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Implementation Rules for Fiscal Decentralization

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IMPLEMENTATION RULES FOR FISCAL DECENTRALIZATION

Roy Bahl*

The last decade has been a time of rhetoric about fiscal decentralization. It is the rare country that has not placed the strengthening of local government on its development policy agenda. Despite pronouncements, plans and even promises, there has not been a rush to endow subnational governments with significant taxing powers and increased expenditure autonomy. Perhaps economic conditions have not been right for countries to adopt comprehensive decentralization schemes, perhaps political freedoms were too new in some cases, and perhaps the idea just takes some getting used to. Whatever the reason, there are signs that some countries are now more ready to move forward, and the next decade may see as much implementation as rhetoric.

There are many analyses of fiscal decentralization as a policy strategy.¹ Most focus on evaluating the decentralization experience around the world, and looking for the match between theory and practice. Far less attention has been given to implementation strategies. This paper is meant to offer some rough guidelines for implementation -- twelve “rules” that might form the basis of a decentralization strategy. We begin with a discussion of the rationale for fiscal decentralization, i.e., with a statement of the objectives that should lead the design of a decentralization program. We turn then to the guidelines that might form the backbone of a strategy.

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

FISCAL DECENTRALIZATION AS A GOVERNMENT POLICY: ADVANTAGES AND DISADVANTAGES

The design of a program of fiscal decentralization should begin with recognition of the benefits and costs of this policy. What are the major advantages to be captured? The first, and most important, are 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 external effects, the potential benefits include better public services, better accountability on the part of government officials, more willingness to pay 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 developing countries: revenue mobilization, innovation in economic activity, accountability of elected officials, and grassroots participation in governance. There are other advantages of fiscal decentralization. Overall revenue mobilization can be improved because decentralization can broaden the tax net. Most government services are financed with value added taxes and income taxes. For administrative reasons, there are very high thresholds associated with both of these taxes, with the result that a large portion of the economy (often with a significant tax paying power) is outside the tax net. Due to familiarity with the tax base, subnational governments can move to capture this base, and have done so in many countries.

Finally, there is the argument that if fiscal decentralization goes far enough, a better size distribution of cities would result. If one forced cities to raise their own taxes, the marginal cost of living in those cities would rise because urban residents would now pay the marginal cost of service provision. If the tax disparities among cities of different sizes grow large enough, presumably some urban migration would be discouraged.

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 about the only comparable data source available, one can observe that the subnational governments’ share of expenditures has remained about 15 percent in developing countries over the last decade. There has not been much movement. In industrialized countries the share is around one-third. Why has there not been much growth in fiscal decentralization? There are very good reasons, in fact, which might be cast in terms of the considerable advantages of fiscal centralization.

Heading the list is macro economic control.² 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 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 a maximum flexibility to respond to macro problems. Of course this does not suit the fiscal autonomy and flexibility needs of local governments, and one man’s feast has become another’s famine. Some have taken a contrary position: 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.

The second argument for fiscal centralization has to do with the direction of investment on social overhead. Central governments properly have an interest in investment in projects with big externalities. The notion is, of course, that such infrastructure investments are central to national economic development. If decision making powers are turned over to the local governments, the

² More 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.

preferences will move toward local benefit projects, e.g., roads, wells, municipal auditoriums, small rural electrification, and the like. In fact, this shift to local choice of projects is what decentralization is all about. It is almost certain that fully honoring 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. Central governments may not equalize very well across the regions, but the *potential* is greater. Fiscal decentralization inherently is very counter equalizing, and leads to a much less equalizing system under a fiscal decentralized system.

A full understanding and evaluation of these tradeoffs is essential for developing a thoughtful decentralization strategy. To find a champion to promote fiscal decentralization in a developing country means that one must defeat the very strong centralization arguments.

RULE #1: FISCAL DECENTRALIZATION SHOULD BE VIEWED AS A COMPREHENSIVE SYSTEM

Intergovernmental fiscal relations must be thought of as a system, and all the pieces in this system must fit together.³ 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 (e.g., revenue sharing), is not likely to lead to success. To be sure, a phased-in strategy may be the right way to go to avoid “reform shock,” but countries should follow a comprehensive plan and be prepared to deal with the transition problems during phase-in.

The key elements of a *system* of fiscal decentralization are described in Table 1. Some of these are more important than others, i.e., they are conditions necessary to the success of fiscal decentralization. Political autonomy is perhaps the most crucial element of a decentralized system. Councils must be locally elected. If the local leadership is appointed by higher levels of government, their accountability will be upwards and not downward to the local population. The efficiency gains that are at the heart of fiscal decentralization strategies will not be captured. It is almost as important that the local council appoint the local chief officers (e.g., treasurer, chief education officer, etc.). Otherwise, implementation will not be locally directed, and services may be delivered as directed by the center. Other necessary conditions for fiscal decentralization are a significant set of expenditure responsibilities and a significant amount of taxing powers, budget making autonomy, transparency and a hard budget constraint. The latter forces local governments to live within their means, and forces local officials to be accountable for hard choices that they must make.

³ *Intergovernmental fiscal relations* is a term that refers generally to division of fiscal powers and responsibilities among levels of government. *Fiscal decentralization* refers to an intergovernmental system where the balance of power moves more toward the subnational government sector than has been the case.

All fiscally decentralized systems will not look the same and some will give more autonomy to local governments than others. The areas where these shades of decentralization are most common, are shown in Table 1 as “desirable” conditions: borrowing powers, freedom from expenditure mandates, and unconditional (versus conditional) intergovernmental transfers.

TABLE 1

THE COMPONENTS OF A *SYSTEM* OF FISCAL DECENTRALIZATION

<u>Necessary Conditions</u>	<u>Desirable Conditions</u>
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
Significant Local Government Expenditure Responsibilities	
Budget Autonomy	
A Hard Budget Constraint	
Transparency	

Not everyone follows this advice that design should be comprehensive. Some countries (and international agencies) think of a fiscal decentralization program as no more than a revision of the revenue sharing system, or an upgrading of the property tax administration. Some ignore the fiscal issues completely and think of decentralization only in terms of the local election system, and planners very often focus exclusively on 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:

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

RULE #2: FINANCE FOLLOWS FUNCTION

The second rule is to get the correct order of reform. First should come the assignment of expenditure responsibility to local governments, and *then* the assignment of revenue responsibility should be determined. This is an important rule, for two reasons. The first is that the central government must establish expenditure needs for each level of government before tackling the question of revenue assignment. The second is that the economically efficient assignment of revenues requires knowledge of expenditure assignment. For example, services that may be priced (public utilities, buses) should be largely financed by user charges; general services with a local area benefit zone (roads, parks) should be financed with local taxes; and goods characterized by significant externalities should be financed from region-wide taxes and intergovernmental transfers.⁴ Governments must settle on the assignment of expenditure responsibilities to local governments, at least an assignment that will hold for the near term future, before it can choose an efficient mix of taxing.

⁴ For a discussion, see Bahl and Linn (1983).

Unfortunately for good policy, most countries begin the business of intergovernmental reform on the revenue side. Some would see this as a not-too-serious policy mistake. One justification for this “back-end” approach is that the expenditure needs of local governments are so great that feasible intergovernmental revenue reform programs do not typically make a big dent into the service level and infrastructure backlog. In such a case, it matters little where one begins. The other, and probably more important reason for getting the order wrong 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 center. Moreover, once decentralized to local governments, expenditures are not so easily controlled or “called back”. Revenue assignment, as practiced in most less developed countries (LDCs), is a less permanent proposition: local tax rates can be limited or subject to approval, intergovernmental transfers to local governments might not be delivered as promised, and all borrowing might be subject to central government approval.

**RULE #3: THERE MUST BE A STRONG CENTRAL ABILITY TO MONITOR AND EVALUATE
DECENTRALIZATION**

The LDCs are for the most part characterized by very centralized systems of government finance and are likely to remain centralized for quite some time. A “controlled” and gradual process of fiscal decentralization will require central government leadership on matters such as the

imposition of a uniform system of financial accounts, audit rules, disclosure requirements for borrowing, and determination of when to relax spending mandates, how to adjust grant distribution formulae, and how to impose proper limits on borrowing. There is also the need for technical assistance to local governments, in several areas. Especially the smaller local governments require assistance in areas such as accounting, treasury, tax administration, data processing and project evaluation.

A problem arises because most developing and transition countries do not have a strong ability to monitor the development of local government finances. The two ingredients necessary are (a) a fiscal analysis unit, probably located in the Ministry of Finance, with staff adequate to continuously monitor local government finances, and (b) an extensive data system that will allow quantitative monitoring and evaluation. With respect to the former, many of the talented analysts have been hived off to other “more important issues” with the result that many countries do not have such a fiscal analysis unit. There also are problems with the availability of a comprehensive data system to support the work of the fiscal analysis unit. It is not common in developing countries to have an up-to-date information system that describes the finances of subnational governments in detail. Rarer yet is a forecasting or fiscal analysis model that is used to track the performance of local government finances.

RULE #4: ONE INTERGOVERNMENTAL SYSTEM DOES NOT FIT THE URBAN AND THE RURAL SECTOR

Many countries believe that there must be a uniform intergovernmental fiscal system under which all subnational governments must operate. This may not be a necessary condition for

effective decentralization. In fact, a better route may be to begin fiscal decentralization with the larger local government units and to let the smaller ones “grow into it”.

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, i.e., where different local governments are given different financing powers and expenditure responsibilities. Places that are in the lower tier could rely more heavily on grants, while more developed places could rely more heavily on local taxation, and could borrow to finance capital outlays. In countries that choose this 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, e.g., the Kenyan cities, large cities in American states, and many national capital districts are given special fiscal powers.⁵

RULE #5: FISCAL DECENTRALIZATION REQUIRES SIGNIFICANT LOCAL GOVERNMENT TAXING POWERS

Voters will hold their elected officials more accountable if local public services are financed to a significant extent from locally imposed taxes, as opposed to the case where financing is primarily by central government transfers. The tax must be visible to local voters, large enough to impose a noticeable burden, 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?

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-

⁵ It is very difficult to identify a set of characteristics that prescribe when a local government should move to the next class of fiscal autonomy. Most countries use population size as the classification criteria.

rated under most VATs, raising the question of whether the local government that is home to the exporter will be responsible for paying the refund. And since imports are taxed at point of entry, it raises the question of whether the local government point of import will receive the revenue benefit.

There are other problems with a subnational VAT. Subnational governments are encouraged to set up protectionist-type measures to enhance their tax base. Finally, differential local tax rates or bases would compromise VAT administration, and local administration could harm the administrative efficiency of a national level, credit-invoice VAT.

There are conditions under which a subnational VAT might work. If there is a strong, well administered central government value added tax, a uniform base, and if the local government piggybacks on the central rate, a local VAT may be workable.⁶ These conditions are rarely met in LDCs and transition countries, and the VAT usually is not workable as a subnational tax. *Foreign trade taxes* are not suitable for subnational governments.

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, one must work out some kind of proration to allocate the profits among the provinces. Otherwise, a great effort is spent in policing the many different kinds of transfer pricing schemes that arise to lower tax liability. State corporate taxes are used by most states in the U.S. The only reason that there is not more public outcry about this tax in the U.S. is because it is such a small revenue source. The transition countries (e.g., Russia and China) allow the subnational governments to retain a share of the enterprise income tax collected within their

⁶ This is now under consideration in India. See also, Bird and Gendron (1998).

boundaries.⁷ The proration problem has not yet arisen on a broad scale, but will become an issue as the transition economies continue to modernize.

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

One might question the administrative feasibility of a local income tax. As a local government sur-rate, it could take the same base as the central income tax, and could rely on central audit. In most developing and transition countries, the income tax is largely a tax on payrolls because the self-employed and capital income are so difficult to reach. The subnational surtax would also be subject to this flaw. Others 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.

Some local governments in LDCs do make use of local income taxes. In Uganda, the graduated personal tax is a locally levied tax on a base that differs from the central government tax base, and is administered by the local governments. The same is true of a payroll tax in South Africa that is levied by subnational governments.

Excises can be an appropriate revenue source for subnational 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.

⁷ See McLure, Martinez-Vazquez and Wallace (forthcoming), Bahl (forthcoming) and Bahl (1994).

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 (e.g., The Philippines and South Africa).

Motor vehicles are potentially an excellent revenue choice for local governments. Motor fuels, restricted licenses, unrestricted licenses, 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 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, has some 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.

The *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 it rarely produces significant revenue.

There are other problems with the property tax as applied in developing countries (Dillinger, 1991). It is administratively difficult and expensive, and it is politically unpopular. For the latter reason, the effective tax rates tend to be kept low, and the property tax yields relatively little revenue in most countries.⁸

User charges should be urged on local governments. Many local government services can be priced and are amenable to full cost recovery or privatization.

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 favor of consumption expenditure. Pushing larger local governments to make more use of bonding may free up grant monies for use in subsidizing the budgets of poorer local governments. However, it is necessary for the central government to put a proper regulatory framework in place.⁹

RULE #6: CENTRAL GOVERNMENTS MUST KEEP THE FISCAL DECENTRALIZATION RULES THAT THEY MAKE

Central governments design fiscal decentralization programs. In most countries, this strategy involves the center 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

⁸ The U.S. is an exception. Local property tax revenues account for about 11 percent of total federal, state and local government revenues.

⁹ For a good discussion of borrowing by subnational governments in developing and transition countries, see Peterson (1997).

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 programs;

The reassignment of expenditures without commensurate reassignment of revenues, and

The abolition of local taxes.

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

If decentralization is to have a chance, the central government must keep the rules it makes. This rule for successful fiscal decentralization should be carefully heeded when the central government is designing its program. If the center 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.

RULE #7: 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. Complication is often introduced by well meaning policy analysts, without regard for the capability of the administrative system to handle these refinements. The following is a list of complications often found in intergovernmental systems that are better avoided:

1. *Complicated grant allocation formulae that cannot be supported adequately by existing data.* Sometimes data are not 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 erosion of confidence in the system.
2. *Local taxes that are structured to accomplish other goals than revenue raising.* For example, property taxes are sometimes structured to control building height, local sales taxes may carry an extensive list of exemptions to promote economic development, etc. The complications 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.
3. *Conditional grants that require a monitoring of the use of the funds.* Conditional grants require local governments to report on the use of funds, and perhaps to set up special accounts. Or, it may induce them to create schemes to avoid actual compliance with the central mandate, e.g., 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 behavior of the local government imposes an administrative cost and

uses up scarce efforts. The decision to establish a conditional grant program should take into account these costs of enforcement.

4. *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” are a case in point. These norms are detailed expenditure requirements for subnational government budgets, which are so complicated that strict enforcement is all but impossible. The rule to follow in designing mandates is 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, e.g., 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.

RULE #8: 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 they have many different types of impacts on local government finances.¹⁰ Some stimulate local spending, some

¹⁰ There 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 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

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 *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 2). First, consider the determination of the size of the total amount to be distributed in a given year (the columns in Table 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. First, consider the shared tax column in Table 2.

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.

A *type A* grant is a shared tax on a derivation basis, i.e., 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.¹¹

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

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.

TABLE 2
ALTERNATIVE FORMS OF INTERGOVERNMENTAL GRANT PROGRAMS

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	N.A.
Formula	B	F	N.A.
Total or partial reimbursement of costs	C	G	K
Ad hoc	D	H	N.A.

N.A. = Not applicable.
Source: Bahl and Linn (1992).

The information in the second column in Table 2 is the *ad hoc* grants, i.e., 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 center to make a yearly political decision about the total distribution, but there is some objectivity

¹¹ For a discussion of shared taxes in the transition countries, see Bahl (forthcoming), Martinez and McNab (1997)

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 pre-determined, 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 favor 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 center 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 program in any country. In many countries, it may be the most important element on the revenue side. The key

and Bird, Ebel and Wallich (1995).

implementation issue is for the design of the grant system to match the objectives of the overall decentralization program. The place to begin is always with objectives. As simple a rule as this seems, it is all too often violated.

RULE #9: 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.¹²

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.¹³

¹² In some countries, there are more than three levels. In the Philippines, the Baranguays, sub-municipal units, are explicitly included in the grant distribution system.

¹³ For a discussion of intraprovince allocations in China, see Bahl (forthcoming), and Wong (1995).

The key policy issue is whether the central government's design of a fiscal decentralization program will cover all levels of government, or whether each state/province will be left to design its own internal program. 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 U.S. In effect, each province/state is thought to be in a better position to determine the proper distribution of resources within its boundaries. In both China and the U.S., 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, i.e., all states could be required to pass grants through to its 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.

RULE #10: 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, i.e., 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 center. 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.

RULE #11: RECOGNIZE THAT INTERGOVERNMENTAL SYSTEMS ARE ALWAYS IN TRANSITION AND PLAN FOR THIS

Some elements of a fiscal decentralization program will have a short life, i.e., 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.

- Establish a type of grant 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.
- 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 (e.g., 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.
- 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 highest 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 a 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.

RULE #12: 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 understand the costs and benefits of establishing such a program.

One might use *ad hoc* reasoning to try and identify the centers of strong support for decentralization policy. Such a categorization, presented in Table 3, suggests why fiscal decentralization has been more rhetoric than action.

The strongest supporters are listed in the top panels of the table. Decentralization is a grass roots movement, which means that voters and elected politicians, including the President, are the natural champions. But, if decentralization conflicts with macroeconomic stabilization policy, the President’s support will be less firm. Hyperinflation or recession offers far more of a threat to re-election chances than does the absence of a good government decentralization program.

Parliament will embrace programs that voters embrace, and therefore is a potential champion of decentralization. However, members of Congress are most interested in how programs benefit their own constituency, hence will be less enthusiastic than policy analysts about the need for transparency. The local governments will favor decentralization, but the rich and poor will have very different views about the best version of decentralization. The more well-off local areas will favor 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.

TABLE 3

THE CHAMPIONS OF FISCAL DECENTRALIZATION

Potentially Strong Supporters

Comments

The People and their elected representatives	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 favor 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.
Potentially Weak Supporters	
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 programs with big externalities vs local benefit programs.
Line Ministries	Would like to control the standards of public service delivery, and often would like to hold an approval or sign off power.
Ambivalent Supporters	
Ministry of Local Government	Would favor a greater guaranteed share for local governments, but would like to control the distribution of those resources.
Weaker local governments	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.

Finally, some of the external donors and advisors will champion fiscal decentralization. The World Bank and the Inter-American Development Bank (1997) 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 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 favoring decentralization, it will tend to be a very controlled form of decentralization. One might look for the following features in such a program:

- 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 favorably 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 on a platform of citizen participation in governance; economic development has eroded some of the arguments in favor 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 is an attempt to stimulate that discussion.

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