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LOS PILARES DE LA DESCENTRALIZACIÓN FISCAL

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RESUMEN

La descentralización fiscal consiste en la transferencia de autoridad presupuestaria de gobierno central hacia los gobiernos subnacionales elegidos, a través de la cual estos últimos adquieren poder para tomar decisiones en materia de impuestos y gastos. El presente trabajo presenta, tanto desde un punto de vista teórico como empírico, lo que algunos consideran en la literatura como los tres pilares fundamentales de la descentralización fiscal, a saber: la asignación de gastos, la asignación de ingresos y las transferencias intergubernamentales. En la realidad, casi todos los países cuentan con estos tres pilares fiscales. Sin embargo, no existen dos países iguales, ya que hay diferentes visiones sobre cómo deben diseñarse. En esta investigación se discuten varias alternativas de diseños institucionales y prácticos de descentralización fiscal, a la luz de distintas experiencias internacionales. Como es de esperarse los resultados varían ampliamente, lo que sugiere que aunque efectivamente no existe una fórmula única que garantice el éxito de cualquier proceso de descentralización fiscal, existen elementos y combinaciones de elementos que sin duda contribuyen a que dicho proceso cumpla de una forma más eficiente con su objetivo último, que es mejorar la provisión de bienes y servicios públicos.

Palabras clave: descentralización fiscal, asignación de gastos, asignación de ingresos, transferencias intergubernamentales

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ABSTRACT

Fiscal decentralization can be defined as the process of transferring budgetary authority from central government to elected subnational governments in order to grant them power to make decisions regarding taxes and expenses. This paper discusses, theoretically and empirically, what some consider the three pillars of fiscal decentralization: expenditure assignment, revenue assignment, and intergovernmental transfers. In the real world, almost all countries have these three pillars. However, there are no two countries alike because of the different possibilities at hand in designing a decentralized fiscal framework. Here, the international experience is studied to shed some light on the various institutional and practical issues arising in the design and implementation of fiscal decentralization. Not surprisingly, results vary widely, and this experience suggests that there are different ways of achieving a successful framework. Therefore, this paper intends to point and describe the key elements that contribute to achieving an effective decentralized fiscal framework that responds more efficiently to the demands of its constituencies.

Keywords: fiscal decentralization, expenditure assignments, revenue assignment, intergovernmental transfers

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THE PILLARS OF FISCAL DECENTRALIZATION

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This paper is about the art and science of building a fiscal decentralization system. It is a science because there is a well received theory on which to build a devolution of budget responsibilities to subnational governments. It is an art because the application of this theory is not a straightforward matter and few countries do things the same way.

We begin with the not-so-obvious answer to the obviously important question “What do we mean by fiscal decentralization”? We then take up two important features of the architecture of fiscal decentralization: the comprehensive nature of a fiscal decentralization policy and the need for it to obey certain rules of fiscal balance. We turn then to a discussion of what many would see as the three pillars of fiscal decentralization: expenditure assignment, revenue assignment, and intergovernmental transfers.

WHAT IS FISCAL DECENTRALIZATION?¹

The following might be used as a working definition of fiscal decentralization: *The empowerment of people by the empowerment of their local governments.* The key term here is “local government.” Fiscal decentralization is all about the central government’s passing budgetary authority to elected

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¹ Also see Bahl (2008).

subnational governments in the form of the power to make taxing and spending decisions. In this paper, we take fiscal decentralization to mean passing fiscal power to any level of government below the center, i.e., states or provinces, cities or districts, and even to fourth tier local governments.

It is also useful to think about what fiscal decentralization is not. The deconcentration of decision-making and service delivery powers within a ministry would not count. This is an approach to decentralizing administration and management, and perhaps even to decentralizing some decision making. However, the dominant voice remains the higher-level government, even when elected local officials are invited to the discussion. Deconcentration of this kind does not empower the local population.

Nor would we count the delegation of service delivery powers to community interest groups or community development committees. Though these units may be locally based, they do not come to power by vote and they are not accountable to the local population.

A COMPREHENSIVE SYSTEM

Implementation should begin with a design of the comprehensive system, and should lay out the plan for each element of the system. A little reflection will lead one quickly to the conclusion that fiscal decentralization involves a lot more than fiscal issues. In fact, the electoral system and the civil service arrangements are arguably as important as the taxing and spending components. A 'one-off' piecemeal reform, encompassing only one element of the system (e.g., revenue sharing), is not likely to lead to a major change in the

approach to governance. To be sure, a phased-in strategy may be necessary to avoid “reform shock,” but countries should follow a plan for comprehensive reform and should prepare to deal with the transition problems that will arise during phase-in.

The key elements of a *system* of fiscal decentralization are described in the first column of Table 1. In the remaining three columns, we summarize how these components might be structured under a more and less successful system of fiscal decentralization. The point to be made here is that there are several elements that must fit together into a comprehensive plan for fiscal decentralization.

Accountability to local voters is perhaps the most crucial element of a decentralized system of governance. Councils must be locally elected, preferably by popular vote of the local population. If the local leadership is appointed by higher levels of government, their accountability will be upwards and not down to the local population. 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 the hard choices that they must make.

Getting all the pieces on the table is the first part of constructing the

system. Making the pieces fit together is the second. Coordination is not always easy. For example, Indonesia's big-bang decentralization of 2000 did consider both expenditure assignment and revenue assignment, but the planning was done by two different ministries with little coordination (Alm, Aten and Bahl, 2001). There did not seem to be a concern about making the two sides of the budget fit together.

Not everyone believes 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 getting inputs from local population groups included in the project selection discussion. The "one dimension" approach may not produce successful decentralization because other elements crucial to capturing the benefits will not have changed in a supportive way, or may even work to yield offsetting results. There are many examples of problems with piecemeal reform from which we might draw:

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

Certainly we have great sympathy for a strategy of not introducing more decentralization than can be handled at one time. However, it is important that there be an overall plan and that each decentralization measure introduced fit into that plan.

FISCAL BALANCE AND FISCAL AUTONOMY

The key to structuring a workable system of fiscal decentralization is for government to decide how much expenditure autonomy they want to devolve to subnational governments and then to put in place a supporting system of vertical and horizontal fiscal balance.

How much Autonomy?

Fiscal autonomy has to do with the amount of discretion a subnational government has in setting the level and the composition of its budget. Some countries limit this discretion dramatically with expenditure mandates, limited local government taxing powers and conditional grants. Others allow local governments to shape and finance their budgets to a much greater extent.

We do not have a good comparative measure of expenditure discretion. We can, however, measure the relative level of subnational government expenditures, and offer the hypothesis that there is a correlation. This is shown for Latin American countries in Table 2. The data used here (IMF) are suspect, but suggest that Latin American countries follow the international pattern. There

is a greater degree of expenditure decentralization in countries that are larger, have achieved a higher level of economic development and have more population diversity. Of course, there are notable exceptions.

Fiscal Balance

There is both a vertical and a horizontal component to fiscal balance. The intergovernmental fiscal system is vertically balanced when each level of government, in aggregate, has the resources necessary to finance a minimum level of the services for which it is responsible. In the case of subnational governments, the resource pool would include both intergovernmental transfers and local taxes and charges.

The greatest difficulty with defining the conditions for vertical fiscal balance is in determining the cost of a “minimum” level of services for subnational governments. While everyone can agree that this is determined more by affordability than by objectively determined needs for public services, there is little agreement about how one goes about measuring fiscal balance.

Vertical imbalance can seriously compromise the intergovernmental fiscal system. If subnational governments are “overassigned” expenditure responsibilities (relative to resources) some services will not be delivered, others will be delivered at very low levels, and fiscal deficits become a risk. This is the case in most developing countries. Where subnational governments are “overassigned” resources (relative to expenditure responsibilities), the central government may be fiscally starved. In such a case, central services will be deficient and there will be pressure for a central government tax increase. This is

the situation that prompted China's major fiscal reform in the mid – 1990s (Bahl 1999). Most industrial countries have vertical balance in their intergovernmental financing system primarily because they have given significant taxing powers to their subnational governments.

The horizontal dimension of fiscal balance refers to the degree to which individual subnational governments are able to deliver minimum levels of services with the resources they have available. That is, even if the sector as a whole is in balance in terms of having resources adequate to deliver minimum levels of service, every local government may not be fiscally balanced. In particular, there may be fiscal disparities with the poorest local governments having the least capability to finance services.²

EXPENDITURE ASSIGNMENT

Most students of fiscal decentralization argue that expenditure assignment is the cornerstone that more or less defines the system. The design of the system begins with expenditure assignment. Then, finance will follow function.

Theory and Normative Rules

The question most often asked about expenditure assignment is whether there is a theory (or at least normative rules) that will lead to placing the responsibility for expenditures at the right level of government. The answer is that there is, but it must be applied with considerable judgment.

²A particular problem arises in some countries because of the uneven geographical distribution of natural resources and the resulting severance of the link between "local" taxes and benefits when subnational governments are able to tax such resources. The ideal solution is of course to prevent them from doing so (Mieszkowski 1983), but if this is not possible, considerable care must be taken in designing other aspects of intergovernmental finance, particularly transfer systems, in order to offset the resulting distortion as much as possible.

The basic rule of efficient expenditure assignment is to assign each function to the lowest level of government consistent with its efficient performance. A well-known manifestation of this principle is the rule of “subsidiarity” in the European Union. In the economics literature, much the same idea is expressed in the so-called “decentralization theorem” (Oates, 1972). So long as there are variations among local areas in tastes and costs, there are potential efficiency gains from assigning responsibility for public sector activities to the lowest level possible. Local decision-makers should decide what services are provided, to whom, and in what quantity and quality, and – importantly -- local taxpayers should pay for the services provided. The apt phrase is that “people get what they want” so the overall public welfare is enhanced.

For some expenditure functions, however, assignment to the lowest level of government does not lead to a welfare gain. There are two general reasons why a public function would not pass the decentralization test. The first is the presence of external effects in the delivery of the service. For such services, lower tier governments would underspend (or overspend) because they would only account for private benefits and costs in their budgetary decisions. Social costs and benefits due to spillover effects would be ignored and society would not achieve as high a level of welfare as would be the case if the service had been assigned to either the regional or national level.

Sometimes the external effects are so great that only central government responsibility will do. If the service in question is one of national importance (e.g., vaccinations, or scientific research) or one in which there is a strong

interest in maintaining national standards (higher education), the responsibility for delivery should be with the central government. Moreover, it is seldom appropriate to delegate major income distribution responsibilities (e.g., cash transfer payments) to lower levels of government.³ Delivery might be local, but program design and financing will remain with the higher level.⁴

A second reason for assignment to a higher tier of government is the presence of economies of scale in the delivery of a service. Generally, there are two reasons why we may observe economies of scale in the delivery of public services.⁵ One is that large fixed costs may be required for the service, such as the case of public utilities. Spreading these costs over a larger population so as to use up the excess capacity lowers the unit cost that must be charged for the service. The other reason is the pecuniary economies that come with large quantity purchases, such as the case of school books and certain medical supplies.

Sometimes scale economics can be captured by delivery on a metropolitan area basis (intra-urban bus services, water supply). In large countries it may require delivery by state or provincial governments (universities, mental hospitals, trunk roads), or central government service delivery may be required in small countries or for services where the good is so public that exclusion from its benefits is not possible. How to identify and accommodate scale economies in expenditure assignment requires judgment and a deep

³For a useful recent review of some of the relevant literature on decentralization and redistribution, see Bird and Rodriguez (1999).

⁴There are exceptions, of course, e.g., the United States.

⁵Technically, this might be better labeled as economies of size.

knowledge of the service in question.

While this theory about which level of government should deliver which types of service seems to be based on a reasonable set of rules, implementation is not so easy and tradeoffs are involved. Most public services do have external effects, e.g., better educated children can make the regional and national workforce more productive. But primary education still might be assigned to the lowest level governments because the welfare losses due to external effects are not believed to be large enough to warrant giving up the gains from local control of primary schools. Nor are economies of scale easy to precisely measure, i.e., finding the optimal population size for delivery of a service is no easy matter.

The problem is even more complicated. A particular service may be "assigned" to a particular level of government, but much of the relevant policy and regulatory framework, and indeed much of the financing, may come from higher levels of government -- and the actual service delivery may be at a lower institutional level.⁶ Such apparently complex divisions of functions may work well in practice so long as it is clear to all *exactly* who is responsible for doing *precisely* what. But this is not always the case. As Martinez-Vazquez and Boex (2001) show, the present situation in Russia seems deficient in this respect. Although Canada is by no means a model of clarity in this sense -- even the federal-provincial level is not divided into "watertight boxes" (Meekison, 2000) --

⁶For example, the central government may set national standards for graduates and for teachers and may also establish the basic curriculum to be covered. Regional governments in turn may, within this framework, develop their own policy goals -- for instance, with respect to school facilities -- and deploy appropriate regulatory instruments in an attempt to achieve them. Local governments may be responsible for actually paying teachers and maintaining facilities. And, of course, educational services are finally delivered by schools which will, experience suggests, produce better outcomes if they have a substantial degree of budgetary autonomy and hence can react to input from teachers, parents, and the local community.

its expenditure structure is certainly much better structured to facilitate relatively responsible government than is Russia's.

These problems aside, there seems to be some consensus about functions and responsibilities that might best be assigned to the local, regional and central tiers of government. Shah (1994) has considered these principles and offered what he argues to be a consistent assignment of expenditure responsibilities. While one might not agree fully with these proposed assignments, it does illustrate how the theory can point to a reasonable division among levels of government. In fact, many countries have adopted expenditure assignments that are consistent with this model. However, these same principles, and politics and history, has led other countries to a very different set of expenditure assignments (Martinez-Vazquez, McLure and Vaillancourt, 2006).

While most countries fuss with the assignment question, and split hairs over bundling and unbundling choices, Indonesia took a faster track in their big bang decentralization in 2001. National defense, international relations, justice, police, monetary, development planning, religion and finance were assigned to the center. Everything else was devolved to the regional governments. The failure to name an exact list for the regional governments became a source of confusion and, arguably, some inappropriate assignments were made (Hofman and Kaiser, 2004).

Assignment and Autonomy

The assignment of an "appropriate" expenditure responsibility to the subnational government level is a necessary condition for fiscal decentralization.

Giving the local government the autonomy to decide on how it will deliver the service and to decide on how much it will spend on the service is the sufficient condition. Central (and state) governments often assign the function to a lower level of government but then constrain the autonomy by either assuming direct responsibility for a part of the function, or by issuing mandates.

In many (most) developing countries, wage levels are set and even establishment levels may be fixed, by the central government. For “assigned” functions that are labor intensive, such a mandate dramatically limits the ability of the subnational government to use its budget to shape the allocation of resources. Even if the salary mandate is funded with a grant (historically the case in Indonesia), the subnational government takes on the role of a spending agent for the higher level government.

The most compromising budgetary arrangement is when the upper level government determines the wage and salary level of the subnational government, but does not provide a compensating grant. If the subnational government cannot raise an adequate level of taxes, a budget deficit will arise.

India is a good example of the unfunded mandate approach. A Pay Commission is constituted every tenth year to recommend pay increases for central government employees. State governments generally follow the commission recommendations for their own employees, because they feel pressured to do so. The predictable result is a significant deterioration in state government finances. Indian states faced an aggregate deficit of 2.1 percent of GDP in the first year after implementation of the last pay commission. A major

Indian rating agency estimates that the impact of the next pay commission could drive up the primary deficit in the 21 largest states to more than 3 percent of GDP.

Some countries place restrictions on the composition of the subnational government budget. Such constraints reflect a paternalistic attitude toward local governments. The tenor of the argument is that subnational governments do not know what is best for them and will make “bad” decisions if left unchecked. A more political explanation is that some central ministries want to protect their programs (and bureaucracies) from fiscal decentralization.

There are many examples of expenditure composition mandates. In the Philippines, for example, the local government code specifies a cap on personal service expenditures by local governments (Manasan, forthcoming). The Brazilian 1988 Constitution required subnational governments to spend 25 percent of their revenue to finance education, and central regulation required that 60 percent of expenditures on education be earmarked to wages and salaries.

What to make of the practice of placing constraints on local autonomy in deciding on the level of expenditures or on the expenditure mix? The answer is that it depends on why these constraints are imposed. The strongest case is when a conditional grant is used to expand local government output to reflect spillover benefits. The weaker case is when the mandate is imposed so as to substitute central for local preferences, or to protect political control. This results in a welfare cost (as noted above), the mandated levels are arbitrarily imposed, and there is a significant monitoring cost if the mandate is to be binding. If the

central government is set on imposing its preferences on the local population, then a better route is deconcentrated delivery with the assignment resting with the center.

Accountability

In principle, governments at all levels should be accountable to their citizens (voters) for their actions. Such accountability is the public sector equivalent of the "bottom line" in the private sector. Fiscal decentralization is mostly about changing the accountability of subnational government officers from a reporting up to higher levels of government to a reporting down to their citizens. The fundamental question is who rewards, promotes and decides on the tenure of subnational government officers. But, as we discuss here, the process of finding the fiscal structure that accommodates "accountability down" is no easy matter.

For most developing and transition countries who seek an accountability of their subnational governments to voters, a number of prerequisites should be considered. First, subnational governments should, whenever possible, charge (or tax) for the services they provide. Second, the budget process should be transparent and reported to citizens. This can be done by the press, in town meetings, or in government reports. Elected officials should be tied visibly to the fiscal decisions that they support. Third, the subnational government must report its spending and subject its books to audit by the higher level body.

REVENUE ASSIGNMENT⁷

Revenue assignment refers to the division of taxing powers among levels

⁷ This section draws from Bahl and Bird (forthcoming).

of government. A properly structured revenue assignment system will make it clear which level of government is authorized to levy which taxes, and will specify the discretion that each level will have in levying and administering the taxes.

Why do we need Subnational Government Taxes?

Simply put, the answer to this question is that locally imposed taxes make locally elected officials more accountable to their voting population for the public services that they deliver, i.e., more accountable than if the services were financed by transfers. This leads to better public services and more revenue. How good is this case for increased local taxation?

Accountability. The increased accountability that comes with local taxation might be a missed benefit in many (most) developing countries. Subnational government tax increases are usually very small in magnitude, and are dominated by revenues from intergovernmental transfers. To the extent taxpayers perceive a linkage at all, they will tie service benefits more to the level of grants than to the level of local taxes. Even more likely, the benefits from increased subnational government taxes will be so negligible that they will go unnoticed. Finally, the process of making a decision to increase taxes is not a transparent one and the voters may not know who to hold accountable.

Increased Revenues?

Will increased subnational government taxing powers lead to a higher overall level of revenue mobilization in developing countries? It might not, for two reasons. First, the local voting population might not buy into the idea that higher local government taxes will result in better services. They might be more

persuaded that these new revenues will find their way into the pockets of corrupt politicians, will lead to bloated payrolls, or will be spent to satisfy the whims of the “elite”. Second, the better-off in developing countries have pretty good substitutes for many local government services (e.g., private schools, security, and refuse collection), so they might be hesitant to vote a tax increase on themselves. There is a national psyche in some countries about keeping taxes low (the United States), so why not the same type of preference among voters in subnational governments in developing countries?

The second reason is that the newfound powers of subnational governments may lead to drawing revenues away from the central government. Or, the fact of sharing the tax base might reduce the future taxing space of the central government. This is the fear of many Ministries of Finance around the world. The result is that they resist giving taxing powers to subnational governments.

If the voting public and the higher level governments are convinced that increased subnational governments taxation is a good idea, then the question arises as to how it can be done and whether it can be revenue productive.

The traditional tax assignments approach is to establish separate tax bases for national and subnational governments, based on comparative advantages of tax administration. This approach could lead to an overall increase in revenue mobilization.

Typically, central governments rely on a combination of company income tax, individual income tax, value added tax, and excises. In most developing

countries, however, these taxes have a high entry threshold.⁸ Small firms, most individuals, and owners of immovable property are under-represented in the tax base as the result of this feature. There is also the question of a low rate of compliance, in part because of poor administration but in part because the base includes several “hard to tax” sectors and activities. Among these are the self-employed, the agricultural sector and the consumption of services.

The revenue mobilization hypothesis offered here is that subnational governments have the potential to reach the traditional income, consumption and wealth tax bases in ways that the central government cannot. Those who are hard to tax under central government regimes may be less hard to tax by provincial and local governments.

Subnational governments can reduce the gap between aggregate tax collections and tax potential because they may have a comparative advantage when it comes to some taxes. Three such advantages might be cited. First, local governments often oversee a variety of licensing and regulatory activities and track property ownership and land-based transactions. They thus have ample opportunity to identify businesses in the community and to gain some knowledge about their assets and scale of operation. Because the potential revenue gain is much more important for them in relative terms, local governments have more incentive to carry out such activities than do national governments.

Second provincial and local government knowledge of the tax base may

⁸See Keen and Mintz (2004) for discussion of the appropriate threshold with respect to value-added taxes: these authors conclude that the VAT threshold is too high in most developing countries -- a fact recently recognized in South Africa's 2008 budget when the VAT threshold was substantially increased.

allow them to capture some of those who presently do not fully comply, or evade taxes altogether. This would include the self-employed --- including small businesses --- who may not be on the property tax roll, who understate property transfer values, and who may not be registered for state and local government consumption taxes. Bird and Wallace (2004, p. 143) put it well: "Most presumptive tax methods have two thresholds. Below some level, entities are untaxed, and above that level, they are in the presumptive system. Above some other, higher level, they are out of that system and in the normal tax system." Local governments may have a comparative advantage in reaching these smaller taxpayers, in the bottom two levels. Again, the issue is one of familiarity with the local tax base. Third, "new taxation" might lead to an overall revenue increase. In many countries, provincial and local governments have broadened the tax base with a variety of tax instruments and administrative measures such as levies on the sales of assets of firms, licenses to operate, betterment charges and various forms of property taxation.

Hard Budget Constraint. Subnational government taxation makes it possible to impose a hard budget constraint on provincial and local governments and to preserve local government autonomy. This is because lower level governments would have the means to pay for overspending, and central transfers would no longer be the only route to budget balance.

The conditions for successful fiscal decentralization are that subnational governments should have some autonomy in determining revenue and expenditure levels and that they should balance their budgets. If they have

expenditure discretion but, for example, no authority to raise the level of spending by raising revenues, they may not balance their budgets. In short, subnational governments need discretion to adjust levels on both the expenditure and revenue sides of the budget.

Tax Administration Advantages. An argument often made for the centralization of taxing powers is the superior tax administration capabilities of the higher level governments. There is much to this proposition:

- Central (and some provincial) officers are usually better trained and more skilled on matters of tax administration than are local government officers. Because they are better paid and have better career tracks, this situation perpetuates itself.
- Central government tax administration can lead to economies of scale because of the national uniformity in the administration. This might include centralized EDP services and record-keeping, uniform approaches to assessment and audit, the development of centralized training programs, etc. (Vehorn and Ahmad, 1997).
- Large taxpayers (companies) often operate on a country-wide basis, and also account for a significant share of total national revenues. They can be effectively administered only by the national tax administration.
- The enforcement of tax collection requires the administering of penalties and possibly court actions that are well beyond the reach of most subnational governments. Moreover, local governments in particular are very close to the taxpayers who might be penalized, whereas provincial and central governments are one or several steps removed.
- Some taxes just “do not belong anywhere but at the central level, so must be administered there.” Customs duties are a good example of this.
- The basic goals of taxation may force central control. For example, the distribution objective of the income tax might require a central design and administration of the tax, industrial policy might dictate central administration of the tax on company income, and taxes on international trade are too locked in to trade agreements and valuation complications to be effectively administered by local governments.
- Fairness in taxation requires a uniform implementation of the tax code,

and this is best done by a single tax administration. The central government is the best choice.

These advantages of central administration notwithstanding, there are comparative advantages of subnational governments in tax assessment and collections (see above). There is an especially strong administrative case for the property tax to be a local government levy. Certainly local governments have a comparative advantage in identifying the tax base, because of their familiarity with local land use patterns. The methods of building a tax roll and valuing properties require site visitations, identification of ownership, and the tracking of improvements to properties, and these are tasks that are much better done from a base of local familiarity with the land use. Central government administration of the land tax, where this is practiced, might work in a small country (e.g., Jamaica) but has not been very effective in large countries (e.g., Indonesia).

Good subnational taxes -- at both regional and local levels -- should in principle satisfy two main criteria. First, they should provide sufficient revenue for the richest subnational units to be fiscally autonomous. Second, they should impose fiscal responsibility at the margin on subnational governments. The simplest way to achieve the latter goal is by allowing those governments to establish their own tax rates with respect to at least some major taxes.⁹

The most immediately important subnational revenue issue facing many larger countries is to develop a satisfactory revenue base for provincial governments and large urban governments, that is, one for which those governments are politically responsible. While more can be done with regional

⁹Of course these criteria do not rule out intergovernmental fiscal transfers to achieve the usual "spillover" objectives or to ensure the adequate provision of certain services at "national standards."

excise taxes on vehicles and fuel, in most developing countries there are really only two important possibilities -- a surcharge on the central personal income tax (PIT) or a surcharge on the central value-added tax (VAT). "Piggybacking" through surcharges is arguably the only viable way to do this while retaining an important element of political accountability.

The implication of this discussion is that three long-accepted principles governing subnational taxation need to be reconsidered, and perhaps discarded (Bahl and Bird, forthcoming). First, the conventional model of tax assignment, which in effect assigns all significant revenue sources to central governments, is clearly inappropriate for countries in which subnational governments account for a significant proportion of public sector spending. Second, the VAT is the key to successful central government finance in most developing countries (Bird and Gendron 2007). In certain circumstances, subnational VATs may be feasible and desirable.

Third, admirable as the property tax conventionally recommended for financing local governments is, experience has made it clear that this tax is difficult to implement and unlikely to provide an adequate fiscal base.

With all of these considerations taken into account, what tax choices would appear most appropriate for provincial and large urban governments?¹⁰ The actual practice varies widely. Sometimes central governments do assign important tax responsibilities to their intermediate level governments. The US constitution allows the state governments almost complete freedom in choosing

¹⁰We use "province" to refer to intermediate level governments, though in various countries they may be called states, departments, or oblasts.

their tax rate and base. Sometimes subnational governments are given significant spending powers, but little or no independent revenue raising powers (e.g., South Africa and Nigeria). In yet other countries, provinces are not afforded much expenditure or revenue raising authority, as in Indonesia after the 2001 fiscal decentralization reform.

Among the taxes that might be considered at the regional (as opposed to the local) level are excises, corporate income taxes, personal income taxes, payroll taxes, retail sales taxes, and value-added taxes (VATs).

Excise Taxes. Largely on administrative and efficiency grounds, McLure (1997) and Crossen (2005) suggest that excise taxes levied on a destination basis are a potentially significant source of regional government revenue.

Excises are a primary source of revenues for Colombia's departments (states) with the primary bases being alcoholic beverages and tobacco. Acosta and Bird (2005, pp. 262-264) take a critical view of Colombia's success with subnational government excises. They argue that they are complex in structure and levied at high rates, which has led to a low collection rate due to evasion and smuggling.

Undoubtedly, the strongest economic and administrative case for regional (and perhaps even local) excises is with respect to vehicle-related taxes (Bahl and Linn 1992). The most important tax on automobiles from a revenue perspective is the fuel tax, which is also the simplest and cheapest form of automotive taxation from an administrative perspective. Although central governments too like to exploit this source of revenue, in principle fuel taxes can

equally well be levied at the regional level. Different regions could impose different taxes, if they chose to do so, subject of course to the constraint that they would not likely be able to differ much from the rates imposed by their neighbors given the mobility of the tax base. Administratively, differential provincial fuel taxes can as a rule be imposed at the refinery or wholesale level, with the refiner or wholesaler acting as a collection agent for the states, remitting taxes in accordance with fuel shipments.

Individual Income Tax. The individual income tax (and payroll taxes) can be a good revenue source for province-level governments. If structured correctly, it can meet most of the tests for a good subnational government tax. It can generate significant revenue from an elastic tax base. It is consistent with the correspondence principle in that the burden falls mostly on province residents who also benefit from the services provided. Tax administration can be feasible. The PAYE portion can be assessed and collected at the place of work with relatively little difficulty.¹¹ The “hard to tax” informal sector should be no more difficult a task for provincial governments than it is for the central government, and there is no reason to believe that the collection rate will be any lower under a decentralized than a centralized tax system.

Among the few countries in which subnational governments both have large expenditure roles and are largely fiscally autonomous are the Nordic

¹¹However, this violates the correspondence principle which would call for a residence-based income tax, and for non-residents to file returns. For a discussion, see McLure (1997).

countries (Soderstrom 1991).¹² These local income taxes are basically levied at a flat, locally-established rate on the same tax base as the national income tax and collected by the central government. In Switzerland, most cantons -- the intermediate level of government -- even permit local governments (communes) to levy surcharges at locally-established rates on the cantonal income taxes. Like some U.S. state income taxes, the Swiss local income taxes are not harmonized with the central income tax.

One reason local governments have seldom been given access to income taxes in developed countries is because of the reliance of central governments on this source of revenue. In developing countries, of course, even central governments often have trouble collecting much from the personal income tax. Still, there are a few exceptions.

Payroll taxes at the state level are important sources of subnational finance in a few countries such as Mexico and South Africa. They are levied on both employees and employers. Their merits are that they are easily administrable, at least when imposed on large enterprises, and they are also productive at relatively low rates. Their demerits are, first, that they act not only as a tax barrier to employment in the modern sector but also encourage firms to substitute capital for labor and, second, that in many countries the payroll tax base is already heavily exploited to finance (central) social security systems.

Consumption Taxes. The general sales tax now found in most countries is a

¹² On the other hand, the fact that piggybacked income tax revenues tend to grow with less political fuss than e.g. the property tax, while presumably good news for local officials, suggests that increased reliance on local income taxes ought perhaps to be viewed with mixed feelings.

VAT. Subnational VATs have been thought to be either infeasible or undesirable for a variety of reasons: high administrative and compliance costs, the possible loss of macroeconomic control, the general reluctance of central governments to share VAT room, and the problems arising from cross-border (interstate) trade.¹³ Early experience in Brazil with subnational VATs was generally taken to support this negative appraisal.

The only well-functioning destination-base subnational VATs now in existence are those in Canada (Bird, Mintz and Wilson 2006). Canadian experience shows that with good tax administration it is perfectly feasible to operate a VAT at the subnational level on a destination basis, at least for relatively large regional governments.

But what can be done when, as in most developing countries, there is no realistic prospect of “good” tax administration, and especially not at the subnational level, in the near future? A potentially promising approach developed (though not implemented) in Brazil (Varsano 1999) is to impose what is in effect a supplemental central VAT, which McLure (2000) has called a “compensating” VAT or CVAT. This proposal reduces the risk that households (and unregistered traders) in any state can dodge state VAT by pretending to be registered traders located in other states. It thus provides some protection to the revenue when tax administration (at all levels of government) is not well-developed. More homogeneous or smaller countries interested in exploring this potential subnational revenue source would on the whole seem better advised to

¹³Broadly, the argument with respect to such trade was that subnational VATs were, if levied on an origin basis, distortionary, and if levied on a destination basis, unworkable.

follow something more like the Canadian HST approach to sharing VAT revenues on a (statistically determined) destination basis.

Small Municipalities and Rural Local Governments

Revenue mobilization by small local governments is a special challenge. Their potential tax base is narrow and mostly in the informal sector, and their experience with tax administration is very limited. Things are made even more complicated by the absence of a culture of paying taxes, and by the fact that these governments may provide little public service benefits in return for tax payment. Inevitably, most of their expenditure budget will be financed by intergovernmental transfers.

Nevertheless, independent taxing powers are important for smaller and rural local governments because it is necessary to make local officials accountable, just as in the case of urban local governments. Many countries have recently begun a push to stimulate local self-governance in the rural sector¹⁴. A reasonable goal in such countries is to get rural local governments on the learning curve for fiscal decentralization, including upgrades in local tax practices.

The property tax in rural areas will be much more rudimentary than that levied in urban areas, and likely will yield very little when viewed as a share of GDP. As a share of local government revenue, however, it can be quite important. The obvious revenue constraint is that the local population has little capacity to pay, but there is also the problem of little local skill in administering a property tax, especially with respect to valuation. On the other hand, there are

¹⁴ For a discussion of the India case, see Sethi (2005).

some comparative advantages that small local governments might have in this area, and some administrative “shortcuts” that they might take.

- Because the community is small, mapping of all parcels might be accurately and easily done.
- Assessment might be done on a basis of physical area, rather than value, so as to minimize skill requirements in the valuation process.
- Small communities might be able to use peer pressure along with penalties to enforce collections.

INTERGOVERNMENTAL TRANSFERS

The third pillar of the fiscal structure is intergovernmental transfers. The design of the transfer system is especially important in developing countries because subnational government taxing powers are so limited. In fact, many different types of transfers are in use around the world and it is difficult to settle on a best practice. The kind of transfers system that will work “best” will depend on what it is meant to accomplish. Below we discuss the objectives and then suggest how the practice has responded to them.¹⁵

The Competing Objectives of Transfer Systems.

Governments consider a number of underlying objectives when they design their grant system. Rarely, however, do they explicitly discuss the weights attached to each objective.

Vertical Balance. Arguably the principal reason for intergovernmental transfers in LDCs is to redress the imbalance between the expenditure responsibilities of subnational governments and their revenue raising powers. With economic growth and urbanization, public expenditure demands shift toward services

¹⁵ For a discussion of the detail of transfer systems, see Bahl (2008) and Bahl and Linn (1992).

provided by lower level governments, e.g., social services such as education and health, water supply and sewerage. But, while economic development has led to growth in the expenditure budgets provincial and local governments, it has not led to a corresponding decentralization of taxing powers. The resulting financing gap (the vertical imbalance) is usually filled in less developed countries by transfers from the central government.

Equalization. Developing and transition countries are characterized by wide disparities among regions in economic well-being. To the extent that subnational governments are given more independent revenue raising powers, these disparities will widen further because the more urbanized local governments have the greatest taxable capacities and the strongest administrative infrastructures.

Most countries must do some equalization of inter-regional differences in financial capacities, and they can rely on intergovernmental transfers to accomplish this. The design of an equalizing transfer system seems simple enough on the surface: measure the extent of fiscal disparities, decide how much of the gap will be eliminated, and develop a formula that will produce the desired equalization. However, the design issues are anything but simple and the building of a successful equalizing grant system is a challenge that few developing countries have met.

Externalities. Left to make their own decisions, without any incentives, local governments will underspend (overspend) on services where there are substantial external benefits (costs). It should come as no surprise that local

voters do not readily choose to spend “their” money on services that benefit non-residents, or on protecting non-residents from any ill effects of their own government spending. Intergovernmental transfers are an instrument that can be used as an incentive to encourage local governments to increase their spending on functions with external benefits.

Administrative Justifications. Another justification for relying on intergovernmental transfers vs. subnational government taxes is that it is a less costly way to finance government. There are two points to make here. The first is that the central government can assess and collect taxes more cheaply than can subnational governments. “More cheaply” means that for any given amount of revenue collected, the pure administration costs (assessment, collection, etc.) are lower, and the compliance costs are lower. The second argument is that subnational governments are more corrupt than the central government, and therefore a shift of responsibility to subnational governments will lead to a waste of revenues. This is because local government officials are more susceptible to influence by the local elite, and because they are closer to the local electorate. To the extent this is true, the cost of a shilling of revenue raised is higher at the subnational than at the central level of government. It is more efficient, therefore, for the central (state) government to collect the taxes and then to allocate the revenues to the lower level of government in the form of transfers.

This argument is flawed, or at least overstated. Some higher level governments hide behind this justification in order to hold taxing powers for themselves. In fact, it may not be true that all taxes are more efficiently

administered by higher level governments, as is discussed above.

Another issue that should be raised in this connection is that the charge of local government tax administration inefficiency can become a self-fulfilling prophesy. Tax administration is a skill that is partly learned by doing, and subnational governments are often very low on the learning curve. To deny them the power to assess and collect will result in continuing their weak capacity in tax administration, even in cases where the local governments have a comparative advantage. The better course in a decentralized fiscal system is to move subnational government on to the tax administration learning curve as soon as they are ready and thereby encourage the replacement of intergovernmental transfers with local taxes.

Finally, the charge that subnational government tax administrations are more corrupt than central government tax administrations is more accurately stated as a hypothesis. Some researchers have pointed out that corruption may be even greater at the central level because of less transparency and because the amounts involved are so much greater (Martinez-Vazquez, Arze del Granado and Boex, 2007).

Political Justifications. Governments in transition and developing countries often adopt (or reject) intergovernmental transfers for political reasons. These reasons fall into three categories. The first is that the central (State) government may have the goal of restraining if not discouraging subnational government budgetary autonomy. Why? Because authority to make decisions about service delivery would be passed from central bureaucrats to provincial and local

bureaucrats, and this would significantly dilute the power of the former. An alternative to giving up this power, while not fully rejecting the decentralization initiative, is to provide local governments with intergovernmental transfers that carry stringent conditions.

A second political reason for advocating intergovernmental transfers is the goal of enforcing uniformity in the provision of public services. One way to restrain local governments from making fiscal choices, while living up to the decentralization mandate, is to structure intergovernmental transfers to limit local discretion. Third, a transfer system may be put in place as part of a political strategy to hold open the option of offloading the budget deficit on to subnational governments (for example, underfunding a grant program). The Philippines and Russia are examples where this strategy was used.

One might imagine that subnational governments would push the central government to replace transfers with independent taxing powers. While this is no doubt true in some places, there are other cases where subnational governments support the intergovernmental transfer strategy vs. the local government tax strategy. Provincial and local government politicians would much prefer to spend central government taxes – if they can get enough of them – than raise their own taxes from local voters. All too often, the subnational government politicians are willing (if silent) partners in the revenue centralization decision.

There also are numerous examples of central governments moving away from subnational government taxation toward grant financing. South Africa is in process of abandoning its RSC levy (a combination payroll and turnover tax

levied by local governments) in favor of a central transfer. A similar story might be told for the octroi in India, Pakistan and Bangladesh, which were abandoned in favor of a “compensating” grant to local governments, and local government head taxes in Tanzania and Kenya.

All this said, the politics may also swing back and forth between preferences for fiscal centralization and for decentralized taxing powers. This was the case in Russia where the Yeltsin years were a time of advocating more power for the regional governments, whereas the Putin years have seen more pushback toward fiscal centralization. (Martinez-Vazquez, Rider and Wallace, 2008, chapter 7).

The Practice: Vertical Sharing.¹⁶ Governments have taken three basic approaches to determining the vertical share for subnational governments: (a) to share a defined percent of the revenues of the higher-level government. (b) use an ad hoc approach where the vertical share is defined by a discretionary decision, and (c) to cover a portion of “allowable costs”, of lower level governments.

Arguably the form of vertical revenue sharing that is most in step with the goals of fiscal decentralization is the *shared tax* approach. In this case, the central government allocates a share of national collections of some tax to the provincial/local government sector. In effect, this gives subnational governments an entitlement to a share of national revenues and makes them partners in the central tax system. It provides some degree of certainty as to the revenue flow to local governments, and it could give local governments access to broad-based

¹⁶ For a more detailed discussion, see Bahl and Wallace (2007).

and income-elastic taxes.

At one extreme, countries may share collections from all taxes with their local governments. The cornerstone of the Indonesian decentralization program that took effect in 2001 was a 25 percent sharing of all “domestic” revenues. The Philippines allocates 40 percent of the total internal tax collection (in the third preceding year) to local governments. The proceeds from all central government taxes are assigned to the divisible pool in India, and in 2003, the state government share was 30 percent. In Pakistan, the provincial share is 41.5 percent of central taxes. Prior to 2002, Russia shared 14 percent of federal taxes (excluding customs) under a Federal equalization fund.

Japan’s local allocation tax involves sharing 32 percent of central personal income and liquor tax revenues, 35.8 percent of company income tax revenues, 29.5 percent of consumption tax revenues and 25 percent of tobacco tax revenues.

There also are drawbacks to using the shared tax method of determining the vertical share, and these need to be controlled. From the point-of-view of the center, the shared tax approach could seriously limit fiscal flexibility because the center is obligated to pass a specified share of its revenues to support subnational government spending. From the point of view of subnational governments revenues become more sensitive to central government tax policy changes. Since subnational governments may have no voice in these decisions, their revenue position can become quite vulnerable. Second, a high tax sharing rate for the subnational government may dampen the enthusiasm of the central

government for vigorous tax enforcement thereby reducing the revenue flow to local governments. Third, a large vertical share of central government taxes can so dwarf the revenue raising potential of subnational government taxes that it discourages provincial and local government tax effort. A case in point is Pakistan where the provincial government entitlement is 41.5 percent of total central government taxes, but where provincial government tax effort is less than one percent of GDP (Bahl, Wallace and Cyan, 2008).

The *ad hoc* approach to vertical sharing allows the central government (e.g., President or Parliament) to determine the amount of transfers on a discretionary basis. Whereas the shared tax approach gives subnational governments an ownership of some share of central revenues, the *ad hoc* approach sends an opposite message: the center owns all of its revenues and may or may not choose to grant some share to the subnational government sector.

Obviously, there are great disadvantages to such a subjective determination of the sharing pool. First, it is not transparent, and it is subject to political manipulation. This leads to uncertainties on the part of the subnational government sector, as they do not know what they will receive each year. Fiscal planning and effective budgeting are discouraged. Second, the *ad hoc* approach signals the central government that it may treat the subnational government sector as one other competing expenditure request (along with those from line agencies). In this setting, reductions in transfers can be a route to offloading budget deficits.

Examples abound of the ad hoc approach to vertical sharing, as is described in Bahl and Wallace, (2007, Table 4). The most common type is a voted annual allocation to conditional grant programs as is done in Tanzania and in Brazil for health and education programs. The Autonomous Region of Muslim Mindanao in the Philippines is funded primarily by an annual ad hoc grant program (Manasan, forthcoming). Russia's system of "mutual settlements" are transfers to subnational governments (sometimes not budgeted) that are made on an ad hoc basis.¹⁷

The size of the revenue pool for distribution to subnational governments also can be determined on a *cost reimbursement* basis. Under this approach, the higher level government defines a service for which it will guarantee to cover some portion of the cost incurred by subnational governments in delivering that service. Functions that are often targeted are teachers' salaries, health supplies, highway construction and maintenance, and infrastructure projects. Most developing countries include some form of conditional grant in their transfer system.¹⁸

The cost reimbursement approach is likely to involve a large number of conditional grants that are controlled by the line ministries and are continued from year-to-year. Before 2004, Tanzania's conditional grants were contained in 21 budget votes (Boex and Martinez-Vazquez, 2006). In Australia, about 40 percent of transfers are made up of 90 conditional grants for both current and capital purposes (Hull and Searle, 2007).

¹⁷ For a discussion of mutual settlements, see Martinez-Vazquez and Boex (1991).

¹⁸ For a review of the practice in developing and transition countries, see Bahl and Wallace, (2007, Table 5).

The great advantage, and disadvantage, of the cost reimbursement approach to vertical sharing is its conditional nature. On the one hand the cost reimbursement grants can be used to direct investment to high priority national needs. So long as these transfers are targeted on public functions where there are significant externalities, conditional grants have the potential to be efficiency enhancing.

The biggest disadvantage of the cost reimbursement approach is the compromise of local choice, i.e., the limits placed on the budgetary discretion of recipient governments. So, central fiscal planners are caught on the horns of an efficiency dilemma. Stay with the conditional grant that is efficiency enhancing if the higher level government can guess right on the external benefits of expenditures on the function, or give an unconditional grant to subnational governments and then deliver functions with big externalities through vertical programs.

The Practice: Horizontal Sharing.

Four methods of horizontal sharing are commonly observed in developing countries: a derivation approach, a formula approach, a cost reimbursement approach and an ad hoc approach.

Under the *derivation approach* to revenue sharing, the total grant pool is determined as a share of a national tax, and each subnational government receives an amount based on collections of that tax within their geographic boundaries. For example, 25 percent of value-added taxes in China are allocated to the subnational government sector, and the allocation is made

according to amounts collected inside the boundaries of each provincial government.

Derivation-based sharing is a way for subnational governments with a stronger economic base to gain access to the more productive central taxes. In this regard, it might be thought of as an approach that is friendly to the economic development goals of decentralization. VAT, company income taxes, individual income taxes, and some of the productive excises are included in the sharing base in some countries. In other cases, the taxes shared on a derivation basis are more narrow-based and less productive. It would be hard to say that there is a “common” practice.

Because revenue sharing by derivation is not so friendly to equalization, it is a controversial policy in many countries. It can pit the haves against the have nots, and raises fundamental questions about what is fair. For example, Zhang and Martinez (2003) point out that 9 of China’s 28 provinces collect 70 percent of income taxes. When the base for sharing is revenues from natural resources, the issue is especially contentious.

Derivation-based shared taxes might stimulate some increase in subnational government tax effort, because there is a link between the amount of tax collection in the local area and revenue accruing to the local government. The basic issue here is whether the subnational government has some discretion to affect the level of tax collections. In Russia, for example, the tax administration is centrally controlled, but local collectors feel a dual subordination. In fact, regional and local governments may have responsibility

for a part of their housing and fringe benefit package (Martinez-Vazquez, Rider and Wallace, 2008). The dual subordination of central tax officials stationed in local areas is a pattern that is rarely observed outside the transition countries.

Third, derivation-based sharing should produce more certainty in local budgeting and fiscal planning than would most other forms of intergovernmental transfer.

Finally, derivation-based sharing leaves individual subnational governments susceptible to changes in central government tax policy, both in terms of changes in the vertical share and changes in the amount of entitlement for individual local governments. For example, China's move from a production to a consumption based VAT has significant implications for the revenue share accruing to provinces. Ahmad, Singh and Lockwood (2004) estimate that the average provincial revenue loss (with 100 percent collection efficiency) will be about 30 percent. Worldwide reductions in the corporate income tax in response to increased capital mobility are another case in point.

A second common approach to the allocation of intergovernmental transfers among local governments is the formula grant. A formula grant uses some objective, quantitative criteria to allocate the pool of revenues among the eligible subnational government units.

The most common reason why governments move to a formula-based distribution is to gain transparency in the distribution of grants. This creates a sense of fairness in that all know the exact criteria by which distributions are made. Still, though, the central government decides on the elements of the

formula and on how each will be weighted.

If there is a golden rule of grant design, it is that the formula should reflect the objectives of the grant program. Usually this implies developing a formula that recognizes expenditure need and/or taxable capacity. But this is much easier said than done. Choosing the formula elements is the most difficult job in developing a formula grant. This is because it raises the mission impossible problem of living up to the objectives of the grant when data limitations seriously constrain the choice of the formula elements.

A common form of horizontal sharing is through *cost reimbursement grants*. Typically these grants have three features. First, the higher level government specifies the functions on which the money will be spent, i.e., the grants are conditional. The local tax price associated with delivering that function is lowered vs a situation where there is no grant support. Second, the degree of cost sharing may be specified, i.e., the grant may carry a matching requirement. Third, standards of performance, construction, employee qualifications, etc., may be part of the conditionality in these grants.

There are important disadvantages to conditional grants. From the point of view of subnational governments, such grants limit budgetary discretion and can lead to “unwanted” public investments. Examples abound of local governments being unwilling to maintain capital facilities that were financed heavily by central government cost reimbursement grants. Another major drawback of cost reimbursement grants is that the recipient governments may not spend the money for the dedicated purpose. “Money is fungible.” Because

these transfer funds are co-mingled with other revenues, their true impacts may be hidden. Monitoring becomes all but impossible.

Finally, a major drawback of conditional grants is that they must be monitored by the higher level government and therefore impose significant administrative costs on the higher level government, and significant compliance costs on the recipient governments.

The horizontal sharing of the total grant pool may be *ad hoc*. That is, each year the higher level government will decide how it will distribute grants among eligible local governments. The method of distribution can vary. It could be purely politically driven. Congress or the Administration might just decide on a distribution based on special interests or on the interests held by the political leadership in this year. A popular method of making ad hoc allocations is for subnational governments to “request” projects and for the higher level government to choose those that will be funded.

By almost all standards of a “good” intergovernmental transfer, ad hoc grants fail. They are not transparent, may fluctuate significantly from year to year, and probably would not be driven by clearly stated objectives such as revenue mobilization or equalization. From a point of view of the central government, however, these grants are “controllable”, and are flexible enough to reflect the changing priorities of the center. They might also allow the government to move through a transition period from one grant system to another without disrupting service delivery.

NATURAL RESOURCE REVENUE SHARING

Most developing countries have instituted intergovernmental transfers to share a significant portion of natural resource revenues. As might be expected, there is a wide variation in the practice.

The same two policy issues arise as for other transfers: how to determine the vertical share for provincial and local governments, and what instrument to use in dividing revenues among eligible local governments. In addition, the sharing of natural resource revenues raises the question of whether natural resource sharing will be separate or somehow integrated with the remainder of the transfer system.

The Case for Decentralization

There are good arguments to share natural resource revenues with subnational governments. One is to compensate for the economic and social costs that mining activities impose on local communities (Bahl and Tumennasan, 2004). These include infrastructure, services for workers, air and water pollution, and crime. The problem is putting a price tag on these costs so as to develop a sharing formula.

There also is a “heritage” argument. McLure says it nicely: “Subnational governments have argued strongly that they may have the right to tax natural resources located within their boundaries, to convert resource wealth (their “heritage”) into financial capital” -- to turn “oil in the ground into money in the bank” (1994, p.199).

Finally, there is the question of preserving national unity. Emotions run

high at the regional level when the center claims all (or most) of the resource rents. The degree of contention has led to threats of secession in some countries. In Nigeria, interregional conflicts over access to petroleum have generated “secession, civil war, and the frequent demise of democracy” (Brosio, 2006, p446).

The Case for Centralization

There also are strong arguments for centralization of natural resource revenues, i.e., a smaller vertical share for subnational governments. Four arguments are usually put forward. First, natural resource revenue flows are determined by world market prices and therefore are unstable over time. Such revenues are unsuitable for financing the essential services that are provided by subnational governments Bahl and Tumennasan (2004). Any policy solution that ties revenue decentralization to natural resource tax revenues will require some feature that accommodates this instability.

Second, natural resource revenues may be too essential to fiscal stability in countries with a large fiscal deficit, i.e., not easily replaced by domestic revenue mobilization efforts. Third, natural resource endowments are unevenly distributed and derivation-based sharing can lead to significant fiscal disparities. For example in Russia, about half of all natural resource revenues are collected in three regions (Bosquet, 2002).

Finally, there is the resource curse argument. An abundance of mineral wealth, received rather quickly, can significantly improve the quality of life, as for example is the case in Brunei (Heeks, 1998), but it also causes perverse local

effects that can retard longer term economic development. Most often cited are a spending effect, where a greater share of domestic resources is allocated to non-tradable sectors such as services and government, as well as the drawing of labor toward the higher paying mining sector and away from other economic activity in the region. Another is that the great amounts of money involved may stimulate corrupt activities. Leite and Weidmann (1999) have argued that there is positive relationship between corruption and natural resource abundance.

More germane to the revenue sharing argument is that many local governments do not have the capacity to take on the large scale capital projects that might result from natural resource revenue sharing. In Indonesia, for example, about 10 percent of all local governments received natural resource transfers that were greater in amount than the general purpose transfer that anchor the system (Bahl and Tumennasan, 2004). In Peru, natural resource revenues account for 90 percent of the total investment budget in some regions (Oxford Policy Management, 2008).

The Options and the Practice: Vertical Sharing

In practice, the revenue sharing arrangements vary widely. At one extreme, Chile and Tanzania assign no vertical share to subnational governments, and Ecuador assigns only 2 percent of total royalty collections. Other countries have established significant vertical shares for subnational governments. Indonesia shares 15 percent of oil royalty revenues and 30 percent of natural gas royalty revenues (though the shared base is well less than total rents collected by the central government).

In Peru, revenue sharing is based on corporate income tax revenues. The department (provincial) government share is 50 percent (Oxford Policy Management, 2008). Local governments are also entitled to a share of royalties, but most mining companies have negotiated an exemption from royalties. Bolivia shares 48 percent of oil royalty revenues with its departments, and Colombia shares 60 percent with departments and municipalities (World Bank, 2005). The vertical share in Ghana is 20 percent of royalties, and is earmarked to a fund to support effected local governments.

The Options and the Practice: Horizontal Sharing

The distribution of this vertical share among local governments depends very much on the attitude of the central government toward the heritage idea, i.e., toward the notion that the natural resource is a property wealth of the region and ought to be replace as it is exhausted. This view would lead to a derivation approach to horizontal revenue sharing.

Russia shares petroleum revenues and excise taxes primarily on a derivation basis. The Indonesia arrangement is basically derivation but allows for additional shares to be distributed to nearly all governments in the natural resource provinces. There is a similar arrangement in Columbia. Other countries have mixed derivation based sharing with other allocation methods. Bolivia uses a combination of transfer payments to oil producing regions, and allocations to local governments through central ministries (health and education). Ghana directs the shared revenues to a municipal development fund earmarked for mining localities and based on needs, but payouts from the fund

have been erratic (Oxford Policy Management, 2008). Peru has substituted a voluntary support fund for the revenue sharing from royalties, where the mining companies contribute to spending for specified activities. An interesting experiment in Papua New Guinea has a major mining company paying local governments to implement priority projects, and then taking these contributions as credits against corporate income tax liability.

CONCLUSIONS

Fiscal decentralization is about people having a say about the package of services that is delivered through government budgets. The best way to do this is by establishing responsive local governments that have some budgetary autonomy. Success with fiscal decentralization can be measured in terms of the extent to which people get the services that they want.

How can such a government finance system be built, and sustained? First, it needs to be comprehensive rather than single-issue based. If important pieces of the reform are left out, the decentralization benefits probably will not materialize. Second, it should feature transparency and a built in fiscal discipline. The latter requires that the subnational government sector be balanced in terms of the expenditure responsibilities they have been assigned and the revenue available to them. Without such balance, the fiscal decentralization will not be sustainable.

The fiscal architecture of a decentralized system stands on three pillars. *Expenditure assignment* is the cornerstone because it defines the service delivery responsibilities of subnational governments as well as the autonomy

these governments have in making decisions about the level and mix of budgetary expenditures. Expenditure assignment goes first, then finance follows function.

The second and third pillars are the finance component. *Revenue assignment* is the leg that guarantees a better degree of accountability of local officials to voters by giving subnational governments some taxing power. *Intergovernmental transfers*, the third pillar, sorts out the vertical balance problems and tends to the equalization of interregional disparities.

In reality, almost all countries have these three fiscal pillars. But no two countries are alike because there are very different visions for expenditure assignment, revenue assignment, and intergovernmental transfers. Because some practices are better than other, it ought not to be surprising that some decentralization architectures work better than others.

Table 1

The Components of a System of Fiscal Decentralization

Component	Desirable Feature	Second Best	Least Desirable
Representation	Popular Election	Indirect Election	Appointment by higher level government
Chief Officers	Locally appointed	Central Secondment	
Budget	Local approval; hard constraint	Local approval; soft constraint	Central approval; soft constraint
Expenditure Discretion	Significant control over how money is spent	Autonomy with significant limits	Effectively a spending agent of the higher level government
Own Revenue	Significant local power	Some local power	No revenue raising power
Intergovernmental transfers	Mostly general purpose		Mostly conditional
Borrowing Powers	Broad and hard budget constraint	Restricted borrowing powers	No borrowing powers
CIVIL SERVICE	Locals hire fire and compensate		No power to hire, fire, compensate

Table 2

Subnational Government Expenditures as a Percent of Total
Government Expenditures in Latin American Countries

<u>Country</u>	<u>year</u>	<u>Percent</u>
Argentina	2004	40.5
Brazil	1998	40.0
Chile	2006	12.2
Colombia	2003	22.5
Costa Rica	2006	3.0
Dominican Republic	1996	3.01
El Salvador	2006	8.0
Jamaica	2006	0.9
Mexico	2000	31.8
Nicaragua	1990	2.9
Panama	1994	2.4
Paraguay	2006	8.5
Peru	2005	20.5
Trinidad and Tobago	1995	4.6

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