OXFORD
UNIVERSITY PRESS

OXFORD
UNIVERSITY PRESS

YMCA Library Building, Jai Singh Road, New Delhi 110 001

Oxford University Press is a department of the University of Oxford. It furthers the University's objective of excellence in research, scholarship, and education by publishing worldwide in

Oxford New York

Auckland Bangkok Buenos Aires Cape Town Chennai
Dar es Salaam Delhi Hong Kong Istanbul Karachi Kolkata
Kuala Lumpur Madrid Melbourne Mexico City Mumbai Nairobi
São Paulo Shanghai Taipei Tokyo Toronto

Oxford is a registered trade mark of Oxford University Press
in the UK and in certain other countries

Published in India
By Oxford University Press, New Delhi

© Oxford University Press 2002

The moral rights of the author have been asserted
Database right Oxford University Press (maker)

First published in India 2002

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, without the prior permission in writing of Oxford University Press, or as expressly permitted by law, or under terms agreed with the appropriate reprographics rights organization. Enquiries concerning reproduction outside the scope of the above should be sent to the Rights Department, Oxford University Press, at the address above

You must not circulate this book in any other binding or cover
and you must impose this same condition on any acquiror

ISBN 019 566 0609

Typeset by Inosoft, New Delhi 110 092
Printed at Roopak Printers, New Delhi 110 032
Published by Manzar Khan, Oxford University Press
YMCA Library Building, Jai Singh Road, New Delhi 110 001

IMPLEMENTATION RULES FOR FISCAL DECENTRALIZATION

Roy W. Bahl

While there are many analyses of fiscal decentralization as a policy strategy,¹ little attention has been given to putting such programmes into place. Yet it is in the implementation, and almost never in the general concept, where decentralization fails. This paper is meant to offer some rough guidelines for implementation—twelve general ‘rules’ that might form the basis of a decentralization strategy. We begin with a discussion of the rationale for fiscal decentralization, that is, with a statement of the objectives that should lead the design of a decentralization programme. We turn then to the guidelines that could form the backbone of a strategy.

ADVANTAGES AND DISADVANTAGES OF FISCAL DECENTRALIZATION

The first, and most important of the advantages of fiscal decentralization, is the gains from moving government closer to the people. This is the efficiency argument that drives the thinking of most economists (Musgrave, 1983). When preferences among voters are diverse, and local governments have responsibility for delivering those services that do not have major spillover effects, the potential benefits include better public services, better accountability on the part of government officials, more willingness to pay

Earlier versions of this paper have been published in Bahl, (1999a) Bahl, (2000).

¹Among these are Bahl and Linn (1992), Litvak, Ahmad and Bird (1998), Bird and Vaillancourt (1998), Tanzi (1996a, b), Martinez and McNab (1997), and Dillinger (1994).

for services, and, hopefully, 'development from below.' If one advocates fiscal decentralization, they must believe this story, because it is the primary argument. It would at once attack several of the development problems that face emerging economies: revenue mobilization, innovation in economic activity, accountability of elected officials, and grassroots participation in governance.

Another advantage of fiscal decentralization is that revenue mobilization can be increased through a broadening of the tax net. Most government services in LDCs are financed with VAT and income taxes. For administrative reasons, central governments set very high thresholds for both of these taxes. The result is that a large portion of the economy (often with a significant tax-paying power) is outside the tax net. Subnational governments have greater familiarity with their tax base than does the Centre and can institute tax-administration practices to capture some of this 'below-threshold' tax-paying capacity. Provincial and local governments in many countries levy payroll, sales and wealth taxes that have greater coverage than central government sales and income taxes.

Finally, there is the argument that fiscal decentralization could lead to a better size distribution of cities. If one forced cities to raise their own taxes to cover the marginal cost of service provision, urban migration would become more costly. This presumes that the unit cost of public services rises with population size and the level of urbanization.

Despite the advantages, there is no hard evidence that fiscal decentralization has 'taken off' in the last decade. Based on IMF *Government Finance Statistics*, which is the only extensive, comparable data source available, one can observe that the subnational governments' share of expenditures has remained about 15 per cent in developing countries over the last decade.² In industrialized countries the subnational government's expenditure share is around one-third. Why has there not been a strong trend toward fiscal decentralization? There are very good reasons, in fact, which might be cast in terms of the considerable advantages of fiscal centralization.

The strongest argument for fiscal centralization is the need for the central government to maintain maximum flexibility to pursue an effective macroeconomic policy. Developing and transition countries tend to be exposed economies, sometimes quite small, sometimes dependent on a relatively small number of primary exports, prone to inflation, and quite

²There are major problems with the IMF data series and this compromises comparative analysis. The problems include missing data from provincial or local governments, or both, and the absence of budgetary expenditure data for central governments (which is the proper comparative).

susceptible to external influences. There is an argument that the major fiscal instruments—taxes, expenditures, and borrowing—ought to be controlled at the central government level. Under fiscal centralization, the government has maximum flexibility to develop and implement a stabilization programme. Some do not accept this argument. The contrary position is that fiscal decentralization is a stabilizing influence. With a hard budget constraint and elected local governance, budget deficits might be actually smaller in a decentralized setting.³ Centralization is also viewed as detrimental to fiscal decentralization in that it does not suit the fiscal autonomy and flexibility needs of local governments.

A second argument for fiscal centralization has to do with leadership in the direction of investment on social capital. Central governments properly have an interest in investment in projects with big externalities. Such infrastructure investments are often central to national economic development. If capital project selection is turned over to the local governments, the investment portfolio will move toward local benefit projects, for example, roads, wells, municipal auditoriums, small rural electrification, and the like. In fact, a shift to local choice of projects is what decentralization is all about. It is almost certain that fully honouring local choices would come at the expense of additional investment in the national power grid, trunk highways, ports, and the like.

Equalization potential is clearly greater in a centralized public sector. The more money the central government has to distribute, the greater is the potential to equalize. In reality, central governments may not equalize very well across the regions, but the potential is greater. Fiscal decentralization inherently is very counter equalizing, and can lead to a much less equalizing system. The equalization issue is especially acute in developing countries where the gap between rich and poor regions is especially great.

The case for a fiscally centralized system, especially in the developing countries, is a strong one. Moreover, most LDCs are presently very centralized (structurally and politically) and the burden of proof about benefits and costs rests very heavily with those who would pass more powers to the local governments. A full understanding and evaluation of the trade-offs is essential for developing a successful decentralization strategy. The champions of fiscal decentralization in a developing country must find a way to minimize the costs of moving from a fiscally centralized system.

³More detailed discussions of this may be found in Bahl and Linn (1992), Prud'homme (1995), Ter-Minassian (1997) and Spahn (1997). A reading of these papers shows that there is anything but uniform agreement on this point.

Fiscal Decentralization Should be Viewed as a Comprehensive System

Intergovernmental fiscal relations must be thought of as a system, and the pieces in this system must fit together.⁴ Implementation should begin with a design of the comprehensive system, and should lay out the plan for each element of the system. A 'one-off' piecemeal reform, encompassing only one element of the system (for example, revenue sharing), is not likely to lead to success. To be sure, a phased-in implementation strategy may be necessary to avoid 'reform shock', but countries should begin with a comprehensive plan and be prepared to deal with the transition problems during phase-in.

Key elements of a system of fiscal decentralization are described in Table 13.1. Some of these are more important than others, that is, they are conditions necessary to the success of fiscal decentralization. Representative local government is perhaps the most crucial element of a decentralized system. Councils must be locally elected. If higher levels of government, or national parties appoint the local leadership, their accountability will be as much upwards, to the central government and the party, as downward to the local population. The efficiency gains that are at the heart of fiscal decentralization strategies will not be captured unless voters determine the longevity of the members of their council. It is almost as important that the local council appoints, and has the power to dismiss, the local chief

Table 13.1
The Components of a System of Fiscal Decentralization

<i>Necessary conditions</i>	<i>Desirable conditions</i>
Elected local council	Freedom from excessive central expenditure mandates
Locally-appointed chief officers	Unconditional transfers from higher-level governments
Significant local government Discretion to raise revenue	Borrowing powers
Expenditure responsibilities	
Budget autonomy	
A hard budget constraint	
Transparency	

⁴Intergovernmental fiscal relations is a term that refers generally to division of fiscal powers and responsibilities among levels of government. Fiscal decentralization refers to change in an intergovernmental system where the balance of power moves more toward the subnational government sector than has been the case.

officers (for example, treasurer, chief education officer, etc.). 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 taxing powers, budget-making autonomy, transparency, and a hard budget constraint. The latter forces local governments to live within their means, and forces an accountability for the hard choices that they must make.

All fiscally decentralized systems will not be the same and some will give more autonomy to local governments than others. However, most decentralized systems will have some common elements, shown in Table 13.1 as 'desirable' conditions: borrowing powers, freedom from expenditure mandates, and unconditional (versus conditional) inter-governmental transfers. This said, it should be pointed out that some countries are implementing decentralization schemes that have not yet incorporated even these necessary conditions. Many countries still insist on central approval of local budgets, minimal local government discretion to tax and even centrally appointed chief officers are not uncommon.

Not everyone follows the advice that design should be comprehensive. Some countries (and international agencies) think of a fiscal decentralization programme as no more than a revision of their revenue sharing system, or an upgrading of their 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 helping local population groups gain access to the project-selection discussion. This '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:

1. 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 are gains in transparency, but this has not been accompanied by increased local discretion as to the expenditures of these monies.

2. South Africa has assigned significant non-property taxing powers to subnational 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.

3. 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.

Finance Follows Function

The second rule is to follow the correct order of reform. The first step is the assignment of expenditure responsibility to local governments, and then the assignment of revenue responsibility and the design of the grant system should be undertaken. This is an important rule, for two reasons. One is that the central government must quantify expenditure needs for each level of government before tackling the question of revenue assignment. How can the central government decide on the revenue-raising power to be given to local governments, or the amount of intergovernmental transfers necessary, unless it knows the amount of money required to deliver a minimum acceptable level of local public services.

The other reason 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 (Bahl and Linn, 1992). The government must settle on the assignment of expenditure responsibilities to local governments 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. Not everyone would agree that this is a serious policy mistake. One justification for this 'back-end' approach is that the expenditure needs of local governments are so great that local government 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. Another, probably more important, reason for a revenue-first ordering 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 governments 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.

There must be a Strong Central Ability to Monitor and Evaluate Decentralization

Because the implementation of a fiscal decentralization programme is a long-term proposition, it will need to be evaluated and fine-tuned by the central government on a regular basis. Successful implementation of a system of fiscal decentralization requires the central government to put in place a monitoring, evaluation, and implementation facility. In some cases these are quite new responsibilities for the Centre and may require the development of some new capabilities, as is suggested by the following:

1. The imposition of a uniform system of financial accounts is crucial for monitoring of the local government financial performance. The Centre must design these accounts, regulate their policy, and manage a reporting system.
2. Timely and thorough audit of the local accounts must be overseen.
3. A regulatory framework of borrowing must be developed and compliance with this framework must be enforced. Major issues here are disclosure requirements, debt limits, limits on purposes of borrowing, and limits on the sources and types of debt instruments allowed.
4. Design and implementation of the system of intergovernmental transfers. If the system is formula-driven, the Centre must maintain the database and make the distributions; and if it is conditional, the Centre must monitor compliance, etc.
5. The provision of technical assistance to local governments, especially the smaller local governments, in areas such as accounting, treasury, tax administration, data processing, and project evaluation, is an important central government responsibility.

Many of these are new responsibilities for the central government and require some organizational adjustments and the acquiring of new skills. Two prerequisites must be in place for successful implementation: (i) a fiscal analysis unit, with staff that is adequate in number and with the technical capability to continuously monitor local government finances and (ii) 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 subnational governments in detail. Also rare is a forecasting or fiscal analysis model that is used to track the performance of local government finances.⁵

One Intergovernmental System Does Not Fit the Urban and the Rural Sector

There is no reason why a fiscally decentralized system need be symmetrical. That is, there does not have to be a uniform intergovernmental fiscal system under which all subnational governments must operate. 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'.

Subnational 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, that is, where different local governments are given different financing powers and expenditure responsibilities. Local governments that are in the lower tier could rely more heavily on grants, and service delivery could be entrusted to higher-level government. Local governments in more developed areas could rely more heavily on local taxation, and could borrow to finance capital outlays. They would be directly responsible for service delivery and would have significant discretion in deciding on the size and composition of the budget. In countries that choose this asymmetrical route, it is necessary to 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, for example, the Kenyan cities, large cities in American states, and many national capital districts are given special fiscal powers.⁶

⁵A contentious issue is the organizational arrangement under which the fiscal analysis unit and the database unit will work. One arrangement for fiscal analysis is the creation of a specialized fiscal analysis unit as in India, Australia, South Africa and previously in the United States. More likely in most LDCs, the candidates are the Ministry of Finance, the Ministry responsible for local government, and in the case of the database development, the Bureau of the Statistics.

⁶It is very difficult to identify an objective set of indicators of when a local government 'is ready' to move to the next class of fiscal autonomy. Most countries use population size as the classification criteria.

Many countries do not choose the asymmetrical route, usually on grounds that it requires arbitrariness in deciding on differential treatment, and to avoid complication. Among the recent de-centralization programmes, both Indonesia and South Africa have awarded all local governments the same taxing and spending powers, but have made provision for 'special arrangements' in the case of local governments with less capacity to finance and deliver services.

Fiscal Decentralization Requires Significant Local Government Taxing Powers

Arguably the greatest potential advantage to fiscal decentralization is the shift in the accountability of subnational government officials: from incentives to please higher-level government officials to incentives to please local voters. To make this shift, however, local government taxing powers are necessary. 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, and the burden 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?

Value Added Tax

The VAT is probably a bad choice for subnational governments in most LDCs and transition countries. The taxation of international trade is one major obstacle. Exports are zero-rated under most VATs, raising the question of whether the local government that is home to the exporter will be responsible for paying the refunds. Since imports from abroad are taxed at point of entry, the local government at the point of import will receive the revenue benefit (irrespective of the point of final consumption). Neither of these outcomes is acceptable, hence VAT on international trade would become a central government matter. But what then of the tax base for local governments in areas that specialize in foreign trade?

There is the potential for an administrative disaster with the imposition of a subnational government VAT. Is the state and provincial collection and assessment apparatus up to the job? Is the local political leadership ready to impose tough sanctions on enterprises that do not comply with the tax law? The major administrative difficulty with a subnational government VAT is the treatment of interstate sales. Enterprises in the exporting state should receive full credit on all taxes paid on imports and buyers in the

destination states should pay fully. But how is a credit-invoice, destination-based VAT to be administered cooperatively among, say, Indian or Brazilian states?

Some of the most astute students of public finance in developing countries now believe that there are conditions under which a subnational VAT might work (Bird, 1999; McLure, 1999). If there is a strong, well-administered central government VAT, a uniform base, and if the local government piggybacks on the central base, a subnational VAT may be workable. In effect, the subnational VAT would be a destination-based tax, and the central government would somehow 'clear' the credits due on interstate sales. The possibility of getting around the administrative constraints has sparked a serious look at a state-level VAT in large countries such as India, Brazil and Argentina (Bird and Gendron, 1998). All of these countries share the feature of a subnational government sales tax that is badly in need of reform and a state VAT is one answer to this problem.

The enactment of a subnational VAT, though it is an appealing idea for strengthening local government finance, will require getting around several important problems

- Developing a well-administered, broad based VAT at the central level.
- Addressing the issue of the resulting fiscal disparities between 'consuming' and 'producing' states.
- Working out a 'fair' method for intrastate distribution of the revenues.

Business Income and Asset Taxes

There is good justification for taxing business activity at the subnational government level. A tax levied on an origin basis can be thought of as a charge levied on businesses to compensate the local governments for the services they provide. The problem is the form this business tax should take.

Corporate income taxes are flawed as subnational government taxes, even though they are often used. The company income-tax base is cyclical, and therefore not suitable for financing essential services. Moreover, for companies to do business nationally, one must work out some kind of proration to allocate profits among the host provinces. Otherwise, a great effort must be spent by the state to police the many different kinds of transfer-pricing schemes that are used to lower tax liability. State corporate-taxes are used by most states in the US, and are plagued by this problem. The transition countries (for example, Russia and China) allow the subnational governments to retain a share of the enterprise income tax collected within their boundaries (McLure, et al., 1999; Bahl, 1999b and

1994). The proration problem (and the transfer pricing issue) has not yet arisen on a broad scale, but will become an issue as the transition economies continue to modernize.

Other forms of business activity tax might be considered. Assets could be taxed, but this penalizes start up companies that have little earnings in their early years of operation, and taxes on net worth both discourage new investment and favour debt over equity finance. Nevertheless, various forms of taxes on business assets (for example, the French inspired *patente*) are widely used.

Individual Income Taxes

The individual income tax is a good choice for subnational governments. It is not easily exported, and it can be easily administered. The advantages of fiscal decentralization can be gained even if the central government determines the tax base. 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.

Some local governments in LDCs do make use of various forms of local income tax. In Uganda, the graduated personal tax—a hybrid between an income tax and a head tax—is locally levied and is administered by the local governments. The large cities and district councils levy payroll tax in South Africa. Among the industrialized nations, the US, Canada, and Denmark are countries that make aggressive use of subnational government income taxes.

Clearly there are problems with using local income taxes. First, one might question their administrative feasibility. This critique can be answered. As a local government sur-rate, it could take the same base as the central income tax, and could rely on central collection and audit. Second, in most developing and transition countries, the central income tax is largely a tax on payrolls because the self-employed and capital incomes are so difficult to reach. The subnational surtax would also be subject to this flaw. This is a fair critique. Third, some would argue that the income redistribution role of the individual income tax makes it unsuitable for local government use. But if local governments simply piggyback onto the central base, with a flat rate, the redistribution objectives of the central income tax will not be compromised. In this case, one might think of the local income (payroll) tax as a kind of charge for the use of services provided by the local government.

Other Indirect Taxes

Excises: 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: Retail sales taxes are not possible in many developing and transition countries because of the administrative difficulty of tax collection from small vendors. Some countries do 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 (for example, The Philippines and South Africa). Turnover taxes, however, have two important problems as local revenue sources. First, they are pyramided forward and lead to price distortions. Second, they may be borne by those in the jurisdiction of consumption but the revenues may accrue to the jurisdiction where the company headquarters is located.

Motor Vehicles

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 (Bahl and Linn, 1992). The motor fuel tax offers the greatest potential for local government revenue, but is likely to be an unpopular choice with central governments that typically depend heavily on this tax.

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

Property Tax

Property tax is a most appropriate source of local government revenue, and it is a revenue source 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 in fact it rarely produces significant revenue.

There are serious problems with the property tax as applied in developing countries (Dillinger, 1991). It is administratively difficult and expensive. The identification of ownership is problematic; records are inadequately kept; assessment is infrequent, often badly done, and based on weak records (Bahl, 1999). Moreover, the property tax is politically unpopular and politicians are afraid to enforce it aggressively. For this reason, the effective tax rates tend to be kept low, and the property tax yields relatively little revenue in most countries.⁷

There are reasons, though, to be optimistic about the property tax as a key element in a decentralized fiscal system. With urbanization, the 'true' property value base will grow, administrative capacity will develop, property transfers will become more formal as housing finance and property markets develop, and local governments will find the property tax to be one of the options to which they may turn. In the longer run, it is likely that many decentralized local governments will make heavier use of land and property taxation.

User Charges and Borrowing

User charges should be urged on local governments. These are the financing sources most consistent with the efficiency goals of a decentralized system. Many local government services can be priced and are amenable to full cost recovery or privatization. Public utilities and transportation services are the most obvious examples, but there are many others that can supplement taxes in a decentralized fiscal system: housing, toll roads, licences, and land betterment charges are examples.

Borrowing should be used by the larger subnational 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 favour of consumption expenditure. Pushing larger local governments to make more use of credit finance may free up grant monies for use in subsidizing the budgets of poorer local governments. Borrowing is consistent with fiscal decentralization. Voters must agree to the proposition that they will incur a long-term obligation, and an effective credit financing mechanism requires that a hard budget constraint be imposed on the subnational

⁷The US is an exception. Local property tax revenues account for about 11 per cent of total federal, state and local government revenues.

governments. However, it is necessary for the central government to put a proper regulatory framework in place (Peterson, 1997).

Central Governments must keep the Fiscal Decentralization Rules that they Make

For the most part, less developed countries are characterized by very centralized systems of government finance. Moreover, they are likely to remain centralized for quite some time. Fiscal decentralization will be a gradual matter, and will require significant central government leadership. Central governments will design fiscal decentralization programmes, oftentimes without significant local government involvement. 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 will be the central government that makes 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 programmes;
- The reassignment of expenditures without commensurate reassignment of revenues; and
- The abolition of local taxes by the national legislature.

Local governments recognize this and in many countries believe fervently in a 'flypaper effect' of revenue sharing, that is, the money will stick where it hits. Rules or no, the belief is that the centre 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 requirement for successful fiscal decentralization should be carefully heeded when the central government is designing its programme. If the Centre intends to give local-government finances a low priority on its policy agenda—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 on a central judgment 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.

Keep it 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. Well-meaning policy analysts often introduce complication 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:

Complicated Grant Allocation Formulae that cannot be Supported Adequately by Existing Data: Sometimes data are not available 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 can raise major problems of administrative cost, lead to a lack of transparency and result in an erosion of confidence in the system.

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 come with the fine-tuning of 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 its main purpose, the collection of revenues.

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, it may induce them to create schemes to avoid actual compliance with the central mandate, for example, reclassifying expenditures, changing accounting procedures, etc. After all, the main reason for a conditional grant is to seduce local governments into doing something that they otherwise would not do. All of this imposes an administrative cost on the local governments, and uses up scarce resources.

It is also true that the creation and operation of the central apparatus necessary to police the behaviour of the local government imposes an administrative and compliance cost. The decision to establish a conditional grant programme should take into account these costs of enforcement.

Expenditure Mandates that have Stringent Compliance Requirements: Expenditure mandates are another way for the central government to enforce preferences on local budgets. All countries use mandates to one degree or another, and the question is the degree to which they should be used. But mandates raise exactly the same issues as do conditional grants in terms of using up scarce administrative resources for compliance and enforcement functions. There also is the question of whether the mandates are even enforceable. The Russian 'expenditure norms' were a case in point. These norms were detailed expenditure requirements for subnational government budgets that were so complicated that strict enforcement was all but impossible. The rule to follow in designing mandates was that they should be kept simple enough to enforce at reasonable cost.

This is not to say that simplicity alone should drive intergovernmental reform. Indeed, there are complications that cannot and should not be avoided, for example, disclosure requirements for local government borrowing, uniform accounting systems that follow accepted principles, prescriptions for audit procedures, etc. But the basic rule is to protect simplicity by limiting the number of objectives to be accomplished by each policy instrument, and to be mindful of the administrative capacity of the local and central governments to administer (enforce) the system being designed.

The Design of the Intergovernmental Transfer System Should Match the Objectives of the Decentralization Reform

There are many different kinds of intergovernmental transfer systems, and these have many different types of impacts on local government finances.⁸ Some stimulate local spending, some are substituted for local revenue effort, some are equalizing, and some lead to more local government fiscal autonomy than others. Countries often enter into grant design without fully exploring the alternatives and these differential impacts.

Intergovernmental transfers have two dimensions: the size of the divisible pool, and the distribution of this pool among eligible local government units. Some have referred to the divisible pool dimension as having to do with the

⁸There is often a debate about 'what is an intergovernmental transfer'. Grants to lower-level governments are clearly intergovernmental transfers. The confusion comes in the case of shared taxes and tax expenditures. If the local government can control either the rate or base of a levy, it is a tax. If the rate and base are determined by the higher-level government, and revenue collections are assigned to the local government, it is a transfer. If the central government allows deductibility of property taxes from central income tax liability, it is likewise a form of transfer.

vertical fiscal balance between the central and subnational governments, and the allocation dimension as having to do with horizontal fiscal balance.

Bahl and Linn (1992, chapter 13) have developed a taxonomy of grant systems that takes both of these dimensions into account (see Table 13.2). These grant types are very different from one another. Consider the determination of the size of the total amount to be distributed in a given year (the columns in Table 13.2). The international practice suggests three basic approaches: a specified share of national (or state) government tax revenues, an ad hoc decision (such as an annual appropriation voted by parliament), or reimbursement of approved expenditures. Once the amount of the distributable pool is determined, allocations among local governments are typically made in some combination of four ways: by returning a share to the jurisdictions from which the taxes were collected, that is, using a derivation principle; by formula; on an ad hoc basis or; by reimbursing costs.

This two-way classification gives a taxonomy of twelve potential grant types, eight of which are more or less common in developing and transition countries. These grant types are very different from one another. Consider the shared-tax column in Table 13.2.

1. A *type A* grant is a shared tax on a derivation basis, that is, the subnational government is allowed to keep a specified share of what is collected within its boundaries. This is the approach to tax sharing used in most transition countries, and in many developing countries (Bahl [forthcoming]; Martines and McNab, 1997; and Bird et al., 1995).

Table 13.2
Alternative Forms of Intergovernmental Grant Programmes

Method of allocating the divisible pool among eligible units	Method of determining the total divisible pool		
	Specified share of national or state government tax	Ad hoc decision	Reimbursement of approved expenditures
Origin of collection of the tax	A	L	NA
Formula	B	F	NA
Total or partial reimbursement of costs	C	G	K
Ad hoc	D	H	NA

NA = Not applicable.

Source: Bahl and Linn (1992).

2. A *type B* grant is based on a share of a national tax, but the distribution among local governments is made by a formula. For example, in the Philippines, 40 per cent of national internal-revenue collections are distributed among local governments on the basis of population, land area, and equal shares.

3. A *type C* grant differs in that the distribution is on the basis of project costs. For example, a fixed percentage of a national tax may be distributed among local governments on the basis of the (approved) cost of constructing public works projects, or the cost of teachers' salaries, etc.

The second column in Table 13.2 lists the ad hoc grants, that is, the central government decides on the total distribution on a year-to-year basis. Even within this category, however, there are major differences depending on the horizontal allocation method used. A *type H* grant is completely centralized, with the central government making all decisions about who gets the money and how much is given to each recipient. The *type L, F, and G* grants allow the Centre to make a yearly political decision about the total distribution, but there is some objectivity in the distributions among local government units. The *type G* grant would be conditional, but the other three grants could be general purpose. The more strings tied to a grant, the more subject it is to control by higher-level governments.

In column 3 are the cost reimbursement grants, where the line ministry will decide on both the amount of funds necessary to carry out the work, and which local projects live up to central standards. These would take the form of conditional grants. Examples here are infrastructure grants where construction standards are specified, teachers' salaries grants where salary amounts are predetermined, and subsidies to individuals which are fixed in terms of eligibility and payment amount by higher-level governments.

A moment's reflection suggests that some of the grant systems are decidedly more decentralizing than others. For example, the *type A* and *type B* transfers are arguably the most decentralizing. They guarantee local governments a specified share of national revenues and they usually carry no conditions as to how the money should be spent. However, even these two have very different impacts. The *type A* grant is counter-equalizing in that it will favour the rich local governments with the strongest tax bases, whereas the formula grant (*type B*) could be distributed toward those with weaker tax bases. The ad hoc column is the most centralizing in that it allows the Centre maximum flexibility in deciding how much to distribute to the local government sector each year. The *type C, G, and K* grants are also centralizing in that they give the central government ministries significant

control over how the money is to be spent and allows for construction and service delivery standards to be laid down.

The transfer system is an important element of the decentralization programme in any country. In many countries, it may be the most important element on the revenue side. The key implementation issue is for the design of the grant system to match the objectives of the overall decentralization programme. The place to begin is always with objectives. As simple a rule as this seems, it is all too often violated.

Fiscal Decentralization Should Consider All Three Levels of Government

There is an intra-province (intra-state) dimension to intergovernmental fiscal relations. In some countries, provincial governments are too large to allow citizen participation at a level that insures that voter preferences will matter, or that accountability of government officials will result. In such cases, fiscal decentralization must be carried through to the lower level of government. Most large countries do provide for a municipal government level, usually subordinate to the province.⁹

The issue is especially important in the large countries. For example, China and India each have four provinces/states that would rank among the world's 20 most populated countries. The fiscal allocation decisions that are made internal to such large states may be large enough to contradict central government policy, or to reinforce it to levels that are not desired. Yet government analysts in those countries spend a great deal of effort tuning the central grant system to achieve a desired allocation across provinces, and pay much less attention to the distribution within provinces.¹⁰

The key policy issue is whether the central government's design of a fiscal decentralization programme will cover all levels of government, or whether each state/province will be left to design its own internal programme. In recent years, policy-makers have debated two policy options. The first is to allow provincial autonomy in deciding on distribution among its local governments. This is the situation that now exists in countries as diverse as China and the US. In effect, each province/state is thought to be in a better position to determine the proper distribution of resources within its

⁹In some countries, there are more than three levels. In the Philippines, the Barangays, sub-municipal units, are explicitly included in the grant distribution system.

¹⁰For a discussion of intra-province allocations in China, see Bahl (forthcoming), and Wong (1995).

boundaries. In both China and the US, the provinces/states have followed very different decentralization policies.

The second approach is for the central government to mandate some degree of uniformity in subnational government fiscal decentralization policy. This can take many forms. It can be a mandated uniformity, that is, all states or provinces could be required to pass grants through to their local units in exactly the same way as grants are allocated to the states. Or, there can be general rules or mandates to force state fiscal decentralization to stay within centrally prescribed limits. For example, education expenditures per student might be required to reach a minimum level in all local units, revenue capacity equalization might be required at some level, or some taxes may be earmarked for local governments. This approach is not uncommon.

Impose a Hard Budget Constraint

A hard budget constraint implies that those local governments who are given autonomy will be asked to balance their budgets without recourse to any end-of-year assistance from the central government. This is another of those rules that central governments must keep, and local governments must believe that they are 'on their own.'

Enemies of the hard budget constraint include fiscal measures such as the following:

- Deficit grants, that is, year-end grants to cover revenue shortfalls;
- Bailouts on delinquent debt; and
- Direct central government coverage of year-end shortfalls on certain items of expenditure.

Many central governments prefer to hold to a paternalistic approach to intergovernmental fiscal relations. The fiscal year begins with a vertical imbalance between local government expenditure needs and revenue authority, and perhaps even an uncertain level of grant distribution from the Centre. A year-end budget deficit is planned, and deficit grants are a guarantee that local governments come to depend on. True fiscal decentralization requires that the central government begin implementation by defining a proper match between expenditure responsibility and revenue capacity.

Recognize That Intergovernmental Systems Are Always in Transition and Plan for This

Some elements of a fiscal decentralization programme will have a short life, that is, their relevance may disappear with economic development.

There are many examples of this. Disparities among regions within a country change, the quality of the basic infrastructure changes, priority areas for investment change, and the technical capacities of local governments change. Central governments must have flexibility in their fiscal decentralization plans to adjust to such changes. How does a government do this while keeping a transparent structure to the intergovernmental fiscal system? The following are some possible answers to this question.

1. Establish a type of grants commission that reviews the allocation of intergovernmental transfers every few years, and recommends changes in the system. This approach gives local governments enough certainty to plan their finances over a multi-year period. The system is transparent, yet it provides some flexibility to accommodate change.

2. Allow for changes in the local tax structure to capture changes in economic structure. As some local areas develop and urbanize, it may be possible to piggyback onto central taxes, the base may be broadened to pick up non-traditional sectors (for example, the self-employed, small shops, etc.), or to use special benefit taxes such as tolls or special land assessments. These improvements in tax structure should be encouraged.

3. Provide for explicit 'graduation' provisions for local governments. There should be a specified period for review to determine whether any given local government could graduate to the next higher class of local fiscal autonomy.

Governments in less developed countries and in transition countries sometimes violate the flexibility rules. There are two more or less common violations. The first is to put detailed fiscal decentralization provisions in the Constitution. This makes for extreme inflexibility. What seems good at the time the Constitution is being framed, may seem less wise at a future date. An example is the provision in the South African Constitution that prohibits local governments from levying any sales or income taxes. The second common violation is to go to the other extreme, and to create a completely ad hoc system with no structure. This provides too much flexibility and is not transparent.

There Must Be a Champion for Fiscal Decentralization

It seems a paradox that fiscal decentralization is such a popular policy in the developing and transition countries, but that it has few enthusiastic champions. For decentralization to succeed, there must be a strong internal champion who understands the costs and benefits of establishing such a programme.

One might use ad hoc reasoning to try and identify the centres of strong support for decentralization policy. Such a categorization, presented in Table 13.3, suggests why fiscal decentralization has been more rhetoric than action.

Table 13.3
The Champions of Fiscal Decentralization

<i>Potentially Strong Supporters</i>	<i>Comments</i>
The People and their elected representatives level.	There is universal demand for more participation in governance at the local level.
The President	Decentralization is a popular policy with the electorate. However, the President must also be very mindful of stabilization concerns with decentralization, since inflation and unemployment are usually the greatest danger to his/her political standing.
The Parliament or Congress	Decentralization is a popular policy with the electorate. Parliament would like to identify with specific local projects they could 'bring home', therefore, they will favour a less transparent and less structured system.
Urban Local Governments	'Give us the autonomy to tax and spend'. Urban local governments are often most concerned with how their autonomy is circumscribed, and how their access to their tax base is limited.
External Donors	These provide encouragement and some technical assistance to get the process underway, but are no substitute for an in-country champion.
<i>Potentially Weak Supporters</i>	
Ministry of Finance	Would propose strict limits to decentralization in order to hold the main fiscal tools for stabilization policy purposes.
Ministry of Economy	Would like to control the type of investment made, as well as the regional distribution of investment. Typically interested in programmes with big externalities vs local benefit programmes.

(Contd.)

Table 13.3 (Contd.)

Line Ministries	Would like to control the standards of public-service delivery, and often would like to hold an approval or sign-off power.
<i>Ambivalent Supporters</i>	
Ministry of Local Government	Would favour a greater guaranteed share for local governments, but would like to control the distribution of those resources.
Weaker local government	Would like a guaranteed transfer of resources from the urban and wealthier local governments to the rest. More interested in a transfer system than in a local taxing system.

The strongest supporters are listed in the top panels of the table. Decentralization is a grassroots movement, which means that voters and elected politicians, including the President, are the natural champions. But, if decentralization conflicts with the 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 government-decentralization programme.

Parliament will embrace programmes that voters embrace, and therefore is a potential champion of decentralization. However, members of Parliament 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 and 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 and the Inter-American Development Bank see 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 (United States Agency for International Development) is also an advocate of decentralization, but is heavily influenced by the democracy aspects. The IMF takes 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 oftentimes 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 gone. Often, the implementation stage is never reached.

There are three major detractors of fiscal decentralization policy. 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 of decentralization. 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 look more favourably on 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, it 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 allocation; 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 so 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 greater enemy of progress now is poorly conceived decentralization policies. Design must match objectives, and implementation must face up to the many dimensions of decentralization. This paper attempts to stimulate that discussion.