Fiscal Decentralization in Developing Countries

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Contents

	List of tables	*page* viii
	List of contributors	xi
	Preface	xiii
1	Fiscal decentralization in developing countries: an overview *Richard M. Bird and François Vaillancourt*	1
2	China: evaluating the impact of intergovernmental fiscal reform *Roy W. Bahl*	49
3	India: intergovernmental fiscal relations in a planned economy *M. Govinda Rao*	78
4	Indonesia and Pakistan: fiscal decentralization – an elusive goal? *Anwar Shah*	115
5	Morocco and Tunisia: financing local governments – the impact on infrastructure finance *François Vaillancourt*	152
6	Colombia: the central role of the central government in fiscal decentralization *Richard M. Bird and Ariel Fiszbein*	172
7	Argentina: fiscal federalism and decentralization *Ernesto Rezk*	206
8	South Africa: an intergovernmental fiscal system in transition *Junaid K. Ahmad*	239
9	Bosnia-Herzegovina: fiscal federalism – the Dayton challenge *William Fox and Christine Wallich*	271
	Index	301

Tables

1.1	Fiscal decentralization: the case-study countries	*page* 19
1.2	Fiscal decentralization: other countries	20
1.3	A taxonomy of fiscal decentralization	23
2.1	China: distribution of budgetary revenues, 1992 and 1995	50
2.2	Tax revenue performance, 1985–95	58
2.3	Tax collection and expenditure of central and local governments, 1980–95	60
2.4	Fiscal and economic concentration in rich and poor provinces	67
2.5	Regressions of per capita local government revenues and expenditures on selected variables	67
2.6	Tax effort indices and rankings, 1990 and 1995	70
2.7	Requirements for effective decentralization	73
3.1	India: revenue receipts of the central and state governments	83
3.2	Share of state governments in total expenditures	84
3.3	Trends in vertical fiscal imbalance	90
3.4	Vertical fiscal imbalance in selected countries	91
3.5	Revenues and expenditures of the states, 1993–94	93
3.6	Coefficients of variation in per capita state government expenditures	94
3.7	Interstate redistribution through regional, loan, and credit policies	98
3.8	Current transfers from the center to the states	99
3.9	Criteria for tax devolution: Tenth Finance Commission, 1990–95	101
3.10	Formula for distributing state Plan assistance	103
3.11	Per capita federal fiscal transfers and Plan outlay in the states during the Seventh Plan	104
3.12	Equalizing effect of transfers	106
3.13	Effect of federal transfers: Gini coefficients of fiscal variables	107
3.14	Regression results	108

4.1 A comparative impressonistic review of selected aspects of the fiscal system in Indonesia and Pakistan 117
4.2 Indonesia: fiscal transfers to subnational governments, 1995–96 123
4.3 Pakistan: legislative responsibility and actual provision of services by different levels of government 130
4.4 Pakistan: federal transfers to provinces, 1994–95 137
4.5 Pakistan: constitutionally mandated revenue-sharing program, 1997–98 138
4.6 Pakistan: vertical imbalances, 1994–5 140
4.7 Principles and best practices in grant design 150
5.1 Morocco and Tunisia: sociodemographic characteristics 153
5.2 Morocco and Tunisia: subnational governments 154
5.3 Morocco: parameters of urban tax and supplementary urban tax 157
5.4 Morocco: sources of funds, local governments, 1991 and 1993 163
5.5 Morocco: sources of funds by type of local government, 1993 163
5.6 Tunisia: sources of funds, local governments, 1992 and 1993 163
5.7 Tunisia: sources of funds by type of local government, 1993 164
5.8 Morocco and Tunisia: main characteristics of local government investment finance, 1995–96 167
5.9 Tunisia: sources of funds for investments by local governments, 1995 167
5.10 Morocco and Tunisia: sources of investment financing, five-year periods 168
6.1 Colombia: structure of the public sector 176
6.2 The system of intergovernmental transfers 180
6.3 Earmarking and mandates in specific municipalities 188
6.4 Macroeconomic effects of increased transfers 193
7.1 Argentina: tax assignment 211
7.2 Tax-sharing systems, 1935–95 214
7.3 Distribution of tax revenue by source and level of government, 1995 215
7.4 Vertical imbalance, 1995 216
7.5 Total spending by level of government, 1991 217
7.6 Total spending by level of government, 1993 218
7.7 Unconditional and conditional transfers to provinces and the city of Buenos Aires, 1983–95 219
7.8 Vertical fiscal imbalance coefficients, 1983–95 222
7.9 Provincial social and economic indicators 226
7.10 Per capita provincial revenue and spending, 1994 228

7.11 Provincial public employment and spending on personnel, 1995 230
7.12 Secondary participation by provinces, selected years 231
8.1 South Africa: shares of revenue, expenditure, and transfers by tier of government, 1990–91 240
8.2 Revenue structure of BLAs in Central Wits: 1991–92 budget 243
8.3 Central Wits: contributions to net income, 1991–93 243
8.4 Shares of property taxes in total revenue: actual and required 244
8.5 Jurisdictional changes 248
9.1 Bosnia-Herzegovina: tax structure, November 1995 284
9.2 Recommended assignment of public functions 292
9.3 Summary of suggested tax assignments 294
9.4 Tax revenue assignments for the Federation, 1997 295
9.5 Tax revenue distribution for Bosnia, 1997 295

1

Fiscal decentralization in developing countries: an overview

RICHARD M. BIRD AND FRANÇOIS VAILLANCOURT

Recent years have seen worldwide interest in fiscal decentralization. Developed countries are reshaping their intergovernmental fiscal structure to be more in tune with the realities of the "post-welfare state" (Bennett, 1990; Wildasin, 1997a).[1] The countries in transition in eastern and central Europe are busily setting up new systems of local and intergovernmental finance (Bird, Ebel, and Wallich, 1995). Many developing countries are also turning to various forms of fiscal decentralization as one possible way of escaping from the traps of ineffective and inefficient governance, macroeconomic instability, and inadequate economic growth in which so many of them have become mired in recent years.[2] Each country does what it does for its own peculiar reasons, but when so many countries in so many different circumstances do somewhat similar things, there is likely to be more at work than meets the local eye. The principal purpose of this book is to take stock of the progress, problems, and potentials of fiscal decentralization in developing countries by bringing together a set of studies from a variety of countries around the world.

Decentralization in developing countries sometimes seems to be viewed as either a panacea or a plague – either a cure for all the ills of such countries or an addition to their already heavy burdens. Some argue for decentralization on grounds of improved economic efficiency, some on grounds of cost efficiency, some in terms of improved accountability, and some in terms of increased resource mobilization.[3] On the other hand, others argue that none of these virtuous outcomes is likely to be achieved in countries in which citizen preferences are unlikely to be reflected in budget outcomes and the institutional capacity of existing subnational (state and local) governments is close to nil.[4] From this perspective, decentralization seems likely to result in increased costs, lessened efficiency in service delivery, and probably greater inequity and macroeconomic instability (Prud'homme, 1995).

In general terms, it is not difficult to defend and elaborate either side of this controversy. With respect to efficiency, for example, the standard

economic view is that the existence of different tax-spending packages in different jurisdictions, coupled with individual mobility, is sufficient to ensure that there will be efficiency-producing interjurisdictional competition in service provision (Tiebout, 1956). Similarly, empirical evidence from a number of countries supports the proposition that locally controlled services are likely to be provided at lower costs than centrally provided ones (Campbell, Peterson, and Brakarz, 1991). On the other hand, reaping these benefits appears to require the prior existence of such rare conditions in developing countries as significant local administrative capacity and locally responsive and responsible officials with substantial discretionary financial control (Bahl and Linn, 1994).

Interesting as such generalities may be, they largely miss the mark. The essence of decentralization is that it does not occur *in general* but rather in a particular country – in a country with its own history and traditions and its own specific institutional, political, and economic context. Moreover, as the various case studies in this book demonstrate, decentralization has taken many different forms in different countries at different times, and even exactly the same variety of decentralization may have very different effects under different conditions – compare, for example, the decentralization in Morocco with that in Tunisia (Vaillancourt, this volume), two countries similar in language, religion, and colonial administrative legacy.

As the ten case studies that constitute the bulk of this book illustrate, economic theorists are theorizing about fiscal decentralization, applied economists are attempting to measure its effects in various dimensions, and policy economists are busily flying around the world dispensing advice about it. But just what is meant by fiscal decentralization? What advice does the academic literature suggest should be given? And how does this advice relate to what is actually taking place in the real world? In this first chapter we attempt both to answer these questions to provide some general background to the case studies that follow and also to draw some general conclusions relevant to these questions from those case studies.

In the next section, we discuss what fiscal decentralization is and why it is a matter of policy concern. We then provide a brief quantitative overview of the extent and nature of fiscal decentralization in the countries covered in this volume and, for comparison, in a few others as well. But numbers alone cannot depict adequately the complex institutional reality that constitutes fiscal decentralization in any country. The third section of this chapter therefore sketches briefly some of the important patterns of fiscal decentralization to be found in the world, referring to some of the key points developed in more detail in the country analyses that constitute the bulk of this book. Finally, in the concluding section of the chapter, we

draw some general lessons from the very diverse experiences recounted here with respect to both the substance and the process of fiscal decentralization in developing countries.

Fiscal decentralization: what and why?

Four questions are addressed in this section. First, how do we define "fiscal decentralization" and assess its success? Second, what macroeconomic questions are associated with decentralization, and, in particular, how should subnational borrowing be managed? Third, how do local managerial capacity and local taxation impact on decentralization? Fourth, what do theory and experience suggest are necessary and sufficient conditions for "successful" fiscal decentralization?

Definition and assessment

Three varieties of fiscal decentralization may be distinguished, corresponding to the degree of independent decision-making exercised at the local level.[5] First, *deconcentration* means the dispersion of responsibilities within a central government to regional branch offices or local administrative units.[6] Second, *delegation* refers to a situation in which local governments act as agents for the central government, executing certain functions on its behalf. Third, *devolution* refers to a situation in which not only implementation but also the authority to decide what is done is in the hands of local governments.[7]

How one assesses decentralization clearly depends in part upon whether what has occurred is best characterized as deconcentration, delegation, or devolution. It also depends upon whether one views decentralization from the top down or from the bottom up (Bird, 1980). The approach to fiscal decentralization from the *bottom up* generally stresses political values – improved governance in the sense of local responsiveness and political participation, for example – as well as allocative efficiency in terms of improving welfare (as in the decentralization theorem of Oates, 1972). The political literature is replete with passages praising the virtues of decentralization. Not only will it produce more efficient and equitable service delivery through making better use of local knowledge, but it will also, so we are sometimes told, lead to greater participation and democracy and hence result in more popular support for government, and presumably in improved political stability. When to these good qualities are added such further ascribed virtues as increased resource mobilization and reduced strain on central finances, greater accountability, and more

responsive and responsible government in general, it is not surprising that some have seen decentralization to be *intrinsically* valuable.

Whatever the precise outcomes of adopting a decentralized (in the sense of devolved) system of decision-making, such outcomes are presumed, from this perspective, to be satisfactory simply because the process itself is intrinsically desirable. Local people may make wrong decisions from the perspective of the central government or of an outside observer, but if *they* make them, the decisions must, by definition, be assumed to be right for them. From this perspective, then, decentralization is intrinsically good because it institutionalizes the participation of those affected by local decisions. The results of a good process must themselves be good.

But matters may not seem so clear if one looks at the process from the top down, rather than from the bottom up. From the *top down* (the central government) the rationale for decentralization may be, for example, to make the life of the central government easier by shifting deficits (or at least some of the political pressures resulting from deficits) downward.[8] Or it may be a desire on the part of the central government to achieve its allocative goals more efficiently by delegating or decentralizing authority to local governments, as appears to have been the case to some extent in Colombia (Bird and Fiszbein, this volume) and Indonesia (Shah, this volume). The goal of the central government may even be to increase the level of national welfare, as often assumed in theoretical discussion (for example, Boadway, Roberts, and Shah, 1993). Whatever the rationale, this top-down approach suggests that the main criterion for evaluating fiscal decentralization should be how well it serves the presumed national policy objectives.

An initial problem in analyzing fiscal decentralization in any specific setting is thus to determine whether a "good" fiscal decentralization is one which better achieves the goals of the central government (or improves national welfare as a whole, if one prefers) or one which frees local governments most from central dictates (or, if one prefers, improves local welfare most). Decentralization may have many virtues: it may, for instance, improve accessibility, local responsibility, and the effectiveness of government. But it is not likely to yield, for instance, precisely the same expenditure pattern the central government would choose to implement except in the extremely unlikely case that the goals of central and local government precisely coincide. In a geographically heterogeneous society, this is simply not possible. Conflicts between central and local governments as to what should be done are inevitable, even if each government tries faithfully to serve the interests of its (different mix of) constituents.

The choice of perspective is thus essential in approaching issues of fiscal

decentralization. The bottom-up perspective may be particularly appropriate for countries like India (Rao, this volume), South Africa (Ahmad, this volume) or Bosnia-Herzegovina (Fox and Wallich, this volume) in which heterogeneity among different territorial units on various dimensions is high, and to a considerable extent reflects political decisions intended to make the national state at least potentially viable. In most of the other countries covered in this volume, however, as in developing countries more generally (Bird, 1993), the top-down perspective seems more likely to be appropriate. In China, for example, Bahl (this volume) suggests that the recent reforms of taxation and intergovernmental finance were intended (1) to reassert macroeconomic control and (2) to secure adequate resources for the central government to achieve such objectives as developing important interregional infrastructure.[9]

Macroeconomic aspects of decentralization

The stringent conditions for successful decentralization have recently been emphasized with respect to developing countries.[10] In particular, it has been argued that not only may decentralization fail to improve local service delivery, it may even risk national destabilization. This risk is greatest when revenues are decentralized without adequate steps being taken to ensure both that local revenue mobilization is maintained and that local authorities are capable of carrying out the corresponding expenditure responsibilities. Argentina in the 1980s is a commonly cited example,[11] but others are not hard to find in the transitional economies of eastern and central Europe (Bird, Ebel, and Wallich, 1995). As just noted, similar fears appear to have played an important role in the recent Chinese fiscal reforms (Bahl, this volume).

International experience indeed suggests that if countries decentralize more expenditure responsibilities than revenue resources, either service levels will likely fall or else local governments will press – successfully, it is usually assumed – for either more transfers, or more loans, or both. One of the clearest, and most analyzed, cases exhibiting this phenomenon is the Russian Federation (Wallich, 1994). On the other hand, if more revenues than expenditures are decentralized, it is often argued that local revenue mobilization may decline and again macroeconomic imbalances may emerge.[12] Countries such as Colombia, Argentina, and Brazil are frequently cited as bad examples in this respect.[13] Even if both sides of the budget are decentralized in a balanced fashion, it is often feared that local governments may not have adequate administrative or technical capacity to carry out their new functions in a satisfactory fashion.[14] Such problems

may give rise to particular concern in developing countries where local governments are charged with important social and economic infrastructure investments (Bird, 1994a) – an aspect stressed in this volume in the chapter on Morocco and Tunisia.

In view of the apparent widespread concern about the destabilizing effects of fiscal decentralization, it may surprise some readers that some of the case studies in this book – see especially those on Colombia and South Africa – lend little support to the more dire predictions of macroeconomic disaster ensuing from fiscal decentralization. Nonetheless, such concerns continue to rank high in many countries, and care must clearly be taken to avoid unwanted outcomes in this respect. The key to unlocking this problem, we shall argue, is to ensure that decentralization is undertaken in such a fashion as to increase rather than decrease accountability.

Concern for macro imbalance lies behind the common recommendation that strict limits be imposed on the borrowing ability of subnational governments.[15] Some fear that, unchecked, subnational governments, particularly those highly dependent on national transfers, may increase current expenditures well above their capacity to finance them out of current revenues and then close the gap through borrowing. Others argue that since macroeconomic stabilization is properly a national government task, it is important that the national government have full control over all the instruments of policy it needs to carry out this task properly, including borrowing – and particularly borrowing abroad.

Such arguments (or variants of them) have been made in many countries, and the result has often been the imposition of a variety of restraints on provincial and local borrowing, for example, limiting such borrowing to financing capital expenditures, limiting debt service to a maximum percentage of current revenues, or requiring prior approval of central government for borrowing (Bird, Ebel, and Wallich, 1995).

In fact, however, a properly designed local finance system would not appear to require any specific controls on debt beyond those imposed by a well-functioning private capital market – something which may not, of course, be considered to exist yet in many developing countries. With respect to foreign borrowing by subnational governments, however, there may be a special problem owing to the apparent assumption by many lenders that all "public" debt is (implicitly) guaranteed by the central government. A possible (partial) solution to this problem might be through "semi-privatizing" subnational borrowing as much as possible, for example, through "revenue bonds" which are guaranteed explicitly and solely by specific (related) revenue sources. This approach would have the additional virtue of increasing one of the potential advantages of

decentralizing public borrowing in the first place – namely, risk diversification – by increasing the (so to speak) portfolio of public debt on offer, assuming (as seems not implausible) that the revenue streams attributable to different components of the public sector are not highly correlated.[16]

Imposing debt limits to prevent local governments from making fiscal mistakes may produce more perverse results than the public insurance of savings deposits so often condemned by economists. Like deposit insurance, debt limits and similar controls may be perverse precisely because they prevent market discipline from being applied (see Ahmad, this volume). Potential lenders to governments, unlike ordinary citizens choosing a bank in which to place their savings, can reasonably be expected to be capable and motivated with respect to finding out what risks they are running with their money. From this perspective, much of the concern about irresponsible local governments getting themselves into trouble seems like another instance of inappropriate and misconceived paternalism – the "father knows best" attitude so common with central governments facing the uncomfortable prospect of losing control as a result of decentralization. In life, children seldom learn to save unless they suffer the consequences of not having done so. And local governments are as unlikely to be well managed if they are saved from the possibility of making mistakes by the imposition of arbitrary limits as they are if they know they will always be bailed out by the central government.

If a national government wants to avoid macro problems arising from subnational debt, it can do so by not subsidizing such borrowing and by letting subnational governments that borrow too much go bankrupt. This is exactly what was done in Morocco, where the government changed the subsidy scheme for local governments from one of budget-balancing grants, in which both capital and interest payments on loans increase transfer receipts, to a formula-based equalization transfer which takes no account of borrowing (Vaillancourt, this volume). In addition, lenders were explicitly told not to count on financial bail-outs.[17] The possible problems arising from misguided foreign borrowing, however, may require more careful national attention, for instance, requiring explicit prior approval from the central government before any such loans may be contracted.

Unless subnational governments are able, so to speak, to "save themselves" from fiscal crises by drawing on their taxing powers, however, their only options in practice in many countries may be bankruptcy or bailout. In the end, the only way to reduce the moral hazard implicit in this situation may be by imposing strict limits on subnational borrowing. What needs to be emphasized, however, is that the root of the problem lies in the

very limited taxing powers available to subnational governments that are expected and required to carry out a much wider range of functions than they can finance on their own without extensive reliance on central support (either direct through transfers or indirect through bail-outs).[18] Unless local "ownership" of the tax base is extended considerably beyond the narrow limits existing in most developing countries (see later discussion) it may not be desirable to loosen borrowing rules.

The difficulty of envisioning, let alone carrying out, bankruptcy in the public sector provides good reason to require that there be fairly stringent conditions on all subnational borrowing – not for macro reasons, however, but in order to ensure local government accountability. Along the same lines, all local borrowing should be reported immediately and in a transparent fashion so that no one can shift hidden debts onto the next administration, and so that both local voters and the national government can have a better handle on what is going on. Moreover, since the only case for local borrowing – and it is a good one – is to finance capital investment, no borrowing should be permitted for other purposes, no matter how worthy.[19]

Finally, one matter that sometimes gives rise to concern appears to be largely a non-problem, namely, the ability of local governments to borrow on the basis of the increased cash flow as a result of transfers (or, for that matter, royalties). As long as the borrowing is not subsidized, why is this a problem? The portion of these transfers that is not specifically earmarked constitutes "own revenues" of local governments, and if some agency is willing to lend money based on this security it should be free both to do so and to bear the consequences if the loan goes bad. Of course, transfers make good security only if they are predictable, which has by no means always been the case in developing countries (Bird, 1990). Generally, transfers are more likely to be used for this purpose when they are enshrined in law (Tunisia) or, even better, in the constitution (Colombia, Argentina, South Africa), than when, as in Morocco, they are made by ministerial directive or, as in China, effectively negotiated on an *ad hoc* basis.

Local capacity and taxation

An essential ingredient in improving the life of the poor in many countries, both immediately and in terms of enhanced productivity in the long run, is the improvement of basic infrastructure – roads, water, sewerage, and electricity (World Bank, 1994). A number of countries have used intergovernmental transfers to guide and shape local investments in these areas, as emphasized, for example, in the chapter on Morocco and Tunisia.

Similarly, in Indonesia, specific grants are provided for provincial and district road improvement (Shah and Qureshi, 1994; Shah this volume). The program is designed to provide minimum standards of road service across the nation and to facilitate the development of an internal common market. The grant allocation formula is related positively to indicators of poor roads and low motor vehicle registrations (proxies for road expenditure needs). As in the case of other Indonesian transfers, local discretion in the use of this grant is restricted, which may limit its effectiveness. The use of the grant is confined to the repair and upgrading of existing roads: new roads have to be financed from other sources. Projects for the repair of roads have to be approved by districts and then forwarded to the central government.

Some have been concerned that local governments subject to less detailed guidance and control than in this case may not have the capacity to handle such critical functions. Colombia, for example, has a much less "guided" system, which nonetheless appears to have been moderately successful in directing infrastructure investment to the poor (World Bank, 1996c). Under the so-called "coparticipation" system, local communities provide labor and local materials, and municipal governments contribute a portion of the cost. This fund not only fosters community involvement in identifying needs and choosing projects but also promotes community participation in the execution, operation, and maintenance of the works. Municipalities have to prepare projects which are then appraised by the fund against technical and environmental criteria. The other important requirement is that the beneficiaries should be low-income rural families. Projects may be carried out by any of a number of types of contractor (private firms, non-government organizations, state agencies, or universities), who compete to supply the works and services.

Although partial and preliminary, the evidence so far concerning local capacity to carry out such functions in Colombia is surprisingly encouraging. A recent study of a sample of sixteen municipalities found numerous beneficial results of decentralization in terms of the enhancement of local capacity in the areas of labor, capital, and technology (World Bank, 1995a). Colombian municipalities are, for example, increasing the skills of local bureaucracies through such means as competitive hiring, sharing the services of professionals among municipalities, training municipal employees, and rotating personnel through different departments in the same municipality. Capacity in terms of capital has also been increased. One municipality has totally privatized road maintenance; another has put private developers in charge of the construction of urban roads.[20] Computers have been introduced to monitor water and sanitation services

in other localities. Municipalities have started to share certain equipment. They have also improved their technological capability in terms of internal organization, planning, and monitoring to ensure better management of municipal projects.

Underlying these improvements is a more basic change: Colombian municipalities have been moving to a "demand-driven" (bottom-up) approach to public services as opposed to the previous "supply-driven" (top-down) one. Increasingly, reflecting both the new liveliness of local politics and (with substantial variations from area to area) more extensive community participation, people are getting what they want, rather than what someone in the capital thinks they should want. In practice, emphasis has been put on roads, education, and water projects: these are the needs people perceive, and these are the needs that the newly empowered and responsive local governments are attempting to satisfy. Opinion surveys suggest that the resulting sectoral allocation of resources is consistent with community preferences, with most respondents indicating that they trust the local government more than the national government to deliver goods and services (World Bank, 1995a).

All this is most encouraging for believers in the potential allocative and democratic virtues of decentralization. As in such well-known Asian cases as the Orangi project in Karachi, Pakistan (Bird, 1995), such popular participation both reveals strong preferences for the project being built and tends to keep costs down. Depending on the precise nature of the project, such community involvement may also enhance substantially the effectiveness of "targeting" in terms of poverty alleviation. Participants in such communal work projects are in effect "self-selected," being poor and willing enough to volunteer their major asset, their labor, without remuneration.

A recent review of experience with the social investment funds set up on roughly similar lines in a number of Latin American countries (Glaessner *et al.*, 1994) concluded that such funds have proved to be generally effective because

(1) they have been demand-driven, thus requiring a high degree of local involvement,
(2) their operations have been transparent and hence accountable,
(3) they have been carefully targeted to low-income groups, and
(4) they have been relatively autonomous in their operation, usually being run by private-sector managers and freed from much official red tape.

Most important is the direct involvement of the beneficiary groups in both the management of the fund, and in the selection, operation, and financing of projects. In particular, it appears to be critical to require cost-

sharing from even the poorest communities – usually their contribution takes the form of land and labor – on the well-founded grounds that people take more interest in what they have to pay for and are hence more likely to be interested in ensuring that they get value for their contributions. On the whole, Latin American experience clearly shows that it is possible to deliver local public services relatively effectively and efficiently even in the face of adverse macroeconomic circumstances and, in some cases, very poorly functioning public administrations. Where there is a will, the way seems to have been shown.

As for local *taxes*, the "correct" revenue assignment in a multi-level government structure is by no means clear in principle, and is generally controversial in practice. The fundamental problems are twofold. First, the central government can inherently collect most taxes more efficiently than can local governments. Second, the potential tax bases that can be reached by the latter vary widely from region to region. The first of these problems gives rise to vertical imbalance; the second produces horizontal imbalance.[21]

Two basic principles of assigning revenues to subnational governments may be suggested. First, "own-source" revenues should ideally be sufficient to enable at least the richest subnational governments to finance from their own resources all locally provided services primarily benefitting local residents. Second, to the greatest extent possible, subnational revenues should be collected from local residents only, preferably in relation to the perceived benefits they receive from local services. More specifically, among the characteristics that might be sought in an "ideal" subnational tax are the following:

(1) the tax base should be relatively immobile, to allow local authorities some leeway in varying rates without losing most of their tax base;
(2) the tax yield should be adequate to meet local needs and sufficiently buoyant over time (that is, it should expand at least as fast as expenditures);
(3) the tax yield should be relatively stable and predictable over time;
(4) it should not be possible to export much, if any, of the tax burden to non-residents;
(5) the tax base should be visible, to ensure accountability;
(6) the tax should be perceived to be reasonably fair by taxpayers;
(7) the tax should be relatively easy to administer efficiently and effectively.

Not everyone would agree that all these characteristics are necessarily or equally desirable – for example, is it unequivocably good that local

governments should be insulated from either the tax base consequences of their tax rate choices or from inflation? Moreover, it is by no means simple to draw from the array of (subjective) information any clear conclusions about different possible local taxes that may be included within this framework. But some candidates come to mind, as discussed to varying extents in the country studies included in this volume, notably property taxes, taxes on automobiles, and, perhaps most importantly if local governments are to have major expenditure responsibilities (for example, for education), some form of surcharge on national taxes. Most of the desired (and desirable) aims of decentralized revenue policy may be achieved solely by allowing variation of the rates of such surcharges, perhaps subject to a constraint on minimum rates to restrict competition for tax base. In addition, since "tax-exporting" breaks the critical link between local spending decisions and the taxes borne by local residents, care should also be taken to prevent provinces from exporting their tax burdens – for example, by limiting access to the taxation of business.

Conditions for success

Experience in a variety of settings suggests that two conditions seem particularly important for successful decentralization, whether success is defined in terms of macro balance or micro efficiency. First, the local decision process must be *democratic* in the sense that the costs and benefits of decisions are transparent and that all those affected have an opportunity to influence the decision. Given the inevitable imperfection of democratic institutions, and the ability of the rich and powerful to come out on top in most systems, this is obviously a counsel of perfection. Nevertheless, the implication is clearly that decentralization means something quite different in countries such as China, Indonesia, and others in this volume that are notably not democratic in this sense than in others such as Argentina and South Africa that, on the whole, are. In the terms used earlier, in the absence of meaningful local democracy, only the "top-down" delegation approach seems to make sense.

Second, and more amenable to policy design, the costs of local decisions must be fully borne by those who make the decisions. That is, there should be no significant "tax-exporting," and no funding at the margin from transfers from other levels of government.[22] This means that local governments need to control the rates (and perhaps bases) of at least some taxes. When these rather strict conditions are satisfied, *devolution* is sensible, whether viewed instrumentally or intrinsically. When they are not, it may not be.

Even when one or more of the conditions set out above does not hold,

the *delegation* of implementation responsibilities to local bodies may still make *instrumental* sense provided that the incentives facing local decision-makers are properly structured, that is, structured to produce the results desired by the central government (in its capacity as representing the population as a whole). In the absence of the right incentive structure, the effects of either delegation or devolution on the efficiency and equity of resource allocation may be much less beneficial than often alleged. What is required for decentralization to produce efficient outcomes is what has been called a *hard budget constraint* with respect to devolved functions in order to ensure accountability, combined with incentive-compatible rules (prices, monitoring) with respect to delegated functions (Bird, 1993).

Accountability is a complex concept, with many dimensions. Political accountability requires political leaders at all levels to be responsive and responsible to their constituents, and those constituents to be fully informed about the consequences of their (and their leaders') decisions. Administrative accountability requires a clear legal framework with respect to who is responsible for what, what financial reports are to be made in what form, to whom, and when, and so on. Economic accountability requires that local residents are responsible for paying for local services, which in turn requires that local authorities can set some tax rates. The critical point in this respect is accountability *at the margin*. It is perfectly possible (in principle) for a local government to be 90 percent dependent on central transfers and still be fully accountable – to its citizens and/or the central government, depending on circumstances.[23] For this reason, the best form of intergovernmental transfer is one the amount of which is fixed in advance and will not be altered as a result of any (in-period) action by the recipient (Ahmad and Thomas, 1997). Such a lump-sum transfer by formula implies that, at the margin, local actions to raise or lower local revenues or expenditures will directly affect outcomes – which is what is needed to ensure accountability.[24]

If decentralization is to work, those charged with providing local infrastructure and services must be accountable both to those who pay for them and to those who benefit from them. Unfortunately, enforcing accountability at the local level is not easy. It requires not only clear incentives from above but also the provision of adequate information to local constituents as well as the opportunity for them to exercise some real influence or control over the service delivery system. "Informal" organizations must be structured like this almost by definition or they cannot exist. But it can be a challenge in the political and social circumstances of many developing countries to introduce a similar degree of responsiveness into formal governmental organizations.

Just as accountability is the key to improved public sector performance, information is the key to accountability. The systematic collection, analysis, and reporting of information that can be used to verify compliance with goals and to assist future decisions is a critical element in any decentralization program. Such information is essential both to informed public participation through the political process and to the monitoring of local activity by central agencies responsible for supervising and (usually) partially financing such activity. Unless local "publics" are made aware of what is done, how well it is done, how much it cost, and who paid for it, no local constituency for effective government can be created. Unless central agencies monitor and evaluate local performance, there can be no assurance that functions of national importance will be adequately performed once they have been decentralized.

An important accompaniment to any top-down decentralization program is thus an improvement in national evaluation capacity. Decentralization and evaluation (for example, using cost-benefit analysis) are not substitutes; they are complements. Another essential element of the "hard budget constraint" system needed to induce efficient local decisions is adequate central enforcement capacity in the shape of credible information-gathering and evaluation. The "carrot" of central financial support of local efforts must be accompanied by the "stick" of withdrawn support if performance is inadequate, which of course requires both some standard of adequacy and some way of knowing whether performance is satisfactory.

Various mechanisms for building such evaluative capacity into a decentralization program are conceivable. One might be to build "sunset" provisions into the program, that is, to provide that (say) the newly prominent role given to local institutions in the water supply area will be subject to renewal in a number of years, provided they pass some kind of independent evaluation of their performance. As noted in Bird and Fiszbein (this volume), such a sunset clause was incorporated in Colombia's 1991 constitutional reform. Another approach, as in India (Rao, this volume), may be to establish a Finance Commission to re-examine intergovernmental fiscal relations periodically and adjust them if necessary. South Africa has adopted a somewhat similar approach with its Financial and Fiscal Commission (Ahmad, this volume). A quite different approach might be to use the likely need for some centrally supported access to capital markets to finance local infrastructure not only as a screening device to reject obviously flawed projects but also as an evaluation system to build up "ratings" of local capacity.[25]

A quantitative overview of fiscal decentralization

The way in which any country organizes its public sector invariably reflects its history, its geography, its political balance, its policy objectives, and other characteristics that vary sharply from country to country. Nonetheless, since all countries, except perhaps the very smallest, have more than one level of government, they necessarily all have some kind of intergovernmental fiscal system. Four big questions must be answered with respect to intergovernmental finance in any country:

(1) Who does what? – the question of expenditure assignment.
(2) Who levies what taxes? – the question of revenue assignment.
(3) How is the (virtually inevitable) imbalance between the revenues and expenditures of subnational governments that results from the answers to the first two questions to be resolved? – the question of vertical imbalance.
(4) To what extent should fiscal institutions attempt to adjust for the differences in needs and capacities among different governmental units at the same level of government? – the question of horizontal imbalance, or equalization.

Ideally, these questions should be approached in the specific circumstances of each country in a manner that is consistent with achieving the relevant policy objectives – not only the normal public finance trio of efficiency (allocation), equity (distribution) and stabilization but also economic growth, as well as such nebulous (but politically resonant) goals as "regional balance." In many instances, of course, there will be conflicts not only between these objectives but also between local and central perceptions of the weights to be attached to them. Moreover, like all public policies, intergovernmental fiscal policies must be developed taking into account both political constraints (for example, the strength of different regions and groups in political decisions) and economic constraints (for example, the stage of development of financial markets) facing policymakers. Finally, all policy changes proposed must of course start from the given set of initial conditions: every country has a history, and the current state of its fiscal institutions in large part reflects the product of an accretionary process of policy change over time.

Any country's intergovernmental finance system inevitably reflects in many ways the complex reality of the country. Clearly, countries differ on many dimensions with respect to intergovernmental finance: how many local governments are there? What are their relative sizes in terms of population and economic activity? How different are they in terms of per

capita income? Natural resource wealth? What are the historical origins of the move to fiscal decentralization: bottom-up or top-down, peaceful or violent? What is the geography of the country: compact or dispersed? How homogeneous is it: in terms of language, in its ethnic groups, and in its unifying cultural myths? To what extent do state boundaries coincide with heterogeneity in any of these dimensions? Are regional interests explicitly represented in the central political structure? How?

Moreover, large countries tend to have more complex and formal systems of intergovernmental finance, often explicitly "federal" in nature.[26] Developing countries tend to face different problems, and possibilities, than developed countries in this as in other areas, in part arising from political instability, in part reflecting their economic status, and in part from lesser technical capacity. And countries in the process of transition from a central-planning to a more "market-oriented" environment have still different problems – for example, with respect to privatization and the allocation of assets among governments.[27]

Given this enormous variety, the optimal (not to mention feasible) solutions to intergovernmental fiscal problems will be quite different from country to country, depending upon where they are starting and what they are trying to do.[28] Nonetheless, although comparative analysis is most unlikely to yield a clear prescription as to what should be done at one particular time in one particular country, it may be helpful in understanding just how and why certain institutional structures work (or do not work) in particular circumstances.[29] While subject to misinterpretation in the absence of complete knowledge of all relevant aspects of the institutions and settings being compared, reference to experience abroad is often the only guide available and, despite its obvious limitations, such experience may provide useful lessons in assessing the potential strengths and weaknesses of decentralization in any country.

In particular, the reasons for success or failure, so far as they can be discerned, may help focus attention on some key factors in the process and at best may highlight a feature that appears to require more emphasis if success is to be achieved. At the very least, a comparative approach may help correct the belief, sometimes held by otherwise well-informed people, to the effect that there must be a simple solution in existence somewhere that could replace the seemingly unending complexity and negotiation characterizing intergovernmental financial arrangements in their own country.

Some international comparisons

How important is subnational spending? Bahl and Linn (1992) found that between 6 percent and 50 percent of total government spending, with an

average of 23 percent, was accounted for by local governments in the twenty-one developing countries for which they had data. For ten developed countries, OECD (1991) found the comparable range to be from 12 percent to 53 percent, with an average of 26 percent. On the other hand, using a different source, and sample, Bird (1995) found an average local expenditure share of 22 percent for 18 developed countries and only 9 percent for 16 developing countries.[30] Comparative data on the importance of local (and other subnational) spending are surprisingly hard to find, and to interpret. Nonetheless, it is probably safe to say that, on the whole, the degree of fiscal decentralization in terms of spending tends to be greater in richer than in poorer countries (Wasylenko, 1987), but that there is considerable variation within each of these groups, however defined.

An alternative, though clearly less satisfactory, way of indicating the relative importance of subnational governments is in terms of the proportion of central government expenditure that goes to subnational governments in the form of transfers. From this perspective, there appears to be no necessary relation between the level of a country's development, the size of its central government, and the importance of subnational fiscal transfers. For example, Bird (1995) found that on average local governments in the industrial countries in his sample financed only 62 percent of their expenditures from their own resources, compared to 88 percent for the developing countries. As usual, of course, there is substantial variation within each group. In Chile and Malaysia, for example, local governments financed more than 60 percent of their expenditures from own revenues in 1990, while Argentina, India, and Pakistan had lower levels of financial autonomy (38 percent to 50 percent), and in Indonesia, the proportion was only 21 percent in 1989 (UNDP, 1993). In most countries, fiscal decentralization in the form of increasing the importance of local expenditures is in practice likely to be accomplished only by simultaneously increasing the importance of national fiscal transfers. The level and design of such transfers is therefore invariably a central aspect of any decentralization process.

Two further broad characteristics of decentralization around the world emerge from reviewing the scarce comparative data available. First, however much local governments spend, and whatever they spend it on, the revenues under their direct control are almost invariably less than their expenditures (Bird, 1995). The only exceptions are a few countries – rich and poor – in which local governments are without any importance as spenders, and a very few rich countries (mostly in Scandinavia) in which local governments have substantial access to large and elastic tax bases usually by levying surcharges on national income taxes (Bird

and Slack, 1991). Countries clearly have considerable discretion in arranging the structure of their public sectors regardless of their level of income.

A similar conclusion emerges from consideration of the second characteristic common to all countries: not all subnational governments are equal. Even in quite small and homogeneous countries, there are big cities and small towns, heavily urbanized areas and rural municipalities. The resulting unevenness in access to local public resources can be marked: in 1993, per capita revenues in low-income provinces of Vietnam were only 9 percent of those in high-income provinces. However, owing to central government transfers, expenditures in the poorest provinces of Vietnam were 59 percent of those in the richest provinces (Bird, Litvack, and Rao, 1995). Similarly, in Indonesia, Timor (one of the poorest provinces) has a per capita own-source revenue equivalent to 4 percent of Jakarta's. Again, however, owing to transfers from the central government, Timor's per capita expenditures are 40 percent of those in Jakarta (Shah and Qureshi, 1994). Transfers are especially important in determining the pattern and level of expenditures in the poorer regions of countries. In Argentina, for instance, although the per capita GDP in low-income provinces is only 39 percent of that in high-income provinces, per capita public spending in the low-income provinces is 130 percent of that in the wealthier provinces (Rezk, this volume).

In the remainder of this section, we present some key comparative information both for the countries included in this volume and for a few other countries that seem relevant for various reasons, namely, the United States, Germany, Russia, Brazil, Vietnam, Australia, Switzerland, and Canada. Russia, like China, is large and in "transition." Vietnam is a smaller representative of the same group (though not nearly as small as Bosnia-Herzegovina). Brazil, like India (and Pakistan), is a large developing country and also a formal federation. The United States, of course, is the largest federal developed country. Germany, Australia, Canada, and Switzerland are smaller (and more equalization-minded) examples of the same group – more comparable in size to South Africa or Argentina, the other formal federations included in this volume.

As shown in tables 1.1 and 1.2, there are, of course, wide variations in many respects among this set of countries. The data shown in these tables, even for the same country, are often from different sources or for different years, and in some instances are estimated in whole or in part. Many of the specific data for individual countries may no doubt be questioned.[31] Nonetheless, the broad comparative patterns shown in these tables seem unlikely to be much changed by most plausible corrections.