Managing Fiscal Decentralization

Edited by
Ehtisham Ahmad
and Vito Tanzi

London and New York

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The growth of interest in fiscal decentralization has meant that there has been something of a rush to enshrine this in policy and implementation of reforms. Some 70 countries see this as a major part of their development strategy. This book critically examines the case for decentralization.

This collection of contributions comes from a world-wide team of experts, including academics such as Albert Breton, Giorgio Brosio and Govinda Rao, as well as senior officials of countries that have undertaken decentralization reforms, and staff from the IMF and the World Bank. After analyzing fiscal decentralization in general, the book goes on to look at intriguing case studies of various regions around the world including:

- the European Union
- Hungary and Slovakia
- Russia and China
- India and Indonesia
- Brazil and Argentina
- the African context, with emphasis on South Africa.

This comprehensive and authoritative guide to fiscal decentralization will be of great interest to academics, researchers and of course policy makers.

Ehtisham Ahmad is with the International Monetary Fund.

Vito Tanzi was with the IMF and is now State Secretary of the Italian Ministry of Finance.

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Preface

The issue of fiscal decentralization has begun to feature significantly in many countries around the globe. Members of the Executive Board of the IMF asked the Fiscal Affairs Department to organize a conference to inform them about the latest methodological developments, and to draw lessons from experiences of different countries and regions. A conference was held in Washington in November 2000, bringing together leading academics and "practitioners" from various countries. This volume is largely, but not exclusively, based on the conference.

The Managing Director of the IMF, Mr Horst Kohler, in his opening remarks at the conference, mentioned that the IMF has no preconceived notion as to the level of administrative or political decentralization that countries should choose – this is largely an accident of history and political decisions. However, the Fund is concerned that macroeconomic stability and effective service delivery should not be endangered by the decentralization process. This volume thus seeks to identify how "fiscal decentralization" might be sequenced in order to ensure that these key objectives are met.

Given space constraints in this volume, we have not been able to include chairpersons' and discussants' remarks, as well as some excellent papers presented at the conference.* However, we are most grateful to our academic and other colleagues, including Teresa Ter-Minassian, Ke-young Chu, Michael Keen, John Norregard, Era Dabla-Norris (all from the IMF), Nicholas Stern and Bob Ebel (from the World Bank); Christine Wallich (Asian Development Bank and World Bank) and Ernesto Rezk (Córdoba), Pierre Pestieu (Liege), Paul Smoke (NYU), Daniel Triesman (UCLA) and Martinez-Vasquez (Georgia) for their very helpful contributions or papers.**

In addition to the general papers, which present sharply contrasting views of the world, our focus has been to present country experiences from the perspective of "practitioners." Many of the practitioners who presented papers at the conference hold or have held senior positions in their own countries (Lavrov, Russia; Li, China; Rao, India; Afonso, Brazil; Tanzi and Giarda, Italy; Vinuela, Spain; Jimenez and Devoto, Argentina; and Momoniat, South Africa). Papers from staff from the international agencies include those by Litwack and Sutherland (OECD), Ahmad, Davies, de Mello, Mansoor, Richardson and Tanzi (IMF), and Dethier and Shah (World Bank).

In addition to papers presented at the conference, we have added commissioned papers on Argentina, by Juan-Pablo Jimenez and Florencia Devoto (then Advisors in

* The conference presentations are available on the IMF website.

** The work by Norregard, Dabla-Norris and Martinez-Vasquez will be published separately as an IMF monograph.

the Ministry of Economy) who was engaged in negotiating with provinces at the time the conference was held, in a belated attempt to establish macroeconomic stability; and on South Africa by Ismail Momoniat (Head of the Department dealing with intergovernmental fiscal relations in the Ministry of Finance). This paper presents a very pragmatic view of how decentralization should be sequenced and managed. Further, papers by Julio Vinuela (former Budget Director of Spain) and Piero Giarda (then Vice Minister of Finance of Italy) were combined with contributions from Matt Davies (IMF) and Stefano Piperno (Turin), to focus on asymmetric decentralization in Spain and Italy, drawing on the effects of the Maastricht agreement.

Marie-Therese Riddell played a critical role in assisting with the organization of the conference, and in supporting the volume that has been put together since then. Diana Ellyn has played an important supporting role. Ann Robertson assisted with the editing of some papers, as did Matt Davies. Christine Fetzer and Arik De helped in the final stages, and Sean Culhane intermediated with the publishers. We are grateful to all of them.

Managing fiscal decentralization

Overview

Ehtisham Ahmad and Vito Tanzi

There is a danger that decentralization may be perceived by policy makers, especially donors, as the latest mantra – the magic potion to cure many governance problems. Decentralization is being promoted by well meaning interest groups, often reacting to highly centralized regimes, as well as by influential international agencies, particularly the staff in the multilateral banks. But does it work? What are the essential preconditions for the success of decentralization? These issues are addressed in this volume, with a set of general papers, followed by case studies of countries in particular regions – the European Union (EU); transition economies including China, and major developing countries in Latin America, Africa and Asia.

The case studies are designed to present a practitioners' perspective drawing on the experiences of officials from the concerned countries, or staff from the OECD, the World Bank and the IMF, who have been engaged in providing direct advice to particular countries (often in conjunction with the officials of the concerned countries). Countries often initiate the administrative or political process of decentralization, without due regard to the fiscal consequences. The questions raised in the country papers concern the sequencing of fiscal decentralization so as to ensure effective governance and public service delivery, without endangering macroeconomic stability.

General issues

The potential dangers of decentralization

Tanzi, in Chapter 2, poses some unfashionable personal views. He argues that if countries are not already committed to decentralization, they should consider alternatives to it and its potential pitfalls. Often decentralization is seen as a response to failed policies – the solution may be to improve the current policies, such as skewed or inefficient spending. Often privatization, and reducing the role of the state may be a preferable alternative – with a smaller government, there may be less or little to decentralize. In the extreme, if local preferences dominate especially in very large countries, then breaking them into smaller states may well be a solution. This has happened as in Yugoslavia and Czechoslovakia.

In any case, the potential dangers posed by decentralization should be clearly recognized – the growth in regulations, the impediments created to an effective internal market, and the likelihood that corruption might increase. Moreover, with the difficulty in clearly separating expenditure responsibilities, and the economies of scale in tax collection, it is likely that there will be a heavy reliance on transfers in decentralized countries. This may sap incentives for efficient management and create soft budget constraints. Decentralized countries such as India, Argentina and Brazil have impediments to the proper design and implementation of effective tax policies. Often tax sharing at different rates generates disincentives for efficient tax administration. Also, assigning significant revenue bases to subnational levels may considerably increase regional disparities.

More decentralized countries, generally, find it more difficult to provide transparent and comparable information on general government activities on a timely basis. Critically, considerable incentives to borrow at the subnational level, have created enormous macroeconomic difficulties in countries such as Brazil, and more recently in Argentina.

However, if the decision is taken to proceed with decentralization, *the proper design and establishment of the key institutions for decentralized governance becomes critical* – this includes tax administration, expenditure management and information generation, and effective design and implementation of transfer systems.[1]

Preconditions for decentralization

Albert Breton (Chapter 3) carefully examines the arguments and preconditions for decentralization (devolution in his terminology). He criticizes the two standard justifications for decentralization – that central governments provide uniform levels of goods and services and that decentralized governance provides a better matching of service delivery to citizens' preferences; and that the more junior a government the closer it would be to the people and, therefore, better able to meet demands. The first proposition is easily dismissed by showing that uniformity of provision may be desirable for certain types of services, and that central governments are perfectly capable of tailoring services to different needs of regions. The second proposition is based on the assumption that smaller jurisdictions reflect more homogeneous preferences than larger ones – this is refuted by juxtaposing the city of Toronto, with 120 different ethnic groups, against large provinces such as Newfoundland or Prince Edward Island. In Breton's view the case for decentralization lies in stimulating intergovernmental competition.

The preconditions for effective intergovernmental competition, not so much in terms of Tiebout mobility, which breaks down with multiple jurisdictions, but in terms of rank-order tournaments used by Salmon (see also Chapter 6), generate both vertical and horizontal benchmarks influencing voter preferences. Decentralization failures arise due to different transaction costs. *Information costs* would arise if oppositions and media at more junior levels of government are weaker than at higher levels. One may ask how junior levels of government would acquire information on local preferences and what they might do if they had this information. Similar failures would arise with local *political participation costs* – including the presence of large and influential families or cliques.

Coordination costs would arise by spillover effects, or the consumption of services by out of jurisdiction households or firms that do not pay for these. While some of these costs can be internalized, it is likely that the spillovers will change over time and across jurisdictions – thus some coordination costs are likely to be present at all times. Whether this is sufficient for centralization or not depends on the balance of marginal benefits against the marginal costs of centralization. Moreover, *diminishing supply costs* occur for many goods and services and for tax collection and bond finance. This places the smaller junior jurisdictions at a disadvantage and decentralization failure occurs. It may be possible to deal with such failures through means other than centralization, such as through purchase agreements, consortia of smaller jurisdictions or equalization transfers. *Dynamic instability*, or a "race to the bottom" occurs through destructive competition. Remedies for this include centralization, or harmonization – which is again destructive of competition. Thus, for each type of decentralization failure that might occur, there are remedies that could be adopted to ensure continuing intergovernmental cooperation, hence realize the potential benefits from decentralization. We note here that Breton is not persuaded by the distinctions between different types of decentralization used by several other authors in this volume.

Decentralization and corruption

There is a continuing debate between proponents of decentralization and others as to whether decentralization leads to more or less corruption. Gurgur and Shah of the World Bank in Chapter 4 present the positive case for decentralization. In attempting to identify the empirical drivers of corruption, they find that its main causes are lack of service orientation, weak democratic institutions, a closed economy and colonial past, internal bureaucratic controls and centralized decision making. They find that decentralization has a greater negative impact on corruption in unitary states than in federal countries, and conclude that decentralization supports greater accountability and reduced corruption.

This view may be juxtaposed against arguments by Tanzi (1995) and Prud'homme (1995) that decentralization could lead to greater corruption.

Decentralization and poverty reduction

Proponents of decentralization, especially in the multilateral development agencies, argue that decentralization is needed for poverty reduction – the argument links decentralization to greater participation by the poor in the political process in a decentralized environment.[2] More recent assessments recognize the importance of a well functioning state, and proper institutions before the participation of the poor can be assumed, as well as the risks associated with decentralization – "the problems of making decentralization work are major, urgent and difficult."[3]

Von Braun and Grote (Chapter 5) examine whether decentralization and poverty reduction might be correlated. They distinguish between political, administrative and fiscal decentralization. In an empirical analysis they find that smaller countries do better with poverty reduction than larger ones – but do not thereby draw the conclusion that large countries should be broken up. It is interesting to note that Egypt, a centralized country does better in terms of service delivery than a more decentralized country, India. In general, the empirical assessment suggests that political and administrative decentralization needs to precede fiscal decentralization otherwise participation and accountability cannot be assured. Political decentralization does appear to have a positive impact on poverty reduction, but the effectiveness of service delivery for health and education, for example, depends on institutional conditions and management capacities. These refrains are also echoed in the case studies for developing countries, especially in India and Africa (see e.g. Chapters 13 and 15 by Rao and Brosio, respectively). The South African case of measured decentralization (see Chapter 16 by Momoniat) is particularly interesting – as the key functions in education and health areas have not so far been devolved to the lowest levels.

If, as suggested in a comment at the conference by Paul Smoke (NYU), political decentralization in Africa is already underway, then the task should be to seek the fiscal underpinnings to make it successful.

The EU and Maastricht constraints

The EU countries reflect very interesting though opposing tendencies – with decentralization in countries such as Spain and Italy, juxtaposed against the problems of unification in Germany, to centralizing constraints associated with Brussels, relating to especially fiscal deficits and aggregate indebtedness.

Salmon (Chapter 5) presents an analytical assessment of the opposing trends. The forces of horizontal competition imposing market based disciplines in Europe are constrained by within-country redistributive tendencies. Countries themselves are subject to mobility-based competition. Salmon posits a 4-tier government, with the 4th tier at the municipal level together with the central or 2nd level as extremely important. The 3rd or regional tier is constrained by financial limitations, whereas "Brussels" or the 1st tier is far from a Federal Government, but is treated as a "supranational" administration.

The possibility of reassigning tax powers in favor of Brussels is not on the political agenda, although "harmonization" of taxation has been espoused by both the Commission and member countries. However, little has been achieved so far. This in Salmon's view is due not just because of the unanimity rule required for fiscal issues, but to the fact that France and Germany have not really wanted to make side payments to or compensate or cajole Luxembourg, one of the smaller states that benefits from the status quo. On the other hand, Maastricht treaty limitations on borrowing may actually increase the central government controls over the subnational levels, and also crowd out local borrowing, and adversely affect capital and infrastructure provision by local governments.

The conflicting tendencies in the EU are summarized in seven observations. (1) The realization of a "closer union" would lead to more bureaucracy in Brussels. (2) The "subsidiarity" principles in the Treaty of Rome should lead to greater decentralization, but the recent trends in Spain, Italy and to some extent in the UK have nothing to do with this principle. (3) The modest funds available in Brussels have led to the development of the regional level in only few countries, such as Portugal, Greece and Ireland, but have had limited impact in larger countries such as Germany and Italy. (4) Governments in Italy and France have decentralized largely because of the demonstration effects on electorates. (5) Governments at the 4th level may be better protected in unitary states than in federal ones – in Germany there has been a drastic consolidation of local governments forced by the Länder. (6) Given the importance of the regional (3rd) level *vis a vis* central governments in some countries, commitments by the latter to Brussels may not be acceptable to the former – opening the possibility of secession by the 3rd level from the 2nd, while remaining within the EU. (7) Finally, regarding the dilemma as to the sharing of responsibilities with higher or lower levels, Salmon feels that in facing challenges of greater mobility and expansion, countries in the EU should unify what must be unified, and allow the rest to diversify or be decentralized.

German unification

Opposing tendencies are also apparent within European countries. Spahn and Franz (Chapter 6) describe the strains of the unification of the West with the poorer East German Länder on the West German cooperative federalism model, which relied on consensus and uniformity of service delivery based on a high degree of interregional equalization. The current system is under revision because of a ruling of the Constitutional Court on the system of horizontal equalization, and increasing competition between governments, public entities and the private sector. While the Court may limit the degree of interstate financial redistribution, its emphasis on interjurisdictional solidarity may be interpreted, according to Spahn and Franz, as allowing financial bailouts that could generate negative incentives for efficient management of revenues and expenditures. These conflicting tendencies pose a dilemma for the future of fiscal federalism in Germany.

Asymmetric decentralization in Spain and Italy

Due to both political-economy considerations of keeping a “rich” region from seceding, and because of notionally differing capacities to manage or finance larger expenditures, countries such as Spain and Italy have opted to implement asymmetric decentralization. Davies, Giarda, Piperno and Vinuela (Chapter 7) contrast the similarities and experiences of Spain and Italy. Both countries were unitary states that have adopted asymmetric decentralization – although Spain has moved faster towards a federal structure from a highly centralized state. Both have had difficulties when national standardization, such as in the health sector, has led to central financing of subnationally managed activities, generating perverse incentives, deficits and reduced accountability.

With the decentralization in the 1980s in Spain, subnational debt was not amenable to central controls and began to pose substantial macroeconomic risks. However, with the Maastricht treaty and Spain’s EMU membership, the situation changed drastically. The central government was able to re-establish controls, and enhanced coordination of central and subnational debt policies virtually eliminated regional deficits by 2000. However, apportioning deficits among different levels of government, given the overall constraints, still poses difficult choices.

In Italy, on the other hand, deficits in the richer regions may force adjustments at the center or on local governments to meet Maastricht conditions on overall general government deficits. It remains to be seen whether the conditions can effectively be met, and if not, whether the inherent EU sanctions are sufficiently credible.

Transition economies

The reform of the centrally planned economies, involving a move towards market mechanisms also led to greater subnational responsibilities, especially for social functions that were previously provided by state-owned enterprises or directly by central line ministries. Thus, some degree of decentralization was inevitable in the loosening of very tight central controls. The process is not unidirectional in that there might be more complicated forces at work that do not quite correspond to the "market-preserving decentralization" story that has been popularized with reference to China.[4]

Hungary and Slovakia

Dethier (Chapter 8) carefully examines the experiences of Hungary and Slovakia, the former being one of the most decentralized countries in Central and Eastern Europe and the latter the least. In both countries to some extent the drive for decentralization is based on expectation of EU accession, and the subsidiarity principle. Dethier assesses the appropriateness of tax and expenditure assignments, accountability and effective delivery of public services. Despite relevant legislation, accountability rests on reporting, monitoring and arms-length control mechanisms, but could be costly for the center and needs local skills. In general, decentralization of functions such as education increases administrative costs in both countries, bearing out one of Tanzi's unfashionable complaints.

Hungary is characterized by a very large number of local governments (over 3000) having more than doubled since the start of the decentralization process in 1990. Inappropriately designed expenditure and revenue responsibilities mean that many localities have virtually no source of financing other than "gap-filling" transfers – this affects the incentives to manage expenditures efficiently. Slovakia displays a similar fragmentation of local governments, although their powers are more limited – education for instance continues to be provided through the regional offices of the central government, on norm-based allocations. Further decentralization, as in Hungary, could further increase administrative costs.

A key difficulty in both countries is the failure to mobilize own-resources. Given the design of the transfer systems, there is little incentive to increase local taxation, and the revenue sharing only exacerbates horizontal inequalities – benefiting mainly the richer regions, leaving others even more dependent on transfers. With shared governance such as for education, this leads to a bargaining for resources and increased overall expenditures.

Dethier stresses the need for accountability and fiduciary responsibility. Despite increased democracy, and the theoretical possibilities due to decentralization, there was no change in local government behavior in Slovakia because of decentralization. And in Hungary, the absence of independent audits creates a severe lacuna. To increase accountability, Dethier argues for strengthening key elements of the policy and expenditure management frameworks simultaneously.

Dethier's themes are worth spelling out in detail as they recur frequently in many countries and regions. He recommends the following:

- clarify responsibilities of local governments, their own-financing powers and to consolidate localities where necessary;
- reform the system of transfers to generate incentives to manage expenditures and raise own-revenues efficiently;
- enhance effective local participation;

- generate systems of arms-length control without centralization, such as effective audit mechanisms; and
- introduce limits to borrowing.

Russia

With the weakening of the party chain of command after the dissolution of the Soviet Union, *de facto* decentralization in Russia outpaced the limited legal autonomy that was provided to regions and local governments. Lavrov, Litwack and Sutherland (in Chapter 9) examine the experience during the past decade and draw lessons, based on proposals of the Russian government as well as research conducted by the OECD. The paper juxtaposes the substantial degree of *de jure* control by the central government against the effectively decentralized reality on the ground.

The principal mechanisms for the *de facto* autonomy of subnational governments include: direct and indirect controls over enterprises and affiliated companies, some providing local public goods directly or subsidizing their provision; control over utilities; and also effective control over the locally based staff of the central agencies, including the tax administration and the treasury. The process was facilitated by weak central budget institutions, and the ability of the subnational governments to create extra-budgetary funds and maintain special accounts, effectively limiting the central information flows over subnational receipts and spending. This created loopholes that enabled avoidance of revenue-sharing while permitting full local control over the expenditures from these "hidden funds."

Centralized controls with weak institutions and imperfect information created incentives for local governments that were exacerbated by unfunded mandates and poorly designed "gap-filling" transfers. There was considerable scope for rent-seeking behavior and creative accounting. Inadequate financing, given the magnitude of responsibilities transferred to subnational levels, permitted the blame for poor service delivery to be deflected to the center. Also, wage arrears led to the need for federal government bailouts.

Since the legislation in 1993, permitting subnational borrowing, there has been a virtual explosion of subnational debt – narrow measures in official statistics put overall subnational debt at around 2 percent of GDP in 1999, but when a number of missing components, including arrears are taken into consideration, the figure rises to 8 percent. The arrears on loan guarantees reportedly increased from 35 percent in 1999 to 40 percent in 2000.

A number of recent reforms in the Russian intergovernmental system have been initiated. The power of regional governors has been circumscribed – making them more amenable to central control. A new federal hierarchy at the regional level has been created to better monitor and execute federal spending. A unified treasury is expected to generate information on all government spending and thus circumscribe the corruption and rent-seeking at subnational levels. Steps have also been taken to limit unfunded mandates, and eliminate mutual settlements and offsets. The government has also moved from a reliance on revenue-sharing to assign 100 percent of the VAT to the center, and assign income taxes to subnational governments. Also the transfer system has been streamlined and consolidated, with better equalization and targeting.

Lavrov, Litwack and Sutherland, however, feel that the limitations on subnational own-revenues may have been taken to an extreme. With the virtually complete assignment of social expenditure responsibilities to the subnational level, there is scope now for further "game-playing" by the local governments. They argue for a need for a proper delineation of responsibilities, commensurate with adequate own-revenue sources, to generate sound incentives at the subnational level. The strong message in this paper is that without a proper design of intergovernmental fiscal relations, decentralized expenditures may fail to boost economic efficiency, may lead to poor social service delivery in many regions, and may also jeopardize macroeconomic stability.

China – recentralization?

As in Russia, a process of recentralization has been taking place in China in the recent past. Economic reforms introduced in China by Deng Xiaoping in the 1980s were greatly assisted by the initiatives at the local level, especially those involving partnerships with industrial and commercial undertakings – leading to the characterization of "market-preserving reforms," and very rapid growth especially in the coastal region and in the larger cities and municipalities. While the process worked well for an initial period, the Chinese leadership recognized that it could not continue indefinitely for a number of reasons. First, China lacked a central tax administration, capable of administering a modern tax system, and reliance on local tax administrations, with relatively unclear revenue assignments, put the center at a disadvantage – with sharply falling declared revenues. Second, the relatively low share of central revenues meant that it could do little to counterbalance a growing disparity between different parts of the country. The differentials between coastal and interior provinces became quite marked. Third, growing contingent liabilities, on account of an aging population, recapitalization of the banking sector and reform of state-owned enterprises will require additional resources. All these issues point to an increasing need for *central government* revenues in the short-to-medium term.

Ahmad, Li and Richardson (Chapter 10) describe the reforms of 1994 which introduced a revenue-sharing system, more standardized tax policies and the bifurcation of central and local subnational tax administrations. Local governments were guaranteed transfers equivalent to pre-1994 levels, and it was assumed that growing fiscal space available to the center would be increasingly used for "equalization" transfers based, as in a number of advanced countries, on measures of expenditure need and revenue capacity. In the event, the coastal provinces generating much of the revenues demanded and received a larger share of "returned revenues" from the fiscal balance accruing to the center after 1994. The basis for the returned revenues has been rationalized given the responsibilities of the provinces for pensions, unemployment benefits as well as enterprise restructuring.

A further rationalization of tax policy and revenue-sharing has become due with China's entry to the WTO. This presents an opportunity to revisit the 1994 arrangement, and clarify the own-sources of revenues for all levels of government. Since 2000, China has initiated a major reform of its capabilities to track and account for expenditures through the establishment of a modern treasury and information system. Together with a reform of social responsibilities, redistribution to the poorer inland and western provinces, there is also now an opportunity to reform the system of special purpose and equalization transfers.

Developing countries

Given that decentralization is seen as a panacea for governance and service delivery problems in developing countries, we examine a range of cases from Latin America, Asia and Africa. Many developing countries have oscillated between military governments or centralized dictatorships, and popularly elected governments – some not surviving for very long. This pattern has been observed in Latin America, Africa (e.g. Nigeria) and in Asia, such as Pakistan and Indonesia. Post-military governments have tried to institute safeguards including decentralized institutions, often specified in the constitutions or basic laws.

Many constitutions promulgated in the 1980s or early 1990s in Latin America contain provisions relating to the lower levels of government, even in unitary states such as Colombia.[5] For instance, Colombia's 1991 constitution devolved social expenditures on education and health to lower levels of government, and provided guaranteed transfers to finance these expenditures. Ten years on, the transfers are actually provided to lower levels but the municipalities refused to take on the payment of teachers' wages – which continued to be borne by the center. Also the guaranteed transfers were used to leverage subnational debt – exacerbating Colombia's macroeconomic difficulties. The problems of subnational debt have been quite severe in both Brazil and Argentina, contributing in no small measure to the macroeconomic crisis in the latter in the past few years.

Since independence in 1947, India has had one of the most stable political systems among developing countries, but the process of decentralization to the subprovincial (panchayat) level only began for some functions during the 1990s, with relatively limited expenditure responsibilities and revenue capabilities. In contrast, the rapid decentralization in Indonesia since the fall of Suharto encompasses many risks, including difficulties associated with a struggle for natural resource (including oil and gas) revenues. This struggle for oil revenues has also marked difficulties in achieving a stable decentralized government in Nigeria. However, South African decentralization since the end of Apartheid has been measured and carefully sequenced. Many of the measures adopted reflect possible directions that might be adopted in other developing countries as a prelude to a well managed fiscal and political decentralization.

Brazil

As Tanzi (Chapter 1, this volume) points out, the inappropriate revenue assignments, for example, the subnational VAT in Brazil, cause difficulties – including distortions – and limit the ability of the central government to meaningfully redistribute or equalize across regions. The imbalances in assignment were combined with a right to borrow at municipal and state/provincial levels, including from their own banks, leading to an explosion of subnational debt. This process is described in Afonso and de Mello (Chapter 11). Subnational debt doubled as a share of GDP between 1995 and 1999, contributing to the stabilization crisis of the late 1990s.

A key element in the response to the latest stabilization crisis has been the promulgation of a Fiscal Responsibility Act, which acts as a *de facto* limit to subnational borrowing. State banks have been divested. Ceilings on borrowing are supplemented by procedures for non-compliance and sanctions. In the view of Afonso and de Mello, the key question that remains to be answered is whether the adoption of the new rules-based form of decentralization, with top–down coordination, leaves "little room for discretionary policy making at the subnational level." Indeed, most states are now so constrained that they spend more on their payroll than on social programs – and the situation will deteriorate as the states face growing pension liabilities.

Despite the recent restrictions on subnational policy making, the delivery of social services by municipalities (albeit financed by transfers from the center and the states) has been a relatively bright element of the Brazilian experience. However, to some extent, this has been due also to greater participatory decision making at the local level – such as with the management of schools. This indicates that improvements in service delivery can be achieved by micro-adjustments in management, or reduction in state interference, at a time when the overall ability of subnational governments to do as they please is considerably circumscribed.

Argentina

Argentina presents an interesting case where the imbalances in the intergovernmental fiscal relations have contributed directly to a macroeconomic collapse and the premature fall of an elected government. At the time the paper by Jimenez and Devoto was written, both were part of a team negotiating an adjustment program with the provinces, based on Fiscal Responsibility legislation, mirroring the Brazilian model, and for a period it seemed that it might succeed. In the event, the provinces balked at the implied inroads on their autonomy, contributing to the collapse of the central government and the prospective end of the currency board arrangement.

In Chapter 12, Jimenez and Devoto describe the genesis of the crisis that came to a head in December 2001. After the period of high inflation in the 1980s, the Convertibility Law in the early 1990s was meant to restore discipline and credibility. Certainly inflation was controlled, a new system of co-participation transfers to provinces promulgated, together with increased devolution of functions, including health and education and responsibility for pensions. However, the pressures on subnational finances remained, and several provinces transferred their pension systems to the new national system. Jimenez and Devoto also argue that the decentralization of health and education did not lead to gains in efficiency or equity.

Under the Argentine constitution, provinces have the right to borrow, although many provincial constitutions specified their own limits. Many of these limits were ignored, as provinces borrowed initially from their official banks (though this was restricted under the Convertibility Law), then towards the end of the decade from financial entities, private bond markets and arrears on wages and supplies. By the end of the decade, the parlous state of general government borrowing was evident. While many provinces were above their constitutional limits of indebtedness, there was ample capacity to borrow in some of the larger states, such as Buenos Aires. Given the overall unsustainable level of debt, austerity measures were needed across the board, including in provinces that had been reasonably prudent and in principle had retained a "safe margin" for additional borrowing. In the event, this across the board austerity was not acceptable to the provinces that matter.

In establishing a new stabilization package in Argentina, the redesign of intergovernmental fiscal relations will perforce remain one of the most contentious issues.

India

India has a federal constitution, with considerable powers and functions at the provincial level – this largely dates back to the Government of India Act of 1935, enacted by the colonial administration. However, most Indian provinces are larger in size and population than most member countries of the UN, and the central government wields significant powers – that were enhanced after independence given the importance of central planning. Local governments acted as agents of state governments until the constitutional amendment of 1992, which created (3,000) urban and (roughly 250,000) rural local governments. Urban local governments have more functions than rural *panchayats*. Rao, in Chapter 13, describes the recent decentralization as a very "top down" process.

Rao points out that a correct measurement of the general government deficit is considerably higher than reported, if the operations of the 3rd tier are incorporated. States have not been able to impose discipline on their local governments. The local governments lack resources to provide infrastructure and social services in a meaningful manner, and have resorted to various creative measures to finance expenditures. Indeed, the only meaningful attempts to play a significant role at the local level have occurred in Andhra Pradesh and Maharashtra, where local bodies have been able to borrow heavily.

Central transfers to the states have been largely of a "gap-filling" nature, contributing to fiscal indiscipline at the subnational level. A reconsideration of revenue-assignments, including differential sharing arrangements is under way – the center did not have an incentive to collect certain taxes if a large share was to be shared with lower levels. A reconsideration of revenue assignments is also needed at the local level, especially to replace the distortive tax on inter-regional trade, the *octroi*. In general, Rao finds that the functions at the local level are not substantial, nor are revenue-bases available at that level. He concludes that the institutional environment is not conducive to the success of decentralization at the local level in India at the present time.

Indonesia

Given the relatively slow pace of decentralization in India, with a mature democratic tradition, the relatively rapid pace adopted in Indonesia appears to be a knee-jerk reaction to almost 40 years of autocratic rule since independence. Relatively vague descriptions of functions to be transferred to the third tier from the central government in a rapid decentralization, with very weak expenditure management functions and institutions at all levels of government, mask a struggle over the control over natural resources and rents, and also reflect an attempt to bolster political support at the center by two relatively weak presidents who followed Suharto.

Ahmad and Mansoor (Chapter 14) point to the risks inherent in the rapid devolution of revenues and ill-defined functions. The resulting fiscal imbalances could endanger macroeconomic stability, in addition to jeopardizing effective delivery of social services. Weak central and local monitoring capabilities add to the difficulties and potential of capture by local vested interests. The absence of adequate own-sources of revenues reduces the possibilities of holding local governments accountable. Further, the sharing of oil and other natural resource revenues poses difficulties for stabilization, given relatively volatile product prices, and also exacerbates regional imbalances. Under these circumstances, effectively equalizing transfers will take on an increasingly important role, but cannot completely counteract significant imbalances in revenue and expenditure assignments.

Although local governments are permitted to borrow, using guaranteed transfers as collateral, the Sukarnoputri administration has wisely been cautious in the implementation of this provision. Nonetheless, considerable work is needed to ensure that the risks of the rapid decentralization are not realized.

African perspectives

As in Indonesia, the decentralization process in many African countries has been a reaction to a decade or more of fairly centralized dictatorial rule, often by military administrations, encouraged by bilateral donors and NGOs, as well as a bandwagon demonstration effect. Brosio (Chapter 15) provides a broad ranging survey of various aspects of decentralization across Africa (excluding the Maghreb and the Arab north of the continent).

Decentralization is being pursued by both unitary and federal states (e.g. South Africa and Nigeria, respectively), and in some countries does not go much further than expressions of intent. He finds that expenditure management institutions are weak, especially at the local levels as well as the center, in many countries. Frequently, too many administrative layers have been created, with very weak taxing powers at the local level, and virtually no revenue sources at the regional level. Fiscal responsibility at the subnational level remains weak, given the overwhelming importance of transfers and revenue-sharing arrangements. Countries with natural resources, such as Nigeria, continue to face difficult tradeoffs between macroeconomic stability, and the appetite of lower levels of government for additional resources, bringing to the fore the latent struggle for control over natural resources that led to civil war in the 1960s.

There is a danger that the weak institutions in many African countries will be overburdened, especially as well meaning donors insist on decentralization to achieve poverty-reduction goals. Surveys from Ghana, for instance, show a great deal of disillusionment among citizens with the priorities and performance of their locally elected officials.

South Africa stands out as a country that has approached the decentralization process in a deliberate and well-sequenced manner. Brosio points out that here too, the revenue assignments at the lower level may be inadequate as more functions are transferred, but recognizes the many advantages of the South African experience relative to that in many other developing countries – this issue is taken up further by Momoniat in Chapter 16.

South Africa

Momoniat describes the carefully-sequenced South African experience with decentralization and also draws useful lessons from this experience for other developing countries.

In a 3-tier administration, local governments are responsible for electricity, water supply and sanitation and local roads and infrastructure. These expenditures are largely financed through the property tax and user charges, although transfers from the center (roughly 5 percent of total inflows) and borrowing (11 percent) also play a role.

Provinces have virtually no own-revenues, and the possibility of imposing a surcharge on the income tax has not been used so far. However, much of the key social spending – for example, on health and education and welfare is carried out by the provinces, with financing from the center through transfers, mainly through the unconditional equalization grants system.

Considerable effort has been placed by the center in developing budget formulation and management capacities at the provincial level – this is to be followed by a similar exercise at the local level. The development of provincial expenditure management functions and joint intergovernmental forums between the treasuries and the related central and provincial departments involved, assisted in rationalizing expenditures in the key areas, and improving the quality of welfare provision (through the social pension program). It also assisted in addressing the imbalances in education and health care, improving non-personnel inputs and ensuring improved expenditure outcomes.

Momoniat stresses the requirement that the devolution of expenditure and revenue powers be phased in gradually, commensurate with the development of expenditure management capabilities. He feels that donors have not given sufficient attention to this aspect in the rush to decentralization in many countries. Thus, decentralization will work only if there are basic budget and financial reforms together with good governance for transparency and accountability. South Africa has benefited from a realistic multi-year budget framework, supported by effective monitoring and auditing systems.

In short, the South African experience illustrates the recommendations by Ahmad and Mansoor for sequencing decentralization in Indonesia – that function should follow capacity, and that financing should follow the effective devolution of functions.

Notes

1 For a discussion of mechanisms for the design and implementation of transfer systems see Ahmad (1997).
2 Burki and Edwards (1996), World Bank (1999), chapter 6.
3 See Nicholas Stern (2001), p. 78. See also Dethier (2000).
4 See Qian and Weingast (1997).
5 The distinction between unitary and federal states has gradually been eroded with the decentralization process – with a significant transfer of responsibilities to the regional and local tiers of government, including elected governors and mayors, in countries from Colombia to Indonesia whose constitutions remain "unitary."

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Part I

General themes

1 Pitfalls on the road to fiscal decentralization

Vito Tanzi

The trend toward fiscal decentralization

Fiscal decentralization has been attracting more general attention than in past years when it had interested mainly specialists, even though several countries – including the United States – had come into existence through the political and economic integration of already existing political entities, such as states or principalities. By fiscal decentralization is intended an increase in taxing and/or spending responsibilities given to subnational jurisdictions. In many cases of fiscal decentralization, additional layers such as states, provinces, and regions, are created.

Until recent years, countries seemed to be divided into two relatively distinct groups: the "federal" and the "unitary."[1] The federal countries included Argentina, Australia, Brazil, Canada, Germany, India, Nigeria, Russia, the United States, and a few others. In federal countries subnational governments have important and independent responsibilities for public spending and taxation. These responsibilities are often outlined in the countries' constitutions that explicitly recognize the existence and the powers of the subnational jurisdictions. The unitary countries include those where spending and taxing decisions are made mostly at the level of the national government, although some spending may be carried out by decentralized agencies or institutions acting on behalf of the national government.[2] This form of *administrative* decentralization or deconcentration must be distinguished from *fiscal* decentralization that generally includes some decentralization of political decisions.

Until, perhaps, the early 1980s there were few countries planning to shift fiscal responsibilities from the national toward subnational governments. More recently, however, pressures for fiscal decentralization – or at least for greater fiscal decentralization – have increased in various parts of the world. Canada, China, Colombia, Indonesia, Italy, Spain, and many other countries have been experiencing such pressures and some have put or are putting into motion policies aimed at increasing the role and independence of subnational governments. In Indonesia, which remains a unitary state, the policies to decentralize are being made in a period of time too short to allow full consideration of alternative policies or to assess carefully the consequences of the decisions made (see Ahmad and Mansoor, chapter 14).

The pressures for more fiscal decentralization have originated from different directions. First, deepening democratization has given more voice and weight to the preferences of specific groups or regions. The view that fiscal decisions made at the local level better reflect the citizens' preferences – than, say, decisions made by politicians or officials in the often distant capital cities – has been a common assumption on the part of those pushing for more fiscal decentralization. It has been argued that decentralization decreases the power of those with less knowledge of the local preferences and increases that of those with more knowledge. When cultural, ethnic, or linguistic diversity characterizes a country's population, the justification for giving different regions more control over their political and economic decisions seems to acquire more legitimacy.

Second, globalization is creating market areas that are no longer identical with the national territory. In the past, when countries' economies were mostly closed, the market area that was relevant to the majority of individuals or enterprises was the *national* market. With globalization certain geographical areas within a country have become more closely linked economically to the markets of others countries than to the national market. In a way, globalization has relaxed the economic links of regions to other regions of the same country and has increased the links with other countries. This by itself may have increased the desire on the part of some regions to become economically less dependent on the national government. For example, the elected officials of Lombardy in Italy have been acting, at times, as if Lombardy was an almost independent country. The same has happened for Quebec in Canada or for Basque Province in Spain, although ethnic and linguistic factors have also played a role in these cases.

Third, in the jargon of economists, decentralization may be similar to a "superior good," which becomes more desirable when incomes increase. As countries become richer, they may demand more of it. If this assumption is correct, decentralization will become even more popular in future years.

Fourth, as incomes and the flow of information increase, and as differences in income levels across regions within countries rise, the richer regions become more aware that through the tax system and through various spending programs, there is some – or at times a lot of – income redistribution taking place from the richer to the poorer regions. This realization leads to demands on the part of the richer regions to reduce the role of the national government and to increase that of the subnational governments. This has been the driving force in the North Italian regions for greater fiscal decentralization.

The literature dealing with fiscal federalism and fiscal decentralization has grown enormously in recent years. For the most part, that literature analyzes specific aspects or describes the experiences of particular countries that have federal characteristics, or that have been experimenting with alternative forms of fiscal decentralization.[3] In these experiences, various governmental functions or responsibilities have been transferred to subnational governments or to decentralized agencies.

This chapter does not deal with specific countries or specific aspects of decentralization; rather, it discusses – in a broad and somewhat non-technical fashion – some issues that have not received the attention that they deserve; or issues that are still being debated in the relevant literature. Some of these issues are relevant to the question of whether fiscal decentralization would generate the positive results that its advocates claim it will. An implicit message of this paper is that decentralization is more likely to lead to positive outcomes when some conditions are met *before* the process of decentralization starts. This position is in contrast with the position held by some experts associated with the World Bank. They have argued that once decisions are made to let the process of greater decentralization go forward, the subnational governments will be stimulated to create the needed institutions and to modify the existing incentives which guide the public action to make the process a likely success.[4]

The next section of this chapter argues that, in some cases, there may be alternatives to decentralization that should be considered and that might be preferable to it. Thus, a country faced with pressures to decentralize, or contemplating a decision to decentralize, should first carefully consider these alternatives before making any final decisions. The section on Potential problems and Decentralization discusses various pitfalls associated with decentralization, and the last section contains some concluding remarks.

Alternatives to decentralization

Before a decision to proceed with fiscal decentralization is made, some alternatives to such a policy ought to be considered. Three alternatives covering a broad range of possibilities are discussed here. The first, and least drastic, is to carefully assess whether some of the objectives being sought through decentralization could not be achieved more efficiently, and less drastically, through changes and improvements in the current policies and institutions. The second is to change the role of the state in the economy. The third is a policy that goes all the way toward extreme decentralization. It essentially contemplates the splitting of the country into two or several independent countries.

Improving current policies

Often demands for decentralization arise because the policies being followed by the national government are not seen as adequate, efficient, or fair by the citizens. For example, other regions may resent policies that concentrate excessive public spending in the capital city. Policies that transfer excessive amounts of income or wealth from resource-rich regions to other regions may be resented by the former. Policies that do not devote enough attention and resources to particular regions or areas may be resented by these regions. Highly corrupt or inefficient governments may also encourage demands for more decentralized policy decisions.

In all of these cases, and in other similar circumstances, a first-best option might be to change the national policies in order to make the government more efficient in its functions, and to make its policies more equitable. In the situations described above, the pressure for decentralization must be recognized as essentially a proxy for pressures for a more equitable and efficient government. If the government can improve its effectiveness, the pressures for decentralization are likely to abate. If it cannot, these pressures are likely to intensify.

Reducing the role of the state

When decisions are being made on whether to proceed with policies aimed at fiscal decentralization, it is customary to start with the *current* functions of the national government and to identify those that could be transferred to subnational governments. This approach to expenditure assignment generally ignores that many governmental activities can be transferred either to the subnational governments (through fiscal decentralization) or, alternatively, to the private sector. Thus, privatization should be considered as a possible alternative to decentralization for at least some governmental activities.

It can be hypothesized that the smaller the government's role in the economy, the less need there is for decentralization. This is the other side of the argument that the growth of government in recent decades has brought with it more demands for decentralization.

A "minimalist" government, or one that carries out only "core" activities, would probably be best if it were largely a national government. When he described his view of what the government should do, it is not likely that Adam Smith considered a decentralized set up. The growth of government in recent decades – a growth that has seen a huge expansion of public sector activities in many countries – must have been partly responsible for the increased demands for decentralization witnessed in recent years.[5] In fact, the growth of national (i.e. federal) government in the United States over the years has led a scholar to ask whether federalism has a future in the United States (see Nivola, 2001).

What kinds of activities lend themselves to privatization and what kinds lend themselves to decentralization? This is an important question that, to my knowledge, has not been explicitly addressed in the relevant literature. With the benefit of the experience of recent years, it appears that many of the things governments have been doing could be accomplished equally well, or in some cases even better and more inexpensively, by the private sector. Technological developments are helping in this direction by often destroying natural monopolies, which in the past created a presumption for public sector involvement, and by creating private alternatives.

Recent experiences from many countries show that the privatization of various public activities is not only feasible but also desirable.[6] Examples go from garbage collection to providing electricity, transportation, communication services, water, health services, higher education, and even all or part of pensions. Even jails and cemeteries can be privatized. Some of these activities are exactly those that are often at the center of discussions for decentralization. Thus, for many public activities, privatization should be considered as an alternative to decentralization. Of course one should not go to the other extreme by assuming that privatization is always the best option for most public sector activities and social services. There are undoubtedly cases where decentralization is the better, or at least the preferred option.

The more extensive the process of privatization, the less justification there must be for fiscal decentralization. It would be useful to make an inventory of activities that could be either privatized *or* decentralized, and to assess the potential costs and benefits of these alternatives. As previously stated, in many instances if an activity can be decentralized it can also be privatized. But privatization removes the element of subsidy for the activity because users must bear the full costs for their privatized activities. Thus, part of the decision to decentralize or to privatize rests on whether the government should subsidize the use of particular activities.[7] The above argument must recognize that the citizens of some countries might wish to keep some activities public, even when private alternatives are available – especially when they wish to subsidize them. Examples are found with some cultural activities and with primary and secondary education.

Breaking up countries

One of the strong theoretical arguments advanced in favor of fiscal decentralization is that the preferences and needs of citizens and taxpayers for public sector activities are better known to the local government officials than to those who represent the central government. The reason given is that vicinity or contiguity provides useful information and creates a more direct link between citizens and those who make spending and taxing decisions on their behalf. On the other hand, distance is assumed to reduce the amount and quality of information available to policy makers and their interest in making policy decisions that citizens want. This argument is assumed by some experts to be strong enough to neutralize the advantages that economies of scale in the production of some public goods and public services, and in the generation of tax revenue, may give to arrangements that keep more power in the hands of the national government.

If accepted, the above argument implies that, *ceteris paribus*, small countries should be more successful than large countries in satisfying the social needs of their populations. In other words, if the arguments for decentralization are assumed to be valid, they offer strong reasons for breaking up large countries into smaller ones.[8] There are examples of countries that have, in fact, chosen this option rather than the alternative of fiscal decentralization. And there is some evidence that small states may have smaller problems (see Easterly and Fraay, 1999). In some cases, the breaking up of countries came after or led to civil wars (Yugoslavia and Indonesia with East Timor). In other cases (Czechoslovakia and, to some extent, the Soviet Union), the breaking up was peaceful.

It must be recognized that when size is no longer important for defense against foreign aggression – that is, when annexing other countries by force is no longer fashionable – and when, because of openness and globalization, size becomes less important for economic reasons, cultural affinity and common history remain the main glue that keeps countries together. When these links become weak, the alternative of breaking them into smaller countries should be considered. The number of countries in the world has been increasing and some predict that this trend will continue (see Alesina and Spolaore, 1997).

Potential problems with decentralization

This section will discuss selected problems that are likely to arise when a process of fiscal decentralization is set in motion. While the appearance of these problems is not inevitable, they have appeared frequently enough in countries with a decentralized fiscal structure to warn that special attention must be directed at reducing the probability that they become major problems. While of relevance to countries at all levels of economic development, these problems are likely to become particularly significant in developing countries.

Decentralization and regulations

Over the past two decades a growing literature has been dealing with the use of regulations by governments and their effects on society and especially on the economy. The OECD in particular has paid a lot of attention to regulations in industrial countries and the World Bank has produced a large number of studies on the effect of regulations in developing countries. In the early 1980s the US Congress also held a series of hearings dealing with regulations affecting various American industries. Some economists have attributed at least part of the rapid growth of the US economy in the 1990s to the removal in the late 1970s and 1980s of many regulations that had been imposed on the financial, transportation, communications, and other sectors of the US economy. The communication revolution that created the New Economy might not have occurred so soon without the deregulation of the communication sector.

It is now understood that, while some regulations are useful and necessary – for example, those that regulate traffic and airline safety – some can be damaging to the economy. Some countries' economies have been choked by excessive regulations. Among the damaging regulations are those that take the form of "quasi-fiscal activities." These are regulations that governments use largely in substitution of taxes or public spending (see, especially, Tanzi, 1998). Ambitious governments that are short of public funds and/or that do not have a deep understanding of how market economies operate (e.g. transition economies and many developing countries) tend to frequently abuse this policy instrument, often causing distortions to the economy and a fall in its growth rate.

Federations or fiscally decentralized countries by definition give more power to subnational governments or jurisdictions. They also have more layers of government than unitary countries. For example, they have states, provinces, regions, etc., with some power to tax and spend, and all with the power to regulate. Furthermore, the introduction of new regulations is often easier to obtain politically and administratively than the imposition of taxes.

Except for a handful of successful federations such as Australia, the United States, and a few others, countries with decentralized fiscal structures have not been able to assign sufficient and efficient revenue resources to the subnational jurisdictions.[9] Therefore, subnational governments or jurisdictions are often starved for funds to meet their expenditure objectives. It is natural then that – especially when faced with what they may see as unfunded mandates – they tend to rely more on a tool that they can easily control, namely regulations. Examples of these quasi-fiscal regulations are zoning laws, rules on the opening and closing of shops, rent controls, controls over opening of enterprises and shops, and controls on special sales by shops. Although not all of these regulations are damaging, many are. The author has always been astonished by the maze of locally imposed regulations that characterize Italian municipalities, for example.[10] From the above discussion a specific hypothesis can be advanced, namely that the more decentralized a country becomes – especially when additional layers are created – the greater the probability that an excessive number of damaging regulations will be created. Although there are no data to prove this hypothesis, informal observations convince the author that it is correct. This is a potential problem that decentralization enthusiasts will need to recognize.

Decentralization and the internal market

It is generally taken for granted that a country represents a single market area within which labor, capital, and goods move freely without having to face government-imposed obstacles as when frontiers between countries have to be crossed. This is not always the case, however. In many decentralized countries and especially in those that do not have a strong tradition of respect for free markets – China, Russia, and to some extent, India – subnational jurisdictions often place various obstacles to these movements. These obstacles can lead to a *de facto* fragmentation of the national market.

The obstacles may take several forms. In some countries residency requirements must be satisfied before a person can work or start an activity in another area, or one must have a job before being allowed to stay. Various hidden obstacles may restrict the movement of individuals or goods from one province or state to another. In some places access to public schools or kindergarten, or other government services, is difficult to obtain for individuals who have moved in from another region. Waiting lists become a tool for discriminating against those who migrate from other regions. In some countries, *de facto* "customs" have been set up between provinces to prevent the export of some goods or to collect some taxes on their movements (such as octroi taxes in India). Different taxes may restrict the movement of capital. Tax competition in the form of different incentives or different tax rates may also lead to the misallocation of resources. This has been a major problem in Argentina, for example, and a minor problem in the United States. All these impediments increase the cost of economic activity and reduce the potential benefits that originate from operating in a larger market.[11]

Although some literature exists for some countries on the misallocation of resources due to tax competition, there is no study that has systematically estimated the costs of market fragmentation due to the obstacles mentioned above. In countries such as Argentina, Brazil, China, India, and Russia, these costs might be significant in terms of misallocation of resources and lower growth rates. Such costs do not arise in truly "unitary" countries. It is rare that fiscal decentralization has the effect of augmenting markets.

Decentralization and corruption

Another issue of potential importance relates to the possible connection between decentralization and corruption. A few years ago papers by Prud'homme (1995) and Tanzi (1995) advanced the hypothesis that decentralization could lead to more corruption. This hypothesis has led to a growing literature that has debated the issue or has attempted to test it. So far, no broad consensus has emerged. *Inter alias*, Brueckner (1999) and Triesman (2000) have backed the hypothesis while Fisman and Gatti (2000) and Gurgur and Shah (2000) have rejected it. de Mello and Barenstein (2001) have reached more nuanced results.

The reason for hypothesizing the existence of a positive relationship between fiscal decentralization and corruption is that, as one would expect, in many countries local institutions are less developed than national ones. As a consequence, their ability to control abuses of power on the part of public employees and officials is more limited than at the national level. Many reasons can account for this difference in the quality of the institutions between national and subnational governments. For example, the brightest and best-trained people tend to join the national government where their long run career prospects and their salaries tend to be higher; therefore, national governments are more likely to be able to create more transparent and more accountable public administrations. See on this, Tanzi (1995). Furthermore, foreign technical assistance by international institutions and industrial countries is generally provided to the national governments of developing countries and not to the local governments.

These conclusions have to be qualified, of course. In countries such as Australia, Canada, Germany, and the United States, the educational level of the population is so high that highly trained people are available for all levels of government and good institutions can be created by all jurisdictions. In many poor, developing countries, however, the best and most talented people, if they go into public service, join the national government. The quality of the subnational institutions and of their staffs tends to be lower. Lower salaries, fewer prospects for advancement, various regulations, and greater contiguity of employees and citizens, create conditions that increase the probability that poor governance will be more common at the subnational level.

Casual observations suggest that corruption is more widespread at the subnational level. Even in the United States cases of explicit corruption have been reported over the years in several local governments, but rarely in the national government. Several unpublished, and confidential, technical assistance reports on the public expenditure management systems of developing countries, prepared within the IMF, provide support for the conclusion that the public expenditure management systems in developing countries are much better at the national levels than at the subnational level.

Decentralization and the assignment of taxes and expenditures

The relationship between decentralization and the assignment of taxes and expenditure is a central feature of fiscal decentralization. Assigning expenditures means deciding what are the spending responsibilities of the national and subnational governments. Assigning taxes means giving the subnational governments the option of covering total or additional expenses with their own resources. These assignments tend to be fixed over time, even though changing technologies and economic conditions would require that they be reviewed from time to time (see Tanzi, 1995).

Like contracts, the legal decisions related to the expenditures and taxation assignments are never, and can never be, precise and final. In the United States for example, education is supposed to be a responsibility of the subnational governments, however, the federal government intervenes on a large scale to define curricula and standards, to grant research money, to regulate, to allocate scholarships, and so forth.[12] This kind of intervention is not limited to the United States, but is common to all decentralized countries. It often brings friction between the local representatives and the national government, obfuscating their distinctive responsibilities. The problem is that it is difficult to assign precise expenditure responsibilities, and this leads to an overlap of responsibilities. Confusion arises when two or three different jurisdictional levels step in to promote similar objectives.

The assignment of taxes to match the expenditure responsibilities of subnational governments is difficult because of administrative consideration, economies of scale in tax administration, access to and sharing of information, tax competition, and other factors which have to be taken into account. Experts generally agree that property taxes are the easiest to assign to subnational and especially to local jurisdictions. Therefore, property taxes should play an important role in countries where subnational governments work well. Such taxes generate about 3 percent of GDP to the local governments of the United States, but somewhat lower shares in other federal countries. Unfortunately, the taxation of real property is not easy because it requires reliable and updated cadastral values or current market values for the taxed properties. In the United States, cadastral values are not needed because the sale of properties is more frequent and more transparent than elsewhere. Thus, the local tax administrations can use the sales prices to determine the tax liabilities not only for the sold properties but also for similar ones. Market valuations are much more difficult in countries where sales of properties take place less frequently or where they are less transparent. In Italy, for example, those who sell and buy property often underreport the sales price in order to reduce their tax liabilities *vis à vis* transfer and capital gains taxes. Therefore, the sale prices are not useful to determine the taxable values of the properties.

Various solutions have been attempted by countries to deal with this problem over the years. An interesting suggestion was made more than three decades ago by Maurice

Allais, the Nobel Prize winner in economics from France, in his book first published in 1977. Allais (1988) proposed that people should self-assess the value of their properties. Their self-assessments would be made public. Anyone who wanted to buy these properties at a price that exceeded the declared price by, say 40 percent, could step forward and propose to buy them. If the seller refused to sell, the bid plus a penalty would become the new base for determining the tax on the specific property. In theory, this is a relatively simple, self-enforcing mechanism. In some countries the government has had the right to buy the properties at the values self-assessed or declared by their owners, but this right has been rarely exercised.

Aside from property and income taxes, taxes on car ownership, and a few other taxes have been assigned to subnational jurisdictions, but with less success. These taxes range from retail sales taxes in many American states and municipalities, value-added taxes in Brazil and Germany, turnover or cascading sales taxes in Argentina, cash-flow taxes (IRAP) in Italy, various excise taxes in India, and so on. In some countries, such as Argentina and Russia, the national governments have shared the revenue from some of the taxes that they collect with the subnational governments.[13] In China, until a few years ago, it was the subnational jurisdictions that shared their taxes with the national governments. This system led to a precipitous fall in revenue (see Ahmad *et al.*, 1995). The experience of many countries shows that it has been very difficult to assign taxes that matched the spending needs or policies of subnational governments.

In general the greater the regional differences in per capita income, and the more uniform the standards of public services that the national government wants subnational governments to provide, the greater must be the resource transfers from the national to the subnational governments, and implicitly from the richer to the poorer regions.[14] The reason for this is simply that poor regions have lower taxable capacity than richer regions. Transfers, however – especially when not determined by a precise formula – create moral hazards and at times situations where "soft budgets" become the norm. Poorer states or regions may become so politically powerful that they come to expect that they will be bailed out by the national government if they overspend. It is difficult, however, to establish the optimal level of transfers or the ideal formula to allocate financial resources among the subnational governments.[15]

Decentralization and tax reform

The existence of a decentralized fiscal structure often becomes a major impediment to fundamental or needed tax reform because of the difficulty in coordinating actions among independent jurisdictions. A few examples will illustrate this problem.

Brazil has been trying to reform its value-added tax for many years but it has faced great political difficulty because the current value-added tax is levied by the states (see Varsano, 1999). It has been impossible so far to reach a consensus among the state authorities for changes that would make the Brazilian tax system more efficient. The current value-added tax has encouraged tax competition and even tax wars among the states, and it has created a substantial *de facto* fragmentation of the domestic market.

Argentine provinces continue to use an outdated turnover sales tax – similar to those that existed in European countries in the 1950s, before they were replaced by the value-added taxes. The Argentine tax is a cascading one, which means that it distorts relative prices.[16] The central government hopes to eliminate this tax as it creates distortions in the economy (including the discouragement of exports), and to replace it with more efficient revenue sources. This issue has for decades been the subject of continuous discussion between the national government and the provincial governments. Experts on both sides agree that the present system is inefficient and needs to be changed, but the tax generates substantial revenue to the provinces – about 2 percent of GDP. And because any change would affect each province differently, it has been impossible so far to reach a consensus for reform.

India would be much better served with a national value-added tax rather than the awkward arrangement it now has to impose different excise taxes at the state level. The national government, however, has encountered difficulties in making the change because of the decentralized character of the country, and because of opposition by some states. These are not isolated examples, but tell a common story.

In countries with revenue-sharing arrangements of major taxes with different levels of government, varying shares of the revenue from particular taxes go to the national and to the subnational governments. These arrangements affect both tax administration and tax policy. In Argentina, for example, when the national government desperately needed to increase revenue to reduce large fiscal deficits in the 1980s, it tended to pay more attention to taxes for which only a small share of the revenue collected was legally assigned to the subnational governments. Some of these were bad taxes, such as those on exports and imports. However, because the national government retained all or most of the revenue from these taxes at a time when this revenue was urgently needed, the national authorities preferred these taxes. This process inevitably contributed to distortions in the structure of the tax system and to the retention of an inferior tax system.

In some cases – Russia, for example – the tax administration paid more attention to some taxes than to others because of political pressures coming from a particular level of government (see Tanzi, 2001).

Decentralization and macroeconomic coordination

The potential conflict between decentralization and macroeconomic policy has been a frequent subject in the literature. Richard Musgrave recognized this conflict more than forty years ago (1959). With a decentralized fiscal structure, it becomes more difficult to coordinate the fiscal actions of national and subnational jurisdictions to achieve the macroeconomic objectives of a counter-cyclical policy. At times, subnational governments may pursue expansionary fiscal policy while the national government is pursuing a contractionary fiscal policy. This is especially true when the subnational governments face soft budgets or when they can easily borrow.

These problems have loomed great in Argentina, Brazil, and in other countries, and are currently a point of discussion in Indonesia. The problems become much less important – even within a decentralized structure – when responsibilities of various governments are well defined, and the subnational governments face difficult budgetary constraints (see Ter-Minassian and Craig, 1997).

Decentralization and fiscal transparency

Transparency is an area of increasing interest in the economic literature and in economic policy. The so-called architecture of the international financial system has given much attention to this issue because of the belief that markets and governments operate much better and more efficiently when they have sufficient, good, and clear information. Transparency must be seen as a public good that only the government can provide.[17] It is obviously more difficult to provide clear and sufficient information when the subnational jurisdictions are fiscally important and they operate independently form the national government. Quite apart from the difficulties in understanding the nature of their operations – a problem that also exists often at the national level – subnational governments rarely generate and publish good data on a timely basis. As anyone who has attempted to do comparative analysis of the fiscal policies of various countries well knows, the lack of complete or timely statistical information complicates the conduct of fiscal policy and the analysis of public sector operations. For many federal countries it is almost impossible to have clear, comprehensive data for the *general* government on a timely basis.

Decentralization and regional disparities

In decentralized settings, especially where ethnic, linguistic, or cultural differences characterize the populations of different regions within a country, the various subnational jurisdictions may begin to view themselves as separate from the rest of the country, thus putting into motion centrifugal forces. This problem tends to have more serious implications in those countries where important natural resources are located in particular regions. In a centralized country such as France, for instance, if large oil deposits were found it would not matter where in the country they were located. The national government would be expected to exploit or tax them, using the money to finance its *national* activities. Thus, all French citizens would benefit from the discovery.

In contrast, highly decentralized countries encounter problems with discovery of resources in particular regions because those regions will attempt to claim for its own use the revenue from such a discovery. This leads to political problems, and occasionally even conflicts between regions, as the current situation in Indonesia and past experience in Nigeria indicate. It can also create problems for the income-redistribution role of the government. Again, one of the major functions of national government in recent decades has been the precise redistribution of income from more affluent regions to those poorer regions, and to individuals, through the broadly uniform provision of public goods and services financed by tax systems that are at least proportional and partly progressive.

When the income levels of regions within a country are relatively equal, and when important natural resources are not concentrated on one region, it is easier to have a well-functioning decentralized system. However, when income levels are vastly different among regions, and if broadly uniform standards in the provision of public services are to be maintained by the more affluent regions subsidizing the poorer ones on a significant scale, it becomes more difficult to pursue an effective policy of income redistribution in a decentralized fiscal setting. When differences in income are due to the concentration of natural resources in one region, the difficulty in pursuing such a policy in a decentralized environment can become particularly great, especially if the region sees itself as culturally or ethnically distinct from the rest of the country.

Decentralization and public sector employment

One last point is that decentralization may require a rise in public employment due to demands for more levels of public administration than would be the case in a centralized structure where there is limited ability to exploit economies of scale on the part of the various administrations. This conjecture could be tested with actual data, however, the author is not aware of any study that has attempted to test this assertion. This issue differs from the more traditional one of whether federal states spend more or less than centralized states.

General conclusions

The issues that are briefly reviewed in this paper must be seen as challenges to the optimists who believe that fiscal decentralization is often the solution to many problems. Rather, the conclusion must be that if decentralization is an important *political* objective for a particular country; if the country is *able to establish institutions* that will make decentralization work with a reasonable degree of efficiency – institutions related to tax administration, expenditure management systems, budgets, and so forth, but especially institutions that allow the central government to transfer resources to subnational governments with some assurance that these resources will be used effectively for the purposes for which they are passed on, and without creating expectations for the local governments to spend more, they will be bailed out by the national government – then fiscal decentralization can be a good policy. However, under different circumstances – which are unfortunately more common than many economists recognize or wish to acknowledge – it may not be wise to recommend to a country *that is not already decentralized* a lunge toward a process of fiscal decentralization. This, for example, is what Indonesia is now attempting to do. It is not difficult to predict that rushing decentralization in Indonesia will produce poor results.

If a country is already decentralized – especially if its constitution requires that it be so – then there is not much one can do except try to make the process as efficient as possible. In such a case, the effort should go into improving the institutions necessary for making fiscal decentralization work.

In the first-best world there is one key decision to make: whether the government should be unified – as in the French model – or decentralized – as in the American model. If the national territory is too large to be optimally administered by one government (assuming that there are no military or security threats or no strong cultural and ethnic glue to hold the whole territory together, the option of having several smaller countries replace one large decentralized country should be considered. This is particularly true when the population of a country is not homogenous and the country does not have a long history as a single entity. It is easier to have an efficient government in a small, open economy than in a large territory – as the contrast between Singapore and, say India or Indonesia will show.

In many real world cases, however, countries are to some extent already decentralized at the municipal level. Decisions must be made at the margin, and the main issues are whether to decentralize more by creating additional tiers or by transferring more fiscal responsibilities to existing subnational jurisdictions. The theoretical validity of the argument that the conditions for the success of decentralization could be created by the process of devolution itself, and that there are examples of local governments that are able to respond to the challenge of increased responsibilities, must be recognized. The experience gained in a large number of countries, however, suggest caution in this process because conditions for successful decentralization are often absent. When this is the case, more decentralization means the country will pay a price in terms of lower efficiency and/or less economic stability.

It may be worthwhile to conclude with a citation from a recent World Bank study that states "… decentralization is neither good nor bad for efficiency, equity, or macroeconomic stability; but rather that its effects depend on institution specific design."[18] Unfortunately the design is often defective, especially in developing countries.

Notes

1 In all countries, municipalities have had some responsibilities in spending and taxing. However, in the unitary countries often their spending has been largely financed by transfers from the national government.
2 In both of these groups, municipalities had some independent power. However, federal or fiscally decentralized, states have additional tiers or layers besides the municipalities and the subnational jurisdictions have more independence in making spending and taxing decisions.
3 For country experiences, see Ter-Minassian (ed.) (1997). For a discussion of issues, see Breton (1996).
4 Of course not all World Bank experts share this position. For a balanced assessment see the paper by Litvack *et al.* (1998).
5 See Tanzi and Schuknecht (2000) for evidence on the growth of government spending during the last century.
6 *Ibid.*, chapter IX.
7 In theory at least, the government could subsidize the users through cash transfers rather than the activity itself. This, for example, is the case with vouchers or food stamps.
8 It could be argued, however, that a decentralized setting combined with labor mobility offers citizens options *vis á vis* alternative baskets of public goods and taxes that would not be available in small countries as long as people can not freely migrate from one country to another.
9 Even in the United States, total federal outlays for grants to state and local governments have risen from less than 1 percent of GDP in the 1950s to more than 3 percent at present. See United States (2000), pp. 203–206.
10 In Italy some municipalities even determine the time of the day when a taxi can operate. They also determine when a shop can have special sales on its goods.
11 For a discussion on fiscal competition between Brazilian states and of impediments to trade between states, see Ricardo Varsano (1999).
12 It is interesting that while the American Constitution does not mention any role for the federal government in the area of education, the first major bill that the Bush administration is sending to Congress deals with education.
13 This sharing has often become a contentious issue.
14 These transfers are often called equalization grants and can be based on fixed formulas or on annual or periodic political agreements. See Ahmad (ed.) (1997).
15 An added problem is that local governments may show different levels of efficiency in the use of money. Thus, similar spending may generate different outcomes. See Reviglio (2000) for the example of health spending in Italy.
16 An added problem is that local governments may show different levels of efficiency in the use of money. Thus, similar spending may generate different outcomes. See Reviglio (2000) for the example of health spending in Italy.
17 By fiscal transparency it is assumed that the fiscal activities of the whole public sector are visible and measurable. The public must have a full understanding of, and be able to measure, what the governments at all levels are doing and intend to do. Also, the relevant statistics must be available without undue delay.
18 See Litwack *et al.* (1998).

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2 An introduction to decentralization failure

Albert Breton

Introduction

If we discard the assumption that politicians and public sector bureaucrats are somehow motivated to maximize a social welfare function, as the most superficial observation of the world entreats us to do, the most important reason for decentralizing the public sector is that decentralization makes possible and, in effect, stimulates intergovernmental competition.[1] Indeed, once it is accepted that public officials, like everyone else, are motivated, to a significant degree, to pursue their own interest, intergovernmental competition becomes mandatory for two different, if related, reasons: (a) as a check on political power, much like market competition acts as a check on corporate power; and (b) as an invisible hand mechanism capable of producing a maximum of social utility.

It is very important to be clear about the foregoing. Decentralization minimizes organizational costs – the cost to citizens of signaling their preferences and of moving among jurisdictions; the costs, proximately to governments though ultimately to citizens, of coordinating intergovernmental affairs and of administering governmental bodies – a minimization that Breton and Scott (1978) showed is needed to achieve an optimal assignment of powers. Decentralization leads to that outcome, because it supports intergovernmental competition which, in turn, impels politicians and public sector bureaucrats to do what is required to make organizational costs as small as possible (see Breton, 1996).[2]

There is a literature which explicitly or implicitly argues that intergovernmental competition leads to inefficient outcomes (see, e.g. Mintz and Tulkens, 1986; Wildasin, 1988) where inefficient means suboptimal from the point of view of maximum social welfare. Given that this literature is based on the assumption that governments maximize a social utility function, we should not be surprised that it reaches such a conclusion. As I will argue in the section on Decentralization failures, it is possible for competition to generate inefficient outcomes even if we jettison the assumption that public officials seek the common good and replace it with the assumption that they are motivated by their own interest. In the argument I make competition is not, however, *per se* inefficient.

Before addressing that question, I wish to note that even if the main argument in favor of decentralized governmental systems is the encouragement it gives to competition, decentralization may have other derivative beneficial effects. Contrary to first impressions, these are, however, very poorly understood; the whole subject begs for careful systematic research. Consider two such benefits which occupy a large space in the literature of what is still sometimes called fiscal federalism[3]: (a) that central governments can only supply goods and services in uniform quantities and qualities over their territory and that, as a consequence, decentralization permits non-uniform provisions that better match the preferences of citizens; and (b) that the more junior the government, the closer it will be to the people and the better, therefore, it will meet their demands. The two arguments are sometimes conjoined. Both, I need not insist, are ultimately propositions about the real world that only empirical analysis can elucidate.

The first proposition was to my knowledge initially put forward by Alexis de Tocqueville (1835) and was brought into Public Economics by Wallace Oates (1972). It is a generally accepted argument.[4] In Oates, the uniformity assumption is satisfied as a matter of definition.[5] The argument put forward is that if the central government is able to replicate the supply of goods and services undertaken by junior governments, then "in terms of the *economic definition* of federalism set down in Chapter 1, this is equivalent to the operation of a federal system with a decision-making unit for each jurisdiction … . It is for this reason that I [Oates] associate centralized decision-making with a uniform level of consumption of public goods across all jurisdictions" (p. 37, n. 9, my italics). Though the argument is repeated in Oates's (1999, p. 1123) excellent recent essay, it is not, as definitional solutions seldom are, very convincing.

In more recent literature, the uniformity assumption continues to play a fundamental role in discussions of decentralization and appears to be taken as reflecting the real world. Alan Hamlin (1991), who diagnoses weaknesses in the conventional analysis of decentralization, nevertheless accepts that central governments are "constrained to adopt policies that apply uniformly across the entire population" (p. 194). Jacques Crémer *et al.* (1995) take the assumption to mean that "the central government is assumed to be institutionally compelled to adopt a uniformity constraint in service delivery" – a constraint that signals "government failure" (p. 99). Paul Seabright (1996) rejects the strong formulation of the assumption as "empirically false," but claims value for a weaker version which states "that centralized political systems do tend to implement policies that are regionally more uniform than decentralized ones" (p. 63).

These statements notwithstanding, it is nevertheless difficult to know what the assumption really means. If we consider a single-tier unitary governmental system – one in which there is only one level of government and hence one central government – it makes little sense to assume that the unique government of that system is "obliged," "compelled," or "constrained" to, for example, remove snow where none actually falls. Seabright's formulation of the uniformity assumption is the only one that can possibly make sense in such a context. If we turn our attention to multi-tier governmental systems, even Seabright's weaker formulation of the assumption will not do.[6] The observation of some uniformity in these systems is not proof that more uniformity is provided than is required and/or desired by citizens. For example, in Canada the power to decide on capital punishment is federal and capital punishment is proscribed uniformly across the whole country, while in the United States the power is a state power, with "oversight" by the Supreme Court, and, as a consequence, there is considerable variation among states in the incidence of executions and in the manner of these executions. However, it cannot be assumed, but must be demonstrated, that Canadians are compelled to uniformity in this matter. In a fundamental sense, an American-type assignment regarding capital punishment was and remains available to Canadians, but so far they have not taken it. In Canada again, under the power it has to regulate the fisheries, the federal government not only implements different policies for different fish stocks, it also pursues different policy objectives on the Atlantic, Arctic, and Pacific coasts.

There are Samuelsonian (1954) public goods – such as international diplomacy, national defense (as deterrence), and exchange rate policies – which cannot easily be provided otherwise than uniformly. The observation of uniformity in regards to these services cannot be used as evidence that central governments are obliged to supply goods and services uniformly. There are also goods and services whose unit cost of production falls when they are produced uniformly and in large volume. Tax collection is an example. The observation of uniformity in these cases cannot either establish that central governments are compelled to uniform provision. Finally, there are goods and services which are neither public nor produced under conditions of decreasing unit costs, but are provided uniformly because citizens want a uniform provision. Among these I note the right to a passport and the right to privacy. To say that the powers under which decisions in respect to the provision of these rights are made should be decentralized and diversified – in each case an easy thing to do – is to say that citizens can never have a preference for uniformity.[7,8]

There are three institutions of governmental systems, which I label *concurrency*, *standards*, and *field administration* which shed considerable light on the question of uniform supply. Let me first look at concurrency. To understand the meaning of this institution, we must first be aware that what is assigned to jurisdictional tiers are powers, not policies. To have been assigned a *power* is to have been given the authority to design and implement *policies* in a particular domain. Authority over, say, agriculture or education is the authority to legislate in matters pertaining to these policy domains. It is because powers (not policies) are assigned that there is concurrency – that it is possible for a part of the authority to legislate in regards to agriculture and education to be centralized and at the same time for another part of that authority to be decentralized. Concurrency means that powers are shared to achieve a degree of uniformity consistent with technical requirements (publicness and scale economies) and the preferences of citizens, while sacrificing a minimum of diversity. But concurrency sheds light on uniformity in another way. Suppose that a central government is providing policies uniformly under the part of the authority it had been assigned and that the provinces or states are doing the same under the part they had been allotted, it would still not be possible to argue that the central government was compelled to uniformity as long as the degree of concurrency was adjusted to reflect changes in the relevant circumstances. The prevalence of concurrent powers is, therefore, *prima facie* evidence that central governments are not obliged to provide goods and services uniformly.

Let me now turn my attention to standards. Uniform minimum (or maximum) standards can be applied across the whole of a central government's jurisdiction in respect of certain dimensions of policies while allowing diversity in other dimensions. An example will clarify. In Canada, power over health, except for responsibility over military hospitals and health in the northern territories, is provincial. It is under that power that the provinces severally have provided their citizens with public health programs. There is, however, at the national level, an Act of the Canadian Parliament called the Canada Health Act which forces some uniformity on provincial programs. The federal government was not compelled to pass and implement that Act, except in the sense that if it had not done so it would have risked defeat at the ballot box. The Act which calls for some uniformity – minimum standards – in some areas is respectful of diversity in others. The presence of standards, like the use of concurrency, is evidence that central governments are not bound by a uniformity constraint – to the contrary, it shows that they have freedom in the matter.

Finally, there is field administration (sometimes also called field service).[9] Often central governments (say) assert control over the financing and the overall design of a policy, but give discretionary authority to an administrator in the field (to a prefect, say, as in France) who then implements the policy in a way that is respectful of local conditions. As a consequence, the policy – though formally uniform – is varied in its application. That institution also shows that central governments are not compelled to uniformity.

The second proposition, that which holds that local governments are closer to the people, rests on the notion that the preferences of individuals in smaller communities are more homogeneous than the preferences of individuals in larger ones. Casual evidence is not obviously supportive. The notion that the preferences of citizens in the provinces of Prince Edward Island and of Newfoundland are less homogeneous than those of the citizens of the city of Toronto with its more than 120 different ethnic groups is not a compelling one.

Intergovernmental competition

In the absence of collusion and other like impediments, governments compete horizontally with other governments located at the same jurisdictional level as the one they occupy and vertically with governments situated at jurisdictional tiers above and below them, if such exist. More precisely, it is elected and nonelected centers of power which make up compound governments that engage in competition. They do so by attempting to supply goods and services in quantities which, given their tax-prices, match the quantities desired by citizens. Discrepancies between actual and desired supplies generate utility losses (λ). To understand the role that these play in the analysis that follows, assume that the notion that those who inhabit these centers of power pursue their own interest is captured by the hypothesis that centers of power maximize expected consent (γ).[10]

For center of power a, I define expected consent as the probability that citizen j will grant her consent to that center of power. Formally,

$$\gamma_a = \sum_{j=1}^{J} \phi_a^j \quad 1 \geqslant \phi_a^j \geqslant 0 \tag{1}$$

in which ϕ_a^j is the subjective probability of center of power a that j will grant it her consent.

I now borrow from the probabilistic theory of voting (see Calvert, 1986) the notion that the probabilities of consent (ϕ_a^j) are continuous and twice differentiable functions of the actions of centers of power, which in the present context means that they are functions of utility losses (λ). To be specific, I assume that there are N elected and nonelected centers of power, indexed n ($=1, 2, \ldots, N$), and that the probability that citizen j will grant her consent to one of them, let us say center a, is a function of the utility losses which that center and the others impose on j. Therefore,

$$\phi_a^j = \phi_a^j\,(\lambda_a^j, \lambda_n^j) \quad \forall j,\ n \neq a \tag{2}$$

with $\partial\phi_a^j/\partial\lambda_a^j < 0$ for all js and $\partial\phi_a^j/\partial\lambda_n^j > 0$ for all js and all $n \neq a$. I also borrow from the probabilistic theory of voting the assumptions that the ϕ_n^j functions are strictly concave in λ_a and strictly convex in λ_n (with $n \neq a$).[11]

A consideration of equation (2) reveals that centers of power necessarily compete with each other. In other words, equation (2) tells us that the probability that citizen *j* will give her consent to center of power *a* depends on what *a* does, but also on what some of the other $N-1$ centers of power do. Since these last centers must be assumed to be seeking their own advantage and not that of *a*, it follows that they will, of necessity, be competing with *a* and, incidentally, with each other. It also discloses that the electoral success of an elected center of power depends on the actions of other centers of power, including nonelected ones. To put it differently, the expected vote of an elected governing party can be adversely affected not only by the actions of opposition parties, but also by the actions of nonelected centers of power such as a supreme court, a commission of inquiry, or a central bank.

But the fortunes of a center of power such as *a* can also be affected by the actions of centers of power inhabiting governments that are horizontally and vertically positioned *vis-à-vis* center *a*. That is,

$$\phi_a^j = \varphi_a^j\,(\lambda_a^j, \delta_{g_h}^j, \delta_{g_v}^j) \quad \forall j;\ h = 1, \ldots, H;\ v = 1, \ldots, V \tag{3}$$

with g_h indexing governmental centers of power at the same tier as *a*, and g_v centers above and below *a*. $\delta_{g_h}^j$ and $\delta_{g_v}^j$ are surrogate measures of the utility losses suffered by *j*, consequent on comparing the benefits she derives from *a* with those she would get from *a* were that center of power doing what g_h and g_v are doing (see below for a discussion of the mechanism underlying this reality). If $\varphi_{a1}^j = \partial\phi_a^j/\partial\lambda_a^j$, etc., we have $\varphi_{a1}^j < 0$ for all *j*s, $\varphi_{a2}^j > 0$ and $\varphi_{a3}^j > 0$ for all *j*s and all $g_h \neq a$ and $g_v \neq a$.

The conventional rationalization of horizontal intergovernmental competition is rooted in Charles Tiebout's (1956) model of preference revelation through fiscal mobility. There is, indeed, an enormous, mostly American, literature which has anchored a theory of federalism and decentralization on Tiebout mobility. Some, like Dieter Bös (1983), have argued that there is simply not enough fiscal mobility in the real world – at least outside the United States – to motivate a Tiebout-based theory of federalism and decentralization. However that may be, the difficulty with what we may call the Tiebout mechanism as a basis for a theory of federalism and decentralization is much more radical.

Fiscal mobility *à la* Tiebout is easily modeled in a world in which there is a central (federal) government and *only one* jurisdictional tier. If there are two jurisdictional levels in addition to the central government, a serious problem arises. How, under such circumstances, does a citizen who wishes to consume the bundle of goods and services made available by the government of Laramie, but does not like the basket supplied by Wyoming, choose where to reside? That citizen may find a Laramie-like bundle of goods and services in a given city in the Canadian province of Saskatchewan, due north of Laramie and she may, in addition, very much like what Saskatchewan has to offer. She cannot, however, imagine herself consuming what Ottawa provides – it is Washington's basket of goods and services that she wants! What will that citizen do? Probably stay put in Laramie, Wyoming, USA, thus generating zero mobility.

A consideration of real world democratic governmental systems reveals that not a single one has elected governments at less than three jurisdictional levels and that, indeed, most have more. If nonelected tiers are included (even if nonelected, they do provide goods and services), the number is much larger. For the mass of citizens, Tiebout mobility would be a nightmare – it is in all likelihood quite weak, possibly nonexistent.

But if fiscal mobility *à la* Tiebout is a tenuous reed on which to hang a theory of federalism and decentralization, we have a strong alternative that can substitute for it.

We owe that substitute to Pierre Salmon (1987a,b) and for that reason I will call it the Salmon mechanism.[12] Salmon uses the economic theory of rank-order tournaments, initially proposed by Edward Lazear and Sherwin Rosen (1981) and refined by many others, to develop a mechanism to explain why governments are motivated to compete within jurisdictional tiers. Greatly simplified, the Salmon mechanism can be summarized as follows: citizens use the information they acquire about the supply performance of one or more benchmark governments to appraise and evaluate the supply performance of their own governments. Opposition parties, therefore, have ready-made platforms, based on the same information as that of their citizens, from which to challenge incumbent governments. The latter's response is a manifestation of competition between them and the benchmark governments. For example, a citizen observes the performance of government (i) as it pertains to the supply of, say, road maintenance, education, research incentives, broadcasting, police protection, or health care, and compares that performance with the performance of her own government (k). Because citizens can influence governments by granting or withholding consent, governments are induced to compete in supplying whatever is the object of comparison.

The mechanism can be modified and extended to apply to vertical competition simply by redefining the variables that are compared. For example, instead of looking at the performance of benchmark governments in the matter of road maintenance and education, it is possible to assume that citizens compare something like, let us say, James Buchanan's (1950) "fiscal residuum" – a measure of the benefits received from a government relative to the costs of these benefits. In other words, citizens compare the fiscal residua generated by governments located at different jurisdictional tiers.[13]

Decentralization failures

In the older literature – the *locus classicus* being possibly Francis Bator's (1958) authoritative synthesis – market failures were associated with the "technocratic data," realities such as increasing returns and neighborhood effects. In the more recent literature – that which follows Ronald Coase's (1960) seminal contribution to the question – market failures have come to be imputed to one transaction cost or another (see Arrow, 1970, for one of the first formal presentation of that position). That is the approach I will follow.

At the outset, I note that the decentralization failures I am concerned with pertain to the incapacity of intergovernmental competition to produce the most desirable outcome. Decentralization failures are, in other words, associated with factors that cause competition to break down or to produce undesirable outcomes.[14] I look at five such factors. I have tried to be exhaustive, but I cannot be certain that some significant factor has not escaped my attention.[15]

Information costs

Information problems are pervasive both in the marketplace and in the public sector. I am concerned with only one of these problems here, namely that which may obstruct the operation of the modified Salmon mechanism and thus either bias or altogether impede vertical intergovernmental competition. The proposition is a simple one: the higher the information costs the smaller will be φ^j_{a2} and φ^j_{a3} in equation (3) above – measures of the effect of the actions of benchmark governments on the consent *j* grants her own government. There is decentralization failure if the costs of obtaining information about the policies of benchmark governments are higher for more junior than they are for more senior governments.

This particular information problem has two sources. Donald Wittman (1995) has persuasively and correctly insisted on the role of oppositions as critics of governing parties in making information available to citizens. When oppositions lack resources, are weak, or are simply nonexistent, some basic relevant information about what benchmark governments are doing will not reach the public. The same will happen if the media do not report that information once oppositions have unearthed it. If the information reported is distorted – as was the case when the American media decided, some years ago, to inform its public about the "Canadian health system" – the outcome may be even worse in that flawed policies may be implemented. Whether oppositions and media are as effective as providers of information about policies and policy-making of governments at the more junior tiers as they are of governments at more senior tiers is an empirical matter. However, if they are not and if powers are decentralized, there will be failure.

To say that knowledge of the influence oppositions and media have in conveying information about the policies of benchmark governments to citizens located at different jurisdictional levels is an empirical question, does not mean that one cannot use casual observation to form an opinion on the matter, only that one should be cautious in doing so. If I do a superficial evaluation of the information provided by oppositions and media about what benchmark local, provincial, and central governments do in Canada, it seems to me that I have to conclude, after noting that none of the information is very good, that as regards Toronto, Ontario, and Canada, the information is worse regarding the first, and best for the last. If one believes that local governments should be given responsibility for the provision of much of what the public sector supplies – according to a shrewd analyst, all policies "except national defense, foreign policy, and surprisingly few others" (Bird, 1993, p. 211) – on the ground that local governments are closer to the people, that is have more information about local preferences, one must also be told how this information is acquired and, more importantly, why local governments would act on it if they had it.

Political participation costs

The costs to citizens of political participation are varied.[16] Decentralization failure occurs whenever powers are decentralized and political participation costs are larger at more junior than at more senior levels of government. If cliques or cabals – family compacts as they were once called in Canada – so dominate the political process that one or a group of them can prevent certain matters from being placed on the agenda for public discussion or can get certain decisions systematically and permanently shelved, then the costs of political participation are high. They may, indeed, be approaching infinity.

Whether these costs are higher at more junior levels of government is an empirical question. To my knowledge, the subject has not been studied. It does appear, however, that sometimes and in some places (see Rushdie, 1981) the costs of political participation at the local level are very high. In that case, decentralization begets failure.

Coordination costs

Decentralization of powers may cause interjurisdictional benefit and cost spillovers for some policies. In other words, decentralization may lead to the consumption of services and to the use of inputs by out-of-jurisdiction households and firms which, in the absence of remedial action, do not pay for the goods and services they consume and use. If the costs of intergovernmental coordination are low, decentralization may still be possible, because coordination can internalize the spillovers.

Coordination costs vary through time as trust among politicians and public bureaucrats at different levels of government ebbs and flows, as the incidence and intensity of personality and other conflicts vary, and as the extent of free riding changes. They also vary with the nature of the spillovers and with the number of jurisdictions over which the spillovers flow. It is virtually impossible to change the division of powers to match the variations in the above variables and in others like them. Consequently, one must expect to observe the presence of non-internalized positive and negative externalities, unexploited economies of scale, and so on more or less at all times. This signals decentralization failure. Whether such a failure calls for less decentralization can only be decided by weighing the marginal benefits against the marginal costs of centralization.

If decentralization is pursued as a "way of escaping from the traps of ineffective and inefficient governance" (Bird, 1993, p. 207), then the cost associated with the failure is the cost of more effective and more efficient governance. That sort of problem arises often when two or more policy objectives are pursued.

Diminishing supply costs

If the marginal cost of producing and delivering public sector goods and services were constant for all goods and services, the disparity in size of jurisdictional units – measured by per capita income or wealth as well as by the population size of provinces or states, regions, and localities – would be *ceteris paribus* of no consequence for intergovernmental competition. However, in general, the size distribution of units matters because for many goods and services marginal supply costs are diminishing. That is also true of the marginal cost of tax collection, of bond finance, and of insurance premiums in matters such as art exhibitions and public buildings.

If powers are assigned to more junior levels of government and if a rule of political *laissez faire* is in effect, the smaller jurisdictional units at the more junior levels will lose capital and labor because they will not be able to compete. In the marketplace, firms in that position go bankrupt. Given that bankruptcy is not an alternative in governmental systems, citizens in these jurisdictions would be disadvantaged.[17] We would have decentralization failure.

The remedy for this state of affairs need not be centralization, at least as this notion is usually construed. Cures for decentralization failures associated with diminishing supply costs are numerous. I mention four which are used in Canada, a decentralized governmental system in which the largest province is more than eighty-five times the size of the smallest, a reality that is compounded by the fact that six provinces are small relative to the other four.[18]

One of the oldest ways of dealing with diminishing marginal supply costs is through purchasing agreements. For example, in the case of police services in Canada, the larger provinces produce their own, while the smaller provinces (and the territories) purchase what they need by hiring the services of the federal police – the Royal Canadian Mounted Police.[19] In the case of tax collection, the federal government collects personal and corporate income taxes for some provinces and not others.[20] The list could be extended.

Another way of dealing with this type of decentralization failure is through the creation of consortiums that bring together a subset of provinces that adopt a common policy in some particular matter. The Canadian Atlantic provinces – New Brunswick, Nova Scotia, Prince Edward Island, and Newfoundland-Labrador – have created structures to deal, *inter alia*, with educational policy. A third way to approach the problem is through what has been called "asymmetric assignments." Through that device, the central government plays a different role in different provinces. In Canada, asymmetric assignments rule in road construction, export promotion, regional development, grants to the arts, and many other areas.

Finally, another very important way Canada has dealt with the decentralization failure that derives from diminishing supply costs is through the implementation of a program of equalization payments based on tax effort and population size. These equalization grants are unconditional (as they must be) and, since 1982, are entrenched in the Canadian Constitution.

Dynamic instability

In the literature of federalism, the phenomenon I consider in this subsection is known as a "race to the bottom." It is generally agreed that the expression is inappropriate (see, e.g. Wilson, 1996; Oates, 1999), but for one reason or another, it continues to be widely used. This consecration notwithstanding, I will refer to what I perceive to be the reality in search of an explanation as *dynamic instability*.[21] The main problem with the race to the bottom expression is that it conveys the impression of displacements that never set in motion countervailing forces or, to use Kelvin Lancaster's (1974, p. 287) term, "restoring forces" that prevent collapse and can even bring whatever factor has been displaced back to its initial equilibrium or to some other equilibrium position far away from the bottom. Anthony Scott (2000) has, correctly in my view, noted that the phenomenon is, at the theoretical level at least, the same as the "beggar-thy-neighbor" tariff policies that were so widely implemented between World Wars I and II. He could also have mentioned the competitive exchange rate devaluations that were prevalent during the same period. Scott, as does Oates (1999), mentions the literature on the setting of property taxes which appear to have responded to the same sort of forces.

A number of scholars believe that races to the bottom are not *de facto* empirically important (see Oates and Schwab, 1988; Wilson, 1996; Oates, 1998, 1999; and Scott, 2000). I believe, to the contrary, that the presumption must be that the phenomenon is, if not ubiquitous, frequent. Indeed, tariff wars (Kindleberger, 1986), competitive exchange devaluations (Nurkse, 1944), and destructive tax competition (Break, 1967; Rowell–Sirois Royal Commission on Dominion–Provincial Relations in Canada, 1940)[22] during the 1930s did take place. I think it significant, in addition, that in the post-World War II era, we have not had serious tariff wars – some skirmishes but no wars – and no sustained competitive devaluations of currencies. This, I suggest, is not an accident. Indeed, a large literature (see, e.g. Keohane, 1984; Kindleberger, 1986) attributes the relative stability of the post-war era in these areas to the existence of international bodies such as the GATT (now the WTO) and the IMF. I concur with the conclusions of that literature. The absence of tariff wars and of competitive devaluations point to dynamic instabilities that have been mastered.[23]

I do not propose a model of dynamic instability; I only want to suggest a different way of approaching the problem. To do so, I begin by assuming that the discrete trajectories – the histories – of expected consent for center of power or government a at time zero is γ_{a0}. The time sequence of that state variable starting at $t=0$ is:

$$(\gamma_{at})_0^{\infty} = (\gamma_{a0}, \gamma_{a1}, \gamma_{a2}, \ldots, \gamma_{at}, \gamma_{at+1}, \ldots) \quad a = 1, 2, \ldots, N. \tag{4}$$

The change in the behavior of the system between discrete time intervals is given by:

$$\Delta\gamma_{at} = \gamma_{at+1} - \gamma_{at} \quad t = 0, 1, \ldots; \quad a = 1, 2, \ldots, N. \tag{5}$$

If we assume that $\Delta\gamma_{at}$ is determined by the state variable at time t, we can write:

$$\gamma_{at+1} = \theta\ (\gamma_{at}) = \gamma_{at} + \mathrm{f}(\gamma_{at}, \mathbf{m}_a) \quad t = 0, 1, \ldots; \quad a = 1, 2, \ldots, N, \tag{6}$$

a first-order difference equation which profiles the trajectories of the system in which θ is the structure of the process and $\mathbf{m}_a$ is a vector of parameters such as the sensitivity of group members in granting consent when utility losses vary (the first derivatives of equations such as (3)), the size of groups, and no doubt many others.

The simplest structure of the process, inspired by the logic underlying equations (2) and (3), can be visualized by assuming two jurisdictions and two groups in each jurisdiction. Suppose that the government in one jurisdiction (a) responds to an action of the government in the other jurisdiction (b) and that this response increases the utility loss of one group in a while reducing it for the other group. The size of the response will depend on the parameters in equation (6) – to repeat, the sensitivity of the groups in granting consent when utility losses vary, the size of the groups, and others. The government in b may or may not counter that response depending on the values of $\mathbf{m}_b$ it faces. Assuming that the marginal utility functions are diminishing in both directions (for gains and losses) as the size of the response increases, the system will generate trajectories determined by the values of $\mathbf{m}_w$ ($w = a, b$). The challenge is to formulate a model that would allow us to examine under what values of $\mathbf{m}_w$ ($w = a, b$) the system would converge to a stationary state or generate periodic cycles (would be ergodic), or would bifurcate and produce a nonperiodic behavior (become nonergodic).

Suppose that a system converges to a stationary state. It may, in that case, be far from the "bottom," but it may also be far from the "top." That could possibly explain what happened in Canada as regards a securities regulation system that permitted delinquent behavior – a problem that is currently being recognized and for which alternative solutions are being considered: one in which the federal government is involved, another which would involve only the provinces. It could also possibly explain the situation that characterized the provincial management of natural resources. In Canada, natural resources belong to the provincial governments. They do not belong in the sense that the power to legislate in the matter of resources belongs to the provinces – they belong to the provinces in the sense that they are owned by provincial governments. Until just a few years ago, the provincial governments literally gave the resources away in order to attract firms that would exploit them and not the equivalent resources in another province. That instability was, to a considerable extent, put in check by the GATT and the check was reinforced by the FTA and NAFTA. The consequent decentralization failure would be one originating in dynamic instability.

It is imperative that the virtues of decentralization – the capacity of competition to check the exercise of political power and to give form to the invisible hand mechanism that nudges governmental systems toward optimality – be preserved to the extent possible. What are the remedies available to deal with the decentralization failures associated with dynamic instability? To my knowledge, two have been considered: (a) centralization – that is a re-assignment of one or more powers to a higher jurisdictional tier (e.g. Carey, 1974); and (b) harmonization through, for example, the adoption of common standards (e.g. Klevorick, 1996; Oates, 1998). The way the literature defines harmonization tends to make it a form of centralization. Both of these remedies are destructive of competition – whether they have worse effects than some types of instability is surely a possibility.

I would like to propose a distinction between the sort of harmonization discussed in the literature which we could call "strong harmonization," and the sort we need to deal with dynamic instability while remaining respectful of decentralization and intergovernmental competition, which may be labeled "weak harmonization." Without going into questions of administration, let me suggest that this sort of harmonization is achieved through institutions that have the *de jure* or *de facto* power to intervene whenever the interaction among centers of power or among governments threatens to generate a dynamic instability in the system with negative effects such as those described above. The intervention should not be one that alters the assignment of powers, simply one that deals with the instability.

There are many such institutions already in existence. Others could be created. A prime example of such an institution are interventions by federal or central governments. I illustrate. A few years ago, an American automobile manufacturer announced that it had decided to build a plant in Canada. It did not, it said, as yet know where it would locate the plant. The manufacturer, no doubt, wanted to ignite a bidding war between the provinces which could assume that they were eligible candidates, and it succeeded. However, the war was not allowed to progress because the Canadian government intervened by, in effect, bribing the likely losers to desist. That is a manifestation of weak harmonization which is respectful of decentralization. If the instability is chronic, it may require setting up standing tribunal-like institutions that will monitor the situation at all times and intervene when it is deemed necessary.

Conclusion

I have argued that the case for decentralization is the case for intergovernmental competition as an instrument to check the exercise of political power and as an invisible hand mechanism to move the public sector toward optimal outcomes. I have also noted that the "classic" benefits imputed to decentralization, though possibly real, are far from obvious. Decentralization, I have argued, may, however, sometimes fail. I have looked at five cases of decentralization failure. In each case, I have pointed, nothing more, to remedies that could deal with the failures while preserving decentralization and hence intergovernmental competition.

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Notes

1 Richard Bird (2000) distinguishes between deconcentration, delegation, and devolution as three different institutional forms of decentralization. That is helpful. In what follows, the word decentralization corresponds to devolution in Bird's nomenclature. I acknowledge that in the presence of delegation (and, unlike Bird, I would add deconcentration), problems of principal–agent relationship may arise. However, since 1978, following work with Anthony Scott (Breton and Scott, 1978), I have placed considerable emphasis on coordination – an activity in which all governments of decentralized systems participate. There are many problems of coordination that look like principal–agent problems (see section on Decentralization and failures, and subsection on Political participation costs). There is not that much distance between Bird's and my own views on this matter, whatever the language may initially disclose.

2 An assumption is needed to connect the behavior of organizational costs to the costs of supplying goods and services (including redistribution). This is a matter that goes beyond the problems considered in this paper.

3 I find the idea that one can separate the fiscal dimension from the other dimensions of federalism, difficult to understand.

4 What follows is adapted from Breton *et al.* (1998).

5 This point is also made by Walsh (1992, p. 5) in his complete and well-balanced survey of the literature.

6 It is not clear whether the uniformity assumption is supposed to apply only to central governments or whether it also reflects what provincial or state or even local governments do. The way that problem is dealt with is not without consequence (see Breton *et al.*, 1998).

7 Uniformity can also sometimes be found in the marketplace. A notorious example is the fixed uniform sales commissions that govern residential real estate transactions between sellers and brokers in Canada and the United States (and possibly elsewhere). For an attempt at explaining this uniformity, without assuming collusion, see Levmore (1993).

8 The problem of uniform provision has an instructive counterpart in the marketplace. If one lives in Toronto and wishes to wear original Yves St-Laurent or Versace clothes, one had better travel to Paris or to Milan, because in Toronto these designers' clothes are tailored to match the preferences of the local market. It seems easy not to be ruled by uniformity!

9 This is what Bird (2000) calls delegation.

10 For elected centers of power, I presuppose that expected consent is proportional to expected electoral support or votes. For a discussion of why nonelected centers of power maximize expected consent, see Breton, 1996, chapters 3 and 4.

11 For criticisms of this assumption, see Usher (1994) and Kirchgässner (2000).

12 The mechanism was independently rediscovered by Timothy Besley and Anne Case (1995) who, in addition, have empirically tested one dimension of the model, obtaining satisfactory results.

13 For a more elaborate discussion of the modifications that are needed to move from the mechanism proposed by Salmon for horizontal competition to a analogous mechanism that applies to vertical competition, see Breton and Fraschini (forthcoming).

14 It should be clear, therefore, that my concerns are totally different from those that have engaged the attention of Rémy Prud'homme (1995). A concern for decentralization failures does not bespeak of a preference for centralization any more than a concern for market failures reveals a preference for economic planning. Given the conventional framework of the discussion in which Prud'homme's critique is cast, I have nothing to add to Charles McLure's (1995) and David Sewell's (1996) apt rejoinders.

15 In the first draft of the paper, I looked at *four* factors! I had overlooked an important additional factor which Govinda Rao brought to my attention.

16 I have examined some of these costs in Breton (1974, chapter 5). It seems to me that none of the costs I discussed in that chapter lead to decentralization failure.

17 Municipal governments are sometimes forced into default in that they become unable to honor their obligations. They may then be placed in the receivership of a more senior government. This is hardly an equilibrium situation.
18 Adding the northern territories – the Yukon, the Northwest Territories, and Nunavut – to the picture would only make the size distribution more skewed.
19 Each province negotiates a separate contract with the federal government. In that way, uniformity in provision can be avoided.
20 In this case also, uniformity is avoided by the existence of individual contracts.
21 In Breton (1996), I called the phenomenon a race to the bottom!
22 The origin of Canada's Equalization Payments system is to be found in that Report which diagnosed some instability in intergovernmental relations in Canada during the great depression and proposed the equalization grants, administered by the federal government, as a remedy for that instability.
23 What is referred to as *Pax Americana* is certainly the product, as the expression implies, of American foreign policy. It is also, at least until recently, due in no small measure to the actions of the United Nations.

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3 Localization and corruption

panacea or Pandora's box?

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Introduction

A large and growing number of countries around the globe are re-examining the roles of various levels of government and their partnership with the private sector and the civil society with a view to creating governments that work and serve their people (see Shah, 1998 for motivations for such a change). The overall thrust of these changes manifest a trend towards either devolution (empowering people) and/or localization (decentralization). Localization has been pursued through varying combinations of political, administrative, and fiscal decentralization initiatives. Political or democratic decentralization implies directly elected local governments (thereby making elected officials accountable to citizens). Administrative decentralization empowers these governments to hire and fire local staff (thereby making local officials accountable to elected officials) without any reference to higher level governments and fiscal decentralization entrusts these governments fiscal autonomy in their spheres of taxing and spending responsibilities. Fiscal decentralization ensures that elected officials weigh carefully the joys of spending someone else's money as well as pains associated with raising revenues from the electorate and facing the possibility of being voted out of office.

Administrative deconcentration, where decision making is shifted to regional and local offices of the central government, would not be consistent with this view of administrative decentralization. Thus, localization of authority is intended to bring decision making closer to the people being served by the public sector. This change has proved to be a controversial proposition. This is because localization is perceived both as a solution to problems such as dysfunctional public sector, lack of voice and exit, as well as source of new problems such as capture by local elite, aggravation of macroeconomic management due to lack of fiscal discipline and perverse fiscal behavior by subnational units.[1] There are also conceptual difficulties in making choices on the right balance as discussed in Shah (1994) and Boadway *et al.* (1994). The impact of localization on corruption (defined as the abuse of public office for private gain or exercise of official powers against public interest) is an area of growing interest inviting much controversy and debate. However, much of the discussion is grounded in selective anecdotal evidence. This paper provides a synthesis and strengthens the empirical foundations of this debate by examining the causes of corruption and trying to isolate the role of centralized decision making in creating an enabling environment for accountable public sector.

Localization and corruption: a Pandora's box perspective

The promise of localization to bring accountability is considered as hollow and such efforts are instead viewed as counterproductive in curtailing corruption by Vito Tanzi (1995), who argued that localization brings officials in close contact with citizens. This promotes personalism and reduces professionalism and arms length relationships. Personalism in his view breeds corruption as officials pay greater attention to individual citizen needs and disregard public interest. Prud'homme (1994) supports this view and argues that incidence of corruption is expected to increase with localization for several reasons. Opportunities for corruption increase due to a greater influence of interest groups at the local level, greater discretion available to local officials and long tenure of local officials at the same place making it easier to establish unethical relationships. Impediments to corrupt practices also decrease as local politicians and bureaucrats collude to advance narrow self-interests while the influence of media and auditing agencies wanes. Treisman (2000) using cross-country regression analysis lends further support to this view and argues that federal systems (a) tend to have higher corruption ratings due to their larger size; (b) are more likely to have separate police forces at both central and subnational levels (which increases corruption due to overgrazing) and their greater propensity to have a regionally elected upper house of parliament with veto power (which also may increase corruption as regional governments may buy off these veto-players or have greater leverage to protect their ill-gotten gains).

Political decentralization is seen as a source of corruption in Russia but not China by Blanchard and Shleifer (2000). This conclusion emerges from the contrasting role of local governments in their relations with local enterprises observed in China and Russia. In China, local governments have provided a supporting role whereas in Russia, local governments have stymied the growth of new firms through taxation, regulation and corruption. The authors note that behavior of Russian local governments can be explained by (a) state capture by old firms, leading local governments to protect them from competition and (b) rent seeking behavior of local officials discouraging new firms to enter. The authors attribute this contrasting experience to the presence of political decentralization in Russia and its absence in China. They argue that political centralization in China contributes to party discipline which in turn reduces the risk of local capture and corruption.

While Tanzi and Prud'homme simply present personal perspectives on this issue, Treisman resorts to empirical evidence to show that localization represents a Pandora's box in fighting corruption. Treisman's empirical results, however, are sensitive to the inclusion of other variables in the equation and may have omitted variables bias in view of a lack of underlying framework for corruption.[2] Blanchard–Shleifer analysis does not pay sufficient attention to local-enterprise relations in the two countries. Local enterprises in China are owned and run by local governments and even deliver local services such as education, health and transportation in addition to their economic functions. Thus, local enterprises are part and parcel of the local government. In Russia, on the other hand, a mixed pattern of these relationships has begun to emerge. Therefore, the contrasting experience of the local governments may better be explained by agency problems rather than by political decentralization. In fact, the weakening of party discipline through the emergence of powerful local leaders may be contributing to growth of local industry as the strong arm of central planning is held at bay by these leaders.

In conclusion, the perception of localization as a "Pandora's Box" is neither grounded in theory nor in evidence.

Localization and corruption: a panacea?

There is a general agreement in the literature that localization can open up greater opportunities for voice and choice thereby making the public sector more responsive and accountable to citizens-voters. Competition among local governments for mobile factors re-enforces the accountability culture. Such enhanced accountability has the potential to reduce corruption. Seabright (1996) argues that accountability is always better at the local level, since local citizens who are better informed about government performance can vote these governments out of office. Under centralization people vote for parties or candidates partly on the basis of performance in other regions and on issues of national interest. As a result accountability is defused and potential for corruption increases. Bardhan and Mookherjee (2000) also argue that decentralization of the delivery of anti-poverty programs in developing countries promotes cost-effectiveness and reduces corruption, owing to the superior access of local governments to information on local costs and needs.

Administrative decentralization causes a loss in control to higher levels, thus curbing their incentives to monitor and detect corrupt activities. However, it also lowers the expected gains from corruption as, following decentralization, the number of individuals who are in charge of a single decision is reduced. It is then more likely that corrupt agents are called to bear the consequences of their actions. Hence Carbonara (1999) concludes that decentralization although creating agency problems inside an organization can help in controlling corruption. Wildasin (1995) also argues that local officials with limited powers have little scope to engage in massive corruption.

Based upon a conceptual model, Ahlin (2000) has argued that deconcentration has the potential to increase corruption, whereas political decentralization has the potential to contain it due to interjurisdictional competition.

A number of empirical studies also provide support for positive influence of localization in controlling corruption. Crook and Manor (2000) examined the process of political decentralization in India (Karnataka state), Bangladesh, Côte d'Ivoire, and Ghana and find that such decentralization leads to enhanced transparency. With this enhanced transparency, ordinary citizen become better aware of government's successes and failures and they may perceive the government institutions more corrupt than the perception they had before. They observed that in Karnataka, India, political decentralization substantially reduced the amount of public funds diverted by powerful individuals. However, since citizens were not aware of these diversions, they concluded that corruption had increased. Crook and Manor based upon evidence from Karnataka conclude that political decentralization reduces grand theft but increases petty corruption in the short run but in the long run both may go down. Olowu (1993) also considers political centralization as a root cause of endemic corruption in Africa. Fiszbein (1997) based upon a review of political decentralization in Colombia concludes that competition for political office opened the door for responsible and innovative leadership that in turn became the driving force behind capacity building, improved service delivery and reduced corruption at the local level.

A few studies show that administrative decentralization reduces corruption. Wade (1997) finds that over-centralized top down management accompanied by weak communication and monitoring systems contributes to corruption and poor delivery performance for canal irrigation in India. Kuncoro (2000) finds that with administrative decentralization in Indonesia, firms relocated to areas with lower bribes.

Increased fiscal decentralization is also shown to be associated with enhanced quality of governance as measured by citizen participation, political and bureaucratic accountability, social justice, improved economic management and reduced corruption by Huther and Shah (1998).

Thus, a small body of theoretical and empirical literature confirms that localization offers significant potential in bringing greater accountability and responsiveness to public sector at the local level and reducing the incidence of grand corruption. However, a systemic examination of the root causes of corruption is not available, and hence the results from the literature must be seen as tentative and subject to further scrutiny.

The causes of corruption: a conceptual framework

The economic analysis of the determinants of corruption has typically drawn upon either Becker's "crime and punishment" model or principal agent theory.[3] The first one focuses on an individual who compares the expected utilities of legal and illegal behavior, where the latter involves some probability of detection and punishment. Fundamental propositions of this model are that the incidence of illegal behavior is positively related to the potential gains from illegal activity and negatively related to the probability of conviction and the punishment. In Becker's framework gains from legal activities are explicitly defined as the government wage, promotion, and public pension, whereas potential gains from corrupt behavior are assumed to be a function of variables describing the size and scope of the public sector. The more governments intervene in the operation of markets, the more opportunities for corruption appear through discretion on regulations and allocation of resources. Since "corruption is a sale of government property by government officials," bigger governments allow corrupt officials to discover and auction more profitable parts of the government. On the other hand, institutions of accountability are pictured as mechanisms that lead to detection and punishment of offenders. Although these institutions are limited, to the judiciary in Becker's model, they can also be extended to political institutions and civil society as well.

The principal–agent models, such as by Rose-Ackerman (1978) and Klitgaard (1988), regard corruption as an information problem on behalf of the "principal" who fails to control the "agent" properly. In this context, the citizens who elect a politician are considered as the principals and the politician as the agent – or the top level of government as the principal and government officials as the agents. These models primarily rely on the information problems in explaining the incidence of corruption. The monopoly power of officials and the degree of discretion they enjoy in exercising this power create a formidable information barrier between the principal and the agent. Not surprisingly these models heavily emphasize the importance of monitoring power of institutions and horizontal competition within the government as an antidote of corruption. The classic principal–agent framework has been extended to include chains of principal–agent relationships exploring various aspects of private organizations with possible collusion among the members (see Tirole, 1986; Laffont, 1990).

A synthesis

There is little difference between crime-and-punishment model and principal agent model in explaining corruption. In both models corruption is regarded as a function of two major sets of variables: opportunities for corruption and controlling power of institutions. The first set covers a wide range of variables from the size of government to state intervention to the economy. Government wage and remuneration practices also belong to this category. The second captures various institutions such as internal control mechanisms, judiciary, political institutions, and civil society.

The state in the economy

A country characterized by large government involvement is more likely to encounter corruption. Since government has the authority to redistribute resources and rents in the economy, this authority can be used for personal gains. Government officials can benefit from their monopoly power and administrative discretion by extracting bribes from those that need the authorizations or permits to engage in activities. These officials may refuse the authorization for new investments, delay the paperwork for import permits, use safety standards as an excuse to close down businesses, give different meanings to economic regulations to turn down foreign exchange or bank credit requests, and so on. In the presence of restrictions on imports of certain goods, the necessary import licenses become very valuable and importers may be willing to bribe the relevant official to obtain them. On the other hand, an open economy reduces the level of available rents, which in turn leads to a reduction in the amount of corruption in the economy.

Similarly, protection schemes generate rents that local firms are willing to pay for. The size of government spending, the procedure used in allocating expenditures or selecting investment projects, active participation in the economy also affect the opportunities for corruption. Government consumption expenditures and government-operated enterprises involve the substitution of political coercion for market choice and coordination. The size of government spending, transfer payments and subsidies, and the procedures used in allocating the expenditure or selecting investment projects constitute sources of rents and corruption. High tax rates and complex tax regulations may be used by corrupt tax officials to collect bribes in exchange for alleviating tax burdens of taxpayers.

Evidence from empirical research suggests that participation of government in the economy through state-owned enterprises, active industrial policies, restrictive trade and exchange regimes, price and interest rate controls, excessive regulations, and complex tax systems are all associated with higher corruption.[4] Usually it is the scope of government activities, not the size of government that affects the incidence of corruption.[5]

Recruitment, enumeration, and government pay

Public officials are supposed to make a comparison between the expected benefit of legal and illegal behavior before indulging in corruption. A satisfactory level of government pay, merit-based recruitment and enumeration, and adequate pensions may constitute powerful incentives not to engage in corruption. When officials are poorly paid, they try to supplement their pay with bribery. In many countries wage reductions have coincided with declines in the efficiency of the public sector, epidemic corruption, and deterioration in revenue performance of governments (van Rickeghem and Weder, 1997). Similarly, the lack of meritocratic recruitment and promotion and absence of professional training are also found to be associated with high corruption(see Evans and Rauch, 1997).

Internal control mechanisms

Rules of conduct and administrative laws are designed defining the operations of the government, such as procedures on public procurement and selecting private firms for contracting. Special agencies within the administration are formed to oversee the implementation of these rules. However, where corruption is systemic, the formal rules are usually superseded by informal rules. Patron–client relationships in bureaucracy undermine the effectiveness of internal monitoring. Especially, when the corruption is triggered by senior officials and politicians, internal control agencies lose their organizational purpose and become demoralized.

Judiciary

An independent, impartial, and informed judiciary has a central role in reviewing actions taken by the government and public officials. Enforcing the rule of law requires a strong, independent, and responsible judiciary, investigative and auditing bodies, and legitimate access to the society. In some cases, governments can influence the judicial system, using covert punishment threats, for example, appointments to less attractive locations in distant parts of the country or it can completely ignore court decisions. Criminal law is usually too blunt an instrument to deal with corruption in the public service. Judicial institutions may operate too slowly or existing laws may not be well defined to deter corruption. Empirical evidence shows that an effective judiciary is a significant element of anti-corruption efforts.[6]

Political institutions

In the political arena government operations are monitored by the parliament, and most importantly by parliamentary committees. Although the jurisdiction of the parliament and committees are usually quite extensive, partisan preferences of members and the lack of resources prevent an adequate oversight of government. Moreover, the executive branch can escape from parliamentary oversight, if the parliament is controlled by the parties in government.

Civil society

A full set of formally democratic institutions will not produce accountable government, without a strong civil society, which enables social groups – trade and professional associations, community groups – to function as "whistle-blowers." Although formal institutions have more power and authority to address the incidence of corruption, the importance of informal institutions and civil society should not be underestimated. Neither internal control mechanisms nor the judiciary is immune to corruption, and more important they often need incentives to function properly. An independent and self-motivated press, responsive opposition groups and well-established non-governmental organizations can express themselves given that civil liberties exist to secure free access to government operations. In many empirical studies political and civil rights are found to have a positive impact on governance.[7]

From theory to practice: what is missing?

So far, we have seen the traditional approach to corruption in government. However, this approach fails to explain widespread corruption in many developing countries. Contrary to the principal–agent models, corrupt practices are not necessarily unknown to the society ("the principal") in most cases. Although the identity of corrupt officials as well as their activities are well known, institutions are not well developed to enforce the rule of law and to punish the disobedient. Similarly, crime-and-punishment models also perform a poor job in explaining why some officials choose illegal behavior over legal ones although they do not need additional compensation to support their living. If the marginal gain from corruption is still high enough to exceed the marginal cost of being caught, this means that probability of punishment and/or penalties are not only far from being deterrent, but also formal rules have been superseded by informal ones, which create an elite class in government immune from formal control.

One explanation for ineffective institutions and pervasive behavior of government officials can be found in the social and bureaucratic culture of the society. Lee (1986) argues that a culture of bureaucratic elitism may lead to a dissociation of civil servants from the rest of the society and breed corruption. In many countries, the bureaucracy is separated from society to such an extent that the state apparatus becomes an end itself, not an instrument working for the public interest. Shah (1998) emphasizes the command and control oriented structure of the bureaucracy in developing countries, especially those that share a common colonial heritage such as India, Kenya, Pakistan, and Indonesia. Hiding behind a centralized government system, civil servants as well as elected officials enjoy a high degree of autonomy from public pressure.

The public perception of government may also play an important role in making the bureaucracy free from popular control. According to the cultural theories of institutions, societies hold beliefs and ideas that shape the quality of government. Some cultures may be more prone to an interventionist government structure as compared to other cultures which emphasize individualism and entrepreneurship. Following Weber's hypothesis on religion, Grier (1997) and La Porta *et al.* (1998) provide some evidence of why "hierarchical" religions (Catholicism and Orthodox Christian Church) may exhibit inferior government performance. The argument is that in hierarchical societies public sector does not need to justify its existence as a service provider, because people generally view the public sector as a position to control rent sources and to exploit state authority for personal gain. Islamic countries fall into this category for a different reason. In Islamic countries, fatalism contributes to lack of citizen activisim for better democratic accountability, giving the autocratic rulers a free hand in self-enrichment.

However, one should also mention that cultural explanations of institutions have also a political element. To the extent that culture is shaped by politics, cultural determinants of governance are endogenous, even in the short term. The radical transformation of Japanese society in the nineteenth century is a perfect example of how the political will of the rulers could change a xenophobic culture and make it open to the rest of the world. Similar examples can be found in China and Catholic Europe.

In this context, decentralization can play an important role in curbing corruption, if the political and institutional environment permits. Decentralization destroys the barrier between citizens and centralized governments by encouraging citizen participation in government decision making, provided that the society possesses basic political and civil freedoms to express opinions. In smaller communities, individuals can find more opportunities to monitor the functioning of local governments and to take action more effectively and promptly, if necessary. As governments come closer to the people they are intended to serve, the civil service re-orients itself towards a service-oriented system to satisfy the basic needs of the society. Armed with strong judicial and political control mechanisms, decentralization may change the social and bureaucratic culture and incentives creating a less isolated thus more accountable civil service (see Shah, 1999, for a framework for improving public sector performance). Whether these relationships hold in practice remains an unsettled empirical question.

The model and variables

Dependent variable: corruption

Corruption is a broad concept covering a wide range of phenomena. It ranges from petty corruption in the form of tips and speed money to grand corruption. The available data on corruption reflect this heterogeneity. Some institutions collect data on irregular payments in the public service, whereas others try to capture corruption in the higher levels of government. Risk rating services, such as Political Risk Services and the Economic Intelligence Units, typically rely on panel of experts who rate countries using a defined set of criteria. Other organizations, such as the World Economic Forum and the Institute for Management Development, rely on surveys of citizens and entrepreneurs.

A common concern with corruption indicators is that they can be inconsistent or unreliable, or affected by the biases of the observer. A country rated high by one agency or panel of experts may be rated lower by another. One solution is to aggregate indicators from several resources into an average or composite index – poll of polls. This is the approach that Transparency International (TI) uses for its Corruption Perception Index.[8] To derive this index, TI collects data on corruption from a number of other sources,[9] standardizes them, and calculates the simple average by assigning equal weights. The assessment also combines data from a few past years to reduce abrupt variations in scoring.

The reliability of each figure is improved by including only countries that have been included into three polls at minimum. An indicator for the overall reliability of the index can be drawn from the high correlation between the sources (see Appendix A). Standardization of the index ensures that the inclusion of a source consisting of a certain subset of countries should not change the mean and standard deviation of this subset of countries in the CPI. The reason is that the aim of each source is to assess countries relative to each other, and not relative to countries not included in the source. This includes the idea that a country must not be punished for being compared with a subset of relatively uncorrupt countries, nor rewarded for being compared with a subset of relatively corrupt countries.

Independent variables

1. *The role of the state in the economy*
We use a variety of measures to capture different aspects of the state:

- *Size of government*: is proxied by public investment as a share of GDP, including investment by public enterprises, local authorities, and consolidated central government.
- *Tax system*: Efficiency and equality of tax system, tax rates, enforcement of tax regulations, and the tax system as an incentive mechanism are used. Our measure comes from the 1997 World Development Report which examines the burden of tax regulations and high taxes. This information is used to measure the overall quality of tax management.
- *Openness of the economy*: is shown by restrictions on foreign trade, foreign exchange mechanism, foreign investment, and capital markets. We use a measure from the Fraser Institute which compares the actual size of trade sector compared to the expected size.
- *Structure of the economy and markets:* are proxied by production and allocation of resources via government mandates rather than private market (price controls, banking sector, state ownership of enterprises, competitive environment). A composite index is formed by using data from the Fraser Institute on state ownership of enterprises, price controls, and interest rate controls.

All variables are re-scaled such that high numbers are associated with more government involvement in the economy.

2. *Institutions of accountability*

- *Internal control*: A survey question from the World Development Report 1997 reflects access to other officials or to superiors to get the correct treatment.
- *Judiciary*: Several indices are available to measure the effectiveness of the judiciary. However, most of them, given the way they are measured, have elements endogenous with corruption. We use an index from the Fraser Institute which is the least susceptible to simultaneity bias.
- *Democratic institutions*: Since it is almost impossible to make a distinction between political institutions and the civil society, we combine these two variables under one title: institutions of democracy. A composite measure for democratic accountability provided is constructed using three indices of the Freedom House. These indices are political rights, civil rights, and freedom of the media.

All variables are re-scaled such that high numbers are associated with more effective institutions.

3. *Social and bureaucratic culture and incentives*
We analyze the bureaucratic culture and incentives under four categories:

- Attitude of the Bureaucracy towards Society and Business.
- Predictability of Laws and Policies.
- Effective Public Service Delivery.
- Perception of the State by the Society.

For the first category we use a rating from the Political Risk Services which measures the attitude of the state towards private investment. For the next two categories we use two survey questions from the 1997 World Development Report: government's adherence to announced policies and public perception of government as an effective public service provider. Assuming that societies with more "hierarchical" religions, such as Catholicism, Orthodoxy, Islam, are more inclined to have a heavy-handed bureaucracy, we use the protestant population in a country as an indicator of the perception of the state as a tool for public service. This index is re-scaled such that low numbers are associated with a more service-oriented bureaucracy.

An additional measure related to bureaucratic culture and incentives is the colonial past. To capture the colonial past of a country we use a dummy variable which is equal to one if country was ever a colony in the last two centuries.

4. Localization/decentralization

For decentralization two measures are commonly used in the literature. One is the level of subnational government expenditures. The other one is the ratio of employment in non-central government administration to general civilian government employment. In this study we use the second measure. This is not only highly correlated with subnational government expenditures ($r = 0.67$), but also covers more countries. Schiavo-Campo argues that this variable may perform better in terms of capturing decentralization rather than deconcentration (the geographical dispersal of central government entities without changing their lines of ultimate authority and sources of finance): "He who pays the piper calls the tune."

Other factors

Finally, some control variables are included in the model. One is the heterogeneity within a country. Shleifer and Vishny (1993) and Tanzi (1994) suggest that countries where the population consists of several different ethnic groups create a fertile ground for bribery, nepotism, extortion, and theft by undermining the public trust towards institutions and creating safe havens within various cliques (see also Mauro, 1995). Our measure for ethnic heterogeneity is the probability that two randomly selected individuals in a country will belong to different ethnolinguistic groups.

Many observers have argued that low government wages in the public service is a major determinant of corruption. Unfortunately data on the ratio of government pay to wage in manufacturing sector covers very few countries (Van Rickeghem and Weder, 1997, use a sample of 22 countries). Therefore, we use the ratio of government wages relative to GDP per capita.

Social and institutional development may have a significant effect on corruption, independent of the institutions of accountability. A common procedure in the literature is to measure the level of development either by the level of income per capita or the average years of total schooling or both. In this study, we try to capture the level of development of the society and institutions by Human Development Index of the United Nations. This index consists of three components: life expectancy, educational attainment, and incomes. The major advantage of this index is that it provides a more comprehensive picture of development than income or schooling does.

Formation of composite indices to overcome multi-collinearity

Available indicators on the structure of the economy, institutions of democracy, and the bureaucratic culture are collinear (see Appendix Table 3.A4). The application of ridge regression can be used to overcome this collinearity, yet a meaningful economic interpretation of transformed variables would not be possible. Omitting certain collinear variables can help, but it weakens the empirical framework and introduces omitted variables bias. Shah (1988, 1989) advocated the use of canonical analysis to form composite indices of collinear variables to overcome multicollinearity. The canonicial analysis is preferable to principal component analysis, because the latter technique attempts to maximize the explained variance in these variables, ignoring correlation with the dependent variable. Canonical analysis, on the other hand, forms linear combinations of original variables in such a way that the resulting composite indices are maximally correlated with the dependent variable. We use canonical analysis to form composite indices of competitive market structure (based upon data for state-owned enterprises, state ownership of banks and price controls), democratic institutions (comprising political rights, civil rights, and free media variables) and bureaucratic culture (by combining state as a helping hand, credibility of announced policies, efficiency in service delivery and informed and demanding citizenry based upon percent protestant population). The formation of these composite indices helped us to retain the richness of a large data set while overcoming multi-collinearity problems in econometric estimation.

Econometric results on the causes of corruption

Since reliability of corruption indices is our main concern, we weight observations by their standard deviation in our regression analysis. These standard deviations published by the TI measure the dispersion of corruption ratings for each country across different polls. Although the White test rejects the existence of heterogeneity, we still use White-corrected standard errors to address country specific characteristics. The estimated model is presented in Table 3.1.

Table 3.1 shows that lack of openness of the economy is significantly related to corruption, whereas public sector size is insignificant and contrary to our *a priori* expectations has a negative sign. Complexity of the tax system also contributes to corruption (significant at the 10 percent level only). The lack of competitive market structure is identified as a significant source of corruption. Weakness in bureaucratic controls lessens the incidence of corruption although this coefficient is insignificant. This confirms the common perceptions that rigidity of internal controls are not effective to curb corruption. Judicial fairness, on the other hand, has the expected sign but is insignificant. We used different measures for this variable, but the result did not change. An explanation may be that the role of judiciary is secondary to more fundamental drivers for corruption, such as citizen-voter accountability as suggested by strongly significant negative coefficient of democratic institutions. This result possibly suggests that democratic rights and institutions are preconditions for an effective judiciary. Democracy and a free media seem to be very effective deterrent factors against corruption.

It is also interesting to see that variables related to the bureaucratic culture and incentives perform quite well. Decentralization has a negative significant impact on corruption, whereas lack of service orientation in bureaucratic culture has a corrupting influence on the public sector. Colonial past has a significantly positive effect on corruption; it

Table 3.1 Causes of corruption: full specification

	WLS full specification	*Effect of one standard deviation change on corruption (% change around the mean)*	*Rank of importance*	*Rank of importance (among significant variables)*
Government size	−0.1213 (−0.37)	−1.15	12	—
Complexity of tax system	0.2900 (1.51)	5.71	6	—
Degree of closed economy	0.3206*** (3.89)	10.37	3	3
Lack of competitive market structure	0.1320** (2.63)	7.15	5	—
Laxity of bureaucratic controls	−0.1138 (−1.01)	−2.00	11	5
Judicial fairness	−0.0355 (−0.26)	−1.09	13	—
Democratic institutions	−0.2571*** (−4.27)	−15.54	2	2
Decentralization	−0.1722*	−4.20 (−2.02)	8	6
Lack of service orientation in bureaucratic culture	0.3324*** (3.54)	17.27	1	1
Colonial past	8.8867** (2.58)	8.23	4	4
Ethnic heterogeneity	0.0387 (0.79)	2.46	10	—
Government pay	−0.8768 (−1.29)	−4.35	7	—
Social development	0.0712 (0.36)	2.50	9	—
Sample size	30			
Adj. R^2	0.9870			

The dependent variable is the corruption index of TI where a higher value of the index corresponds to more corruption. The inverse of standard deviation of corruption index is used in the weighted LS regression. Errors are White-Heteroskedasticity consistent, *t*-statistics are in parenthesis – standard errors are White-corrected for heterogeneity. *** significant at $p < 0.01$; ** significant at $p < 0.05$; * significant at $p < 0.10$.

increases the rate of corruption by almost 9 points. Colonial past captures command and control habits and institutions and divisive nature of the society left behind by colonial masters. Our control variables, government pay and social development levels have expected signs but are insignificant.

Ranking of the key factors

Regression results show that the key determinants of corruption are centralized government structures, bureaucratic elitism fueled by colonial history, weak political and civic institutions, government's intervention to the economy, and being closed to international markets. We look at the impact of a one standard deviation change in these variables on corruption in Table 3.1. It turns out that a move from command-and-control culture to service-oriented culture at a magnitude of one standard deviation may decrease corruption by over 17 percent. Civic institutions may also play an important role in anti-corruption efforts (16 percent). Among other significant variables, openness of the economy is in third place with 10 percent, market economies with 7 percent, and decentralization with 4 percent.

Table 3.2 Corruption in developing countries

	Developing country sample
Government size	−0.0938 (−0.26)
Complexity of tax system	−0.0346 (−0.09)
Degree of closed economy	0.3911*** (4.63)
Lack of competitive market structure	−0.0217 (−0.17)
Laxity of bureaucratic controls	−0.1220 (−0.67)
Judicial fairness	0.0752 (0.52)
Democratic institutions	−0.1985** (−2.63)
Decentralization	−0.1773 (−1.14)
Lack of service orientation in bureaucratic culture	0.2918*** (3.76)
Colonial past	2.4636 (0.60)
Ethnic heterogeneity	0.0778 (1.02)
Government pay	−1.3091 (−1.39)
Social development	−0.0029 (−0.01)
Sample size	20
Adj. R^2	0.9658

The dependent variable is corruption index of TI where higher value of the index corresponds to more corruption. Inverse of standard deviation of corruption index is used in the weighted LS regression. Errors are White-Heteroskedasticity consistent. *t*-statistics are in parenthesis – standard errors are White-corrected for heterogeneity. *** significant at $p < 0.01$; ** significant at $p < 0.05$; * significant at $p < 0.10$.

Causes of corruption in developing countries

Next, we examine the causes of corruption based upon a developing countries sample in Table 3.2. Although our sample size is small ($n = 20$), we are able to identify some key factors. Openness of the economy, democracy, and bureaucratic culture are the significant factors. The importance of having a colonial past, in particular, does not have a great impact on corruption within developing countries. One reason for this result is that all developing countries in our sample have a colonial past in general. The fact that the structure of the economy and decentralization lose their significance in our restricted sample suggests that more fundamental considerations such as democratic institutions, rule of law, and bureaucratic culture have dominant influences in developing countries.

Corruption and decentralization

In our previous regressions we have found that decentralization reduces corruption in government. However, one can argue that decentralization may not be successful unless it is supported by participation of local communities in policy-making progress through local elections or federalist government structures. Ideally, we would prefer to divide countries into two groups according to the existence or absence of local elections. However, only one country (Senegal) in our sample does not organize local elections. So, the coefficient of the decentralization variable also represents the effect of decentralization with local participation.

Table 3.3 Decentralization and corruption: unitary vs federal states

	All countries
Government size	0.0458 (0.15)
Complexity of tax system	0.3030 (1.50)
Degree of closed economy	0.3217*** (3.60)
Lack of competitive market structure	0.1244** (2.49)
Laxity of bureaucratic controls	−0.1521 (−1.13)
Judicial fairness	−0.0135 (−0.09)
Democratic institutions	−0.3065*** (−5.05)
Decentralization in unitary states	−0.4758** (−2.28)
Decentralization in federal states	−0.2260** (−2.51)
Lack of service orientation in bureaucratic culture	0.3219*** (3.45)
Colonial past	9.7196** (2.58)
Ethnic heterogeneity	0.0370 (0.83)
Government pay	−0.8758 (−1.22)
Social development	0.1065 (0.54)
Sample size	30
Adj. R^2	0.9873

The dependent variable is corruption index of TI where higher value of the index corresponds to more corruption. Inverse of standard deviation of corruption index is used in the weighted LS regression. Errors are White-Heteroskedasticity consistent. *t*-statistics are in parenthesis – standard errors are White-corrected for heterogeneity. *** significant at $p<0.01$; ** significant at $p<0.05$; * significant at $p<0.10$.

Next, we ask ourselves whether the relationship between decentralization and corruption differs between federalist and unitary states. We divide our sample into two groups and look at the coefficient of decentralization in each group. The results are shown in Table 3.3. Decentralization in unitary states has a greater impact on the incidence of corruption. The reason for this may be that, as shown by Huther and Shah (1998), federal states typically have a lower degree of corruption due to competition among governments. We test the equality of coefficients and it is rejected at the 5 percent significance level.

Robustness of the results: sensitivity analysis

Our WLS results show that variables related to bureaucratic culture and incentives – including decentralization and colonial past – are surprisingly significant despite the presence of all other variables included in our basic regression. One concern in cross-sectional studies on corruption is the robustness of these results to outliers and influential observations. We first repeated our full specification using a robust regression technique (*M* estimators) and compare the results with our basic findings. We also used an iterative least square estimation technique, which uses absolute residuals of the previous regression as weights in the new regression. Both regressions gave us estimators quite similar to our basic results. This is particularly true for variables that are significant in the basic model.

To further test the robustness of our results, we performed a variation of extreme bounds test (Leamer, 1985) suggested by Levine and Renelt (1992). The purpose of extreme bounds analysis is to assess the sensitivity of results to the model specification. The set of explanatory variables is divided into two subsets representing the variables that should always be included in the regression (*I*-variables) and the variables that could potentially be included (*Z*-variables). A separate regression is performed for every combination of *Z*-variables. It requires that a regressor remains significant at the 5 percent level with the same sign in all regressions. There are no previous studies on which to decide which subset of variables should always be included and which are of potential interest. So, we use the reliability of data as our criteria. The ratings and data used to measure some of our variables are quite imperfect, so they may not capture the potential effect of these variables. Our *Z*-variables are tax system, internal control, ethnic heterogeneity, social development, and government wage. We perform 31 regressions. Bureaucratic culture remained significant in all regressions, and colonial past slipped over the 5 percent significance level 5 times. However, colonial past failed to pass the test only in some of the models in which social development is excluded. This suggests the negative effect of colonial history on corruption may be less significant in countries that inherit a well-developed and educated society.

Conclusions

This paper has attempted to identify major drivers of corruption in order to isolate the role of centralized decision making. In a sample of industrial and non-industrial countries, the lack of service orientation in the public sector, weak democratic institutions, economic isolation (closed economy), colonial past, internal bureaucratic controls and centralized decision making are identified as the major causes of corruption. For a non-industrial countries sample, drivers for corruption are lack of service orientation in the public sector, weak democratic institutions and closed economy. Decentralization has a greater negative impact on corruption in unitary countries than in federal countries. In conclusion, decentralization is confirmed here to support greater accountability in the public sector and reduced corruption.

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Appendices

Table 3.A1 Sources for the 1998 corruption perception index

No.	*Source*	*Year*	*Who was surveyed?*	*Subject asked*	*Number of replies*	*Number of countries*
1	Political & Economic Risk consultancy	1997 1998	Expatriate business executives	Extent of Corruption in a way that detracts from the business environment for foreign companies	280	12 Asian countries
2	Gallup International	1997	General public	Cases of corruption for the following group of people: politicians, public officials, policeman, and judges	over 34,000	44 mostly developed countries
3	Institute for Management Development (World Competitiveness Yearbook)	1996 1997 1998	Business executives in top and middle management	Improper practices (such as bribing or corruption) in the public sphere	3,102 2,515 4,314	46 mostly developed countries
4	World Economic Forum (Global Competitiveness Survey)	1996 1997 1998	Business executives	Irregular, additional payments connected with import and export permits, business licenses, exchange controls, tax assessments, police protection, or loan application	1,537 2,778 3,500	40 developed and developing countries 56 developed and developing countries 68 developed and developing countries
5	Political Risk Services (International Country Risk Guide)	1998	Assessment of staff	Assessment of corruption in government	—	135 developed and developing countries
6	World Bank (World Development Report–Private Sector Survey)	1997	Business executives	Irregular, additional payments are common and represent an obstacle to doing business	over 3,500	73 developed and developing countries
7	Economic Intelligence Unit (Country Risk Service and Country Forecast)	1998	Assessment by staff	Assessment of pervasiveness of corruption among politicians and civil servants	—	115 developed and developing countries

Table 3.A2 Sample space (developing countries in bold)

1. Austria	11. **Ghana**	21. **Senegal**
2. **Bolivia**	12. **Hungary**	22. **South Africa**
3. **Cameroon**	13. **India**	23. Switzerland
4. Canada	14. Ireland	24. **Tanzania**
5. **Columbia**	15. Italy	25. **Turkey**
6. **Côte d'Ivoire**	16. **Jordan**	26. **Uganda**
7. **Ecuador**	17. **Kenya**	27. United Kingdom
8. **Estonia**	18. **Malaysia**	28. United States of America
9. France	19. **Morocco**	29. **Venezuela**
10. Germany	20. Portugal	30. **Zambia**

Table 3.A3 Data sources and descriptions

Corruption		
	1998 Corruption Perception Index of TI. The Index includes data from the Economist Intelligence Unit, Gallup International, the Institute for Management Development, the Political and Economic Risk Consultancy, the Political Risk Services, World Development Report, and the World Economic Forum. Some of these sources are based on poll of experts, some others on investor and public surveys. The Index combines assessments from the past three years to reduce abrupt variations in scoring. None of these sources differentiate between special forms of corruption, such as political or administrative. So, they aim to measure the same phenomenon. All indices are strongly correlated with each other. The reliability is further improved by including only countries that have been included into three polls at minimum. Simple average method is used to aggregate the data.	Transparency International
Size of government		
	Ratio of nominal public domestic investment (fixed capital formation) to nominal GDP	World Development Report 1997 and OECD
Tax system		
Burden of Tax regulations	"Tax Regulations and/or high taxes are major problem areas"	World Bank: World Development Report 1997 Q-12G
Openness of the economy		
Restrictions on International Trade	An index constructed from the ratio of actual size of trade sector to the expected size. Regression analysis is used to estimate the expected size of the trade sector given geographic size, population, and location relative to potential trading partners	Fraser Institute: Economic Freedom of the the World 1997 Category VI-B.ii

(Continued)

Table 3.A3 (Continued)

Structure of the economy		
Government Enterprises and Investment	An index based on government enterprises and investment as a proportion of GDP	Fraser Institute: Economic Freedom of the World 1997 Category II-A
Price controls	An index based on the extent to which businesses are free to set their own prices	Fraser Institute: Economic Freedom of the World 1997 Category II-B
State ownership of banks	An index based on the percent of credits issued by privately owned banks	Fraser Institute: Economic Freedom of the World 1997 Category VI-A
Formal institutions		
Internal control mechanism	"If a government agent acts against the rules I can usually go to another officials or to his superior and get the correct treatment"	World Bank: World Development Report 1997 Q18
Judiciary	Legal institutions are supportive of rule of law principles and permit access to non-discriminatory judiciary	Fraser Institute: Economic Freedom of the World 1997 Category V-C
Institutions of democracy		
Political rights	Average county scores for the years 1990–99	Freedom House: Annual Survey of Freedom
Civil liberties	Average county scores for the years 1990–99	Freedom House: Annual Survey of Freedom
Press freedom	Average county scores for the years 1990–99	Freedom House: Press Freedom 1999
Decentralization and Bureaucratic Culture		
Investment profile	A measure of government's attitude to inward investment as determined by four sub-components: the risk to operations, taxation, repatriation, and labor costs.	Political Risk Services: International Country Risk Guide
Stick to announced policies	"Do you expect the government to stick to announced major policies?"	World Bank: World Development Report 1997 Q3
Efficiency of public service delivery	"How would you generally rate the efficiency of government in delivering services?"	World Bank: World Development Report 1997 Q25
Protestantism	Ratio of protestant population in the country	La Porta *et al.* (1998)
colonial past	Dummy variable which is equal to one if the country has a colonial past in the last two centuries and zero otherwise	CIA World Fact, La Porta *et al.* (1998), and Encyclopedia Britannica and the World Handbook of Political and Social Indicators
Decentralization	Ratio of employment in non-central government administration to general civilian government employment.	Schiavo-Campo *et al.* (1997)

(Continued)

Table 3.A3 (Continued)

	Non-central government administration encompasses all government administration employees who are not specifically funded by the central government. It includes municipalities, as also regional, provincial, or state employment.	
Federal structure	Subnational elections in state or province level	IMF Government Finance Statistics (1998)
Other		
Ehnolinguistic heterogeneity	The probability that two randomly selected individuals in a country will belong to different ethnolinguistic groups	La Porta *et al.* (1998)
wage/GDP	Average government wages to per capita GDP	Schiavo-Campo *et al.* (1997)
Social development	Human Development Index of the United Nations. The index as crafted by UNDP includes measures of mortality, education, and economic activity.	United Nations Human Development Report 1998

Table 3.A4 Composite measures

Structure of the economy	*SOE*	*Price control*	*State banks*	*Corruption*
State-owned enterprises	1.00			
Price controls	0.57	1.00		
State ownership of banks	0.43	0.60	1.00	
Corruption	0.64	0.67	0.47	1.00

Structure of the economy = 0.48 ∗ SOE + 0.30 ∗ Price_Control + 0.22 ∗ State banks.

Institutions of democracy	*Pol rights*	*Civil rights*	*Media*	*Corruption*
Political rights	1.00			
Civil rights	0.93	1.00		
Free media	0.90	0.89	1.00	
Corruption	−0.72	−0.80	−0.70	1.00

Democracy = −0.15 ∗ Pol rights + 0.98 ∗ Civil rights + 0.17 ∗ Media.

Bureaucratic culture	*Helping hand*	*Policy*	*Public service*	*Protestant*	*Corruption*
State as a helping hand	1.00				
Stick to announced policies	0.32	1.00			
Efficiency of public service Delivery	0.49	0.30	1.00		
Percent of protestant Population	0.10	0.33	0.18	1.00	
Corruption	0.21	0.40	0.76	0.43	1.00

Bureaucratic culture=0.08 ∗ Helping Hand + 0.18 ∗ Policy + 0.55 ∗ Public Service + 0.19 ∗ Protestant.

Notes

1 See Tanzi (1995) and Shah (1998) for opposing views.
2 For a critique of Treisman, see Lambsdorff (1999).
3 See Becker (1968), Becker and Stigler (1974), and Huther and Shah (2000).
4 See Ades and Di Tella (1997), Van Rijckeghem and Weder (1997), Treisman (1998), and Johnson *et al.* (1998).
5 Goel and Nelson (1998).
6 See Ades and Di Tella (1997), Van Rijckeghem and Weder (1997), Goel and Nelson (1998), and Treisman (1998).
7 See Ades and Di Tella (1997), Van Rijckeghem and Weder (1997), Johnson, Kaufmann and Zoido-Lobaton (1998), Isham *et al.* (1998), and Treisman (1998).
8 For details see www.gwdg.de/-uvw/icr.htm.
9 Of these, five are for business executives of international or business companies, two by the relevant organization's staff, one of employees of multinational forums and institutions, and one of embassies and chambers of commerce.

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4 Does decentralization serve the poor?

Joachim von Braun and Ulrike Grote

Introduction

Decentralization and poverty reduction may be correlated, but theoretically, there is no clear-cut functional relationship between the two. Until recently, development policy debates on decentralization largely focused on governance and efficiency, and hardly on poverty effects. Now, with the aim of supposedly more effective poverty reduction agendas in mind, local and international organizations are increasingly calling for decentralization.

Decentralization may affect poverty directly and indirectly. Direct effects of decentralization on poverty reduction relate, for instance, to regional targeting of transfers, which may have a direct benefit for the poor. Indirectly, decentralization may affect poverty reducing economic growth and the efficiency in the delivery of local public services.

Decentralization is an instrument of efficient and participatory governance, and not a goal in itself. But it certainly is not an instrument for a narrowly definable single goal, and it therefore runs the risk of being overextended and aimed at multiple goals. Still, if decentralization impacts on poverty reduction, and if the linkages under well-defined conditions are generally positive and reenforcing – given countries' institutional conditions and the social costs arising from building decentralization-related capacities – poverty reduction effects would add a dimension to the challenge of optimizing decentralization. This additional dimension would further complicate matters for any comprehensive evaluation of "optimal" decentralization, and for related policy advice in low income countries where poverty is concentrated. In this paper, we ask:

1 What are the conditions for positive or negative relationships between decentralization and poverty reduction? We distinguish between different types of decentralization when addressing this question.
2 Does decentralization promote participation by the poor, which may be facilitated by increased supervisory powers and improved governance (e.g. reduced corruption)? We are interested in this because if decentralization increases participation and the voice of the poor, investment choices may be directed more towards a pro-poor pattern.
3 Does decentralization improve the level of inputs and quality of poverty reducing public services, for example, health and education? Better local information and influence may help to expand and improve the efficiency of public services for the poor. Outcomes obviously depend on the types of public goods and transfers as well as institutional and organizational design. Thus, a central policy question is: *how* to make decentralization pro-poor?

The paper is structured as follows: first, we disaggregate decentralization into various types – political, administrative, fiscal – and present a conceptual framework for the analysis of its impact on poverty. Then we assess broad cross-country associations between decentralization and poverty reduction. Linkages between decentralization and the provision of public services, especially in the education and health sectors are further explored. In that context, insights from decentralization trends and their implications for the poor in selected countries are reviewed. Conclusions on the above-mentioned questions and research implications are discussed at the end.

Conceptual framework

Defining and measuring decentralization

Defining decentralization

Decentralization is the transfer of authority and responsibility for public functions from a central government to subordinate governments. Governments are typically heterogeneous and complex entities that may consist of central, provincial, and local layers. Centralization and decentralization are modes of governance, that is ways in which control is exercised and decision-making operates within the government. Decentralization involves devolution of different decision-making powers and responsibilities to subunits of the government. The following types of decentralization shall be distinguished in evaluating impacts of decentralization on poverty (Litvack, 1999):

- *Political decentralization* gives local citizens and their representatives more power in any type of decision making, including setting standards and legal frameworks.[1]
- *Administrative decentralization* redistributes authority, responsibility and resources among different levels of government. Suitable capacities and institutional strength at all tiers are a precondition for the effectiveness of this.
- *Fiscal decentralization* entails the definition of authority over raising revenues or access to transfers and making decisions on current and investment expenditures.

The three basic types of decentralization are interlinked and their effects for poverty reduction cannot be evaluated separately. Often, decision-making is mixed between layers of government: for instance financial decisions can be centralized, but the provision of public goods can be decentralized. It is often the case that taxation and expenditure responsibilities for various kinds of public services and transfers are not clearly assigned by the constitution or by law (Ahmad, 1997). Moreover, the extent to which any particular decision is decentralized or not, is often unclear. Less extensive forms of administrative and fiscal decentralization include *deconcentration* with the central government merely posting employees to the local level, and *delegation or shared governance* systems, where some functions are delegated to the local level, but the central state remains in charge.

Governments at central and local level may go beyond decentralization and pass on functions to the private sector (e.g. utilities) or to nongovernmental organizations (e.g. for hospitals) through *deregulation and privatization* of public service provision. In contrast to the three forms of decentralization mentioned above, the consequences for regional supply patterns are endogenous and not predetermined. The outcome may or may not result in reduced size of "decentralized" supply units (companies, cooperatives, civil society organization) providing the (former public) services and infrastructure. We do not address this (highly relevant) form of institutional change.

Measuring decentralization

Given its various dimensions, measuring decentralization in an aggregate way is not straight forward. One way of measuring it is to apply governance indicators to different layers of government. In recent years, there has been a proliferation of indicators describing different aspects of governance. Kaufmann *et al.* (1999) analyzed numerous cross-country indicators as proxies for various aspects of governance including: voice and accountability; political stability; government effectiveness; regulatory burden; rule of law and control of corruption. In principle, each of these aspects can also be applied to decentralized structures. Such governance indicators are often problematic with respect to coherence and comparability of data. For example, it is obvious that the measurement of corruption – for example, based on perceptions in the business community – causes difficulties; comparing scores between regions is generally problematic. In addition, indicators are always externally imposed and not related to the norms of a society. Despite these shortcomings, a number of indicators shall be used below as proxies for the different types of decentralization:

- political decentralization is captured by the degree of decentralization of elections (elections held at first, second, third tier of government);
- administrative decentralization is approximated by the degree of subdivision of nation states, and by the size of countries in terms of population;
- fiscal decentralization is approximated by the share of subnational expenditure in total expenditure.

All these proxies for the different types of decentralization have their deficiencies. For example, local elections as such do not guarantee local power, and the extent to which a state is subdivided may not say much about accountability and functions.

Driving forces of decentralization

In the last decade, a worldwide trend towards decentralization has been noted (Dethier, 2000). Administrative and fiscal decentralization occurred in Latin America and China, and political decentralization in transforming economies, for example, within Russia. Deepened political decentralization giving more responsibilities to local government was also implemented in India. It is tempting to speculate about a common driving force behind this trend. However, there may be several rather than just one force, including the following internal and external pressures and demands for decentralization:

- *Regional political freedom participation, and conflict resolution.* Decentralization occurred as a political reaction to the failures of overcentralized political systems. This type of decentralization was at least in the first place not driven by economic efficiency goals, but by demand for regional independence and freedom from central government influence. Similarly, decentralization may be driven by latent or open ethnic conflict. Also, decentralization is seen as a way to reconnect central regimes to social groups from which they have become increasingly divorced (Manor, 1999).

- *Pressure of global competition.* Decentralization, curiously enough, is not just a parallel trend of globalization, but is very much driven by it. Increased competition between and within countries enforces efficient allocation of all resources, publicly and privately managed ones, at all levels including regional and local ones. This exogenous pressure is stimulating endogenous institutional and organizational change. Governments are forced to look at international policies when setting up their own policies. This holds true in trade, tax, stabilization and even in social policies.
- *Demand for stabilization.* While there is an increasingly felt need for many developing and transition economies to "open up," this exposes economies to exogenous shocks and makes them potentially more vulnerable. A response from the regional and local level is to gain power over protective and stabilization related policy instruments. Thus, decentralization for regional "shock absorption" may be a paradoxical result of opening up (e.g. Russia, Indonesia, China).
- *Demand for equity and efficiency in local public services.* Partly related to the forces of global competition mentioned above, major changes in development strategies have been adopted by many countries. Noted inefficiencies in the management and delivery of local public services, often provided earlier through central government without a proper notion of local needs and demands, has raised the demand for decentralization to improve level, quality and efficiency in delivering public services.

These four forces – in which the first two probably dominate – often overlap and reenforce each other. Each has implications for poverty reduction, which are not just mediated through their effects on decentralization.

This paper does not aim to explore the global and local driving forces of decentralization. We pursue a more limited agenda in tracing decentralization – poverty linkages. In addressing the above-mentioned set of research questions we largely treat decentralization as exogenous to poverty. This can be justified because up to now the poor themselves are at best part of the driving forces through their demand for political decentralization.

Conceptual linkages between decentralization and poverty reduction

The patterns and causes of poverty in a specific country setting (e.g. lack of resources; discrimination) along with governance conditions will largely determine the opportunities and risks of decentralization for the poor.

Potentials of decentralization for the poor

In the economic literature on poverty, decentralization has long been ignored, even that on public spending and targeting of the poor (e.g. van de Walle and Nead, 1995). In the mid-1990s, there was a strong focus on public sector reform as well as capacity building and institutional strengthening to increase the focus on social priorities and the capacity of the state to reduce poverty (Lipton and van der Gaag, 1993). Recently, increased attention is being paid to promoting opportunities, to human resource, enhancing security and rights, and facilitating empowerment. All these are closely related to local public goods and services, and are directly linked to decentralization. Thus, lately decentralization and poverty reduction have come jointly into focus through the search for "good governance" and related poverty implications (e.g. Dethier, 2000).

For developing an effective poverty alleviation strategy, it is necessary to identify the poor and their characteristics and the factors that contribute to poverty. This is easiest done at the local level. Participatory local governments are generally better informed about the needs and preferences of local population than central government, which has limited capacity to collect information (Rao, chapter 13, this volume). In a decentralized system, monitoring and control of local agents by local communities is easier, in principle. Elected local governments may generally be more accountable and responsive to poor people, and better at involving the poor in political processes. Decision making at the local level gives more responsibility, ownership, and thus incentives, to local agents, and local information can often identify cheaper and more appropriate ways of providing public goods (Bardhan, 1997a).

Risks of decentralization for the poor

However, there are also dangers and disadvantages for the poor as a consequence of decentralization. Problems of expenditure control are more complicated in a decentralized than in a centralized system, can arise, and may lead to "capture" of public resources by the elite and administrations at the local level. Decentralization can also lead to fragmentation of society or exclusion of the poor in the presence of a local elite, and to corruption.

Decentralization can also exacerbate political tensions between regions if they have significantly different income levels and natural resource endowments. A centralized government is presumably better able to take account of economies of scale in the provision of public goods and services, and the need for coordinated fiscal policy.

While successful decentralization may improve the efficiency and responsiveness of the public sector to the needs of the poor, unsuccessful decentralization may threaten economic and political stability with negative outcomes for the delivery of public services for the poor. Even if decentralization were to raise aggregate welfare, but if increased poverty results, compensation for the poor would be complex and far-fetched.

Conceptual linkages

Besley (1997) categorizes approaches to poverty reduction: technocratic or institutional. The first emphasizes targeting and explores program designs that try to direct limited resources to people with greatest need. The latter approach notes that the poor lack political power, and that administrative incompetence and corruption hinder public service delivery. Poverty reduction therefore requires developing institutions, and changed political structures, improved governance, and changed attitudes towards the poor. Decentralization has implications for both of these two broad approaches. Decentralization may facilitate more effective technocratic program designs, as regional targeting may be facilitated, accountability of bureaucrats may be strengthened, and managing poverty reduction programs may be enhanced. Also decentralization can offer the legal framework and serve as a means for institutional approaches to poverty reduction, as it may enhance political power of the poor via increased participation.[2]

Taking these two broad categories of poverty reduction approaches as a base, we move from pros and cons of decentralization towards a conceptual framework, which distinguishes between two sets of linkages: political empowerment and efficiency. In both, adverse forces and risks may interfere, undermining potential benefits of decentralization for the poor, which includes:

- Decentralization may promote participation by the poor, facilitated by increased supervisory powers and enhancement of pro-poor choices of investment.
- Decentralization may help local governments to improve the efficiency of public service delivery to the poor and targeting efficiency in transfer programs.

While equity and efficiency considerations are thus described as largely independent, they generally overlap. By engaging the poor in operating, monitoring and evaluation of delivery of public services at the local level, accountability of local government increases leading to more efficiency in the delivery of public goods. The two linkages are explored further below. In order to shed further light on the linkages between decentralization and poverty reduction, Figure 4.1 asks also whether public services for the poor are fostered by decentralization, and by fiscal decentralization in particular.

Link I: Decentralization and participation/empowerment for poverty reduction
Decentralization enables civil society to participate in the policy process and thus increase transparency and predictability of decision-making. Local governments are generally better informed about, and more responsive to, the needs and preferences of local populations than central governments. It is easier for them to identify and reach the poor as long as local politics permit this.[3] Decentralization also has the principal advantage that local officials can be more easily monitored and controlled by the local communities than officials in the central government, if the rule of law exists on the local level.

Whether local participation in governance systems of public goods and services will really have a positive impact on low-income groups is unclear. Participation, to be operational, requires first, a minimum of education, basic capabilities and equality based on gender, *religion or caste*, and second, empowerment of people at local level. Often, these

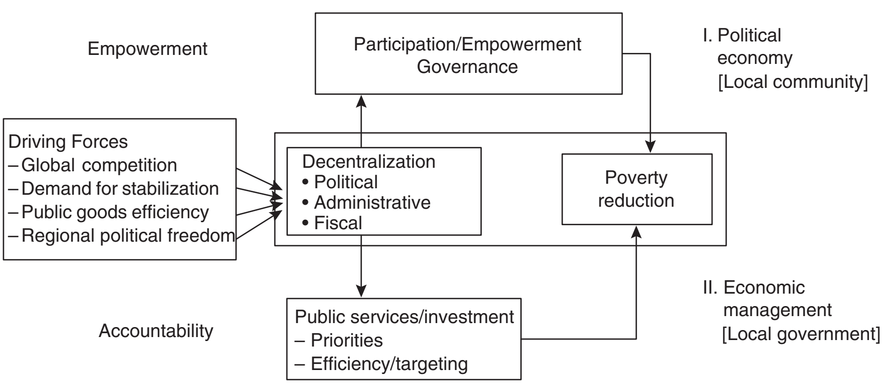

Figure 4.1 Conceptual framework.

pre-conditions are not met. In addition, the local elite often has direct access to and influence over local officials, and resist sharing power (Narayan *et al.*, 2000). If communities or the state cannot influence or control the actions and power of local leadership, this often leads to investments, which benefit elite interests and an underinvestment in public goods and services for the poor. There is also evidence that in many settings, such as heterogeneous communities and underdeveloped rural economies, the benefits of decentralized social programs are captured by local elites (Bardhan, 1999; Galasso and Ravallion, 2000). Then, pro-poor coalitions like cooperatives, farmers or the landless, may be important to improve the outcomes of decentralization from an equity perspective. But, often those in positions of power, have few incentives to allow participatory institutions to develop. Mahal *et al.* (2000) tested the hypothesis that increased decentralization/democratization at local level positively influences enrollment rates and child mortality controlling for the influence of socioeconomic circumstances, civil society organizations, and the problem of capture of local bodies by elite groups. They find that indicators of democratization and public participation, such as frequency of elections, presence of nongovernmental organizations, parent–teacher associations and indicator variables for decentralized states generally have the expected positive effects.

Link II: Decentralization, public services, and pro-poor investment

From the perspective of information and transactions costs, externalities provide an argument for centralization if the central authority has unlimited ability to gather, process and disseminate information. But, there are advantages to decentralization since central authority does not generally have that ability. Decentralization can be powerful in achieving development goals by assigning control rights to people who have the information and incentives to make decisions best suited to those needs (Bardhan and Mookherjee, 1998). For example, local information can often identify cheaper and more appropriate ways of providing public goods (Bardhan, 1997a; Rao, 2000a).

Decentralization can also be seen as a way to increase authority and accountability of local officials. Decision-making at the local level gives more responsibility, ownership and thus incentives to local agents. There is some evidence that, by making local officials more accountable and placing responsibility for decision-making and implementation in the hands of local stakeholders, the quality and efficiency of public services improves (Bardhan, 1997a,b). However, there are also counter examples.

What local governments can achieve depends on the resources and responsibilities they are granted. The separation of financing responsibilities from expenditure administration can lead to inefficiencies. Fiscal transparency decreases when subnational governments are strong and independent of the national government. Decentralization can also create a fragmentation of domestic markets (e.g. India, Russia). Tax and custom regulations can become impediments for exchanging goods between regions. Tanzi (2000) notes that certain conditions have to be met before fiscal decentralization can successfully take place. These include conditions related to tax administration, public expenditure management systems, or hard budget constraints, which derive from political and administrative decentralization.

In a politically and administratively decentralized system, each tier of government feels entitled to add its own regulations. The resulting fragmentation of the domestic market (tax competition) can lead to distortions in resource allocations. Excessive legislation may be a consequence, too, driven by the scope for local rents to be captured by bureaucrats and policy makers. This may also apply to public services meant to cater to the needs of the poor. Regulations in such areas as health, sanitation and environmental protection often result in significant expenses for enterprises and therefore, have often been breeding grounds for corrupt practices. Even when bureaucrats are accountable to the local government, benefits can be "captured" by interest groups with implications for efficiency. Capture leads to several problems in the delivery of local public services, including cost effectiveness and black market problems. Corrupt bureaucrats will tend to overstate costs, divert public goods to the nonpoor, or give priority to powerful socioeconomic groups (Dethier, 2000). As Alderman (1999) states, the increasing complexity of decentralized programs may raise the potential of improved delivery, but it also increases the chances for misallocation of funds at different nodes of the system.

Many decentralized countries have a corruption problem (e.g. Nigeria, India and China are at the bottom of the Transparency International Index). Corruption increases poverty and to the extent it is increased or reduced by decentralization it is relevant here. Gupta *et al.* (1998) show that corruption increases income inequality and poverty through channels such as lower growth, regressive taxes, less effective targeting of social programs, unequal access to education, policy biases favoring inequality in asset ownership, reduced social spending, and higher investment risks for the poor. It has also been found that corruption increases infant mortality and reduces life expectancy and literacy (Kaufmann *et al.*, 1999). Country analysis shows how regressive corruption is as a tax. For example, poor households in Ecuador must spend three times more on bribes as a share of their incomes for access to public services than richer households. Similarly, in various surveys of public officials in Latin America in the late 1990s, bureaucrats were found to discriminate against the poor by limiting access to basic services and by failing to pursue poverty alleviation (World Bank, 2000). Proximity between the government and the governed may reduce corruption due to improved accountability and transparency. However, there is also empirical evidence and economic theory indicating that decentralization may increase corruption and reduce accountability (see Rose-Ackerman, 1997). Corruption is often more widespread at the local than the national level (Tanzi, 2000). It is often easier to enforce the rule of law among strangers than among neighbors or friends at the local level. It is also easier to buy votes or influence in a local setting. Still, a general conclusion on the relationships between decentralization and corruption cannot be drawn, and especially how it relates to services for the poor.

Decentralization and poverty

Political decentralization and poverty

The political power of the poor plays an important role in affecting levels of living. On the one hand, the democratic process encompasses the poor. The major power of the poor is participation in the election process. On the other hand, decentralization could lead to political conflicts and affect macroeconomic stability. Both aspects will be considered in the following.

Theoretical reasons for a positive impact of political decentralization (with democratic elections) on poverty reduction can be derived from a simple political economy concept. Assuming poverty is a regional phenomenon, the median voter model suggests that the needs of the poor are better served in a decentralized setting, at least when each constituency receives the same per capita amount in fiscal transfers. The median voter is likely to be poorer in a decentralized poor district than in a centralized setting. Thus, the allocation of public goods and services demanded by that median voter will be more tailored to the needs of the poor when the relative voting power of the poor is enhanced by decentralization; this also holds under certain circumstances in multidimensional voting (Gandmont, 1978). The gains for the poor can be through directly targeted transfers to the poor or appropriate income generating projects. Often, but not always, poor people tend to live in the same areas of a town, or country (e.g. China's poor are concentrated in the Western rural regions, Brazil's poor in the North-East). Poverty is often related to structural and ecological factors, and these are often unequally distributed across regions. Pro-poor investment in these cases may for instance emphasize rural infrastructure and agricultural growth.

Cross-country comparisons

When decentralization prevents violent conflicts and war, or facilitates overcoming them, this will help the undernourished poor. Absolute poverty expressed in terms of hunger today is concentrated in countries affected by internal wars and violent conflicts (Wiesmann *et al.*, 2000). In famine prone and ethnically diverse Ethiopia, for example, decentralization has become a tool for deflating secessionist tendencies. However, the central government in Ethiopia still controls most of the revenues and has a strong redistributive function. Since economic conditions differ considerably within the country, large inequalities are likely to be maintained. In Bosnia and Herzegovina, the state's authority is limited to a few responsibilities like international relations and infrastructure. It has few spending powers and no redistributive functions (Fox and Wallich, 1997). Decentralization provides an institutional mechanism for bringing divided groups into a formal, rule-bound bargaining process (Treisman, 1998). South Africa and Uganda are two examples where decentralization has served as a path to national unity.

But decentralization is not a panacea for ending conflicts. It can also exacerbate political tensions between regions if they have significantly different income levels, or if they lay claim to the natural resources in their regional territory. Costs of providing public services may also vary because of regional characteristics, such as population density and geographic location. To correct for these limitations in public service delivery, most decentralized fiscal systems include equalization grants (Ahmad, 1997). Evidence from India and Indonesia shows that even dramatic redistribution across regions will have limited results on poverty or inequality unless targeting is improved within regions themselves. In many countries, income inequality is based mainly on differences among individuals, rather than on differences among regions (Ravallion, 1999).

In decentralized countries where the local governments have significant power, macroeconomic stability can be threatened (Tanzi, 2000). For example, in the Philippines, the central government is very limited in its ability to adjust to critical situations because nearly half of its tax revenues is allocated to local governments. In many Latin American countries, collection of revenues was decentralized before expenditure responsibilities in the 1990s. Thus, central governments were forced to maintain spending levels with a smaller resource base, leading to macroeconomic imbalances.

Political decentralization should, as hypothesized above, give more voice and influence to the poor in their own localities. We would thus expect less poverty in countries with voting at a provincial level (second tier) and a district level (third tier) than in countries voting only for central governments, or not having democratic elections at all. The following tabulations show some interesting patterns in this respect. There is a strong relationship between decentralization expressed in the number of election tiers, and the Human Development Index (HDI) of UNDP, which aggregates per capita income, literacy and life expectancy. It can be seen that poor countries (with a low HDI) tend to be politically centralized, that is, they have no elections or only elections at the central level (Table 4.1a). This is also evident for the countries with poor economic performance measured in Gross National Product (GNP) (Table 4.1b). The countries classified as "nonpoor" in terms of HDI or GNP tend to have a higher degree of political decentralization with elections at the 2nd and 3rd tier.

Absolute poverty, as defined by income below one US$ per day, is not related to political decentralization except for the case of 3rd tier elections, whereas the HDI continuously improves with political decentralization (Table 4.2, first and second lines). Few countries have elections at the third or even at the fourth tiers, which are closest to the poor. The fourth tier refers to village or township level, while third tier is counties, and second the provinces.

The effects of political decentralization for the poor – as found in the HDI – may be mediated through services improving human resources. Clearly the health quality index of the World Health Organization (WHO) shows significant improvement when decentralization is deepened (Table 4.2, line 3). It may be noted, however, that a well-known centralized state ranks at the top of the WHO list: France. The trend for illiteracy is less linear than the trend observed for the health service indicator.

Causality behind these tabulated results must be interpreted cautiously. Are countries decentralizing as they get richer (e.g. decentralization as a political "good") or does decentralization contribute to economic growth, or both? Further, research building on

Table 4.1a Political decentralization, elections and human development (HDI)

HDI	*Number of election tiers*				
	No election	1	2	3	*Total*
Poor countries	19	25	7	0	51
Nonpoor countries	11	28	26	9	74
Total	30	53	33	9	125

Source: Own calculations based on data from UNDP 1999 and WDR 1999/00.

Table 4.1b Political decentralization, elections and GNP per capita

GNP per capita	*Number of election tiers*				
	No election	1	2	3	*Total*
Poor countries	25	42	13	2	82
Nonpoor countries	2	9	19	7	37
Total	27	51	32	9	119

Source: Own calculations based on data from UNDP 1999 and WDR 1999/00.

long-term data sets could help to identify not only optimal degrees but also optimal timing of decentralization in the development process.

The broad cross-country comparisons have the obvious shortcomings that institutional characteristics, space and change over time could not be considered. We therefore turn now to some country specific reviews of "political decentralization – poverty linkages."

Selected country evidence

A review of experiences with democratic local government in six developing and transition economies finds little evidence so far that democratic local government can do much directly to reduce poverty, at least in the short run (Blair, 2000). But country and regional experiences are very heterogeneous. We look further into experiences of China, India, Egypt and Ghana, which have been selected for this purpose because they are of global or regional relevance, display diversity in terms of size, of political regimes, degree and change in decentralization, levels and change of poverty, and economic structure. Poverty is a major concern in all four countries. Table 4.3 shows some basic decentralization, poverty and growth indicators for the four countries.

The reform process in *China* which started in 1979, was strongly supported and defended by local governments (Rana and Hamid, 1996). They were considered as an

Table 4.2 Political decentralization, poverty and human development

	No election	*Elections at … level*		
		Central	*Province*	*District*
% Pop. < 1$/day	20.9	29.3	29.9	7.1
HDI	0.575	0.644	0.746	0.884
WHO index	0.533	0.610	0.704	0.845
Illiteracy percent	33.8	24.5	22.5	1.4

Source: Own calculations based on UNDP 1999, WHO 2000, and World Bank 2000.

Table 4.3 Basic indicators of China, India, Egypt and Ghana

	Size of the country (sq. km)	*No. of elected subnational tiers* 1999	*GDP per capita, PPP, current international prices (US $)*			*Life expectancy at birth (years)*		*Human Development Index (HDI)* 1998	*WHO index (health sector performance)*
			1978	1988	1997	1978	1998		
China	9,572,400	0[a]	320	1,310	3,130	65	70	0.706	0.485
India	3,287,300	2	430	1,020	1,670	53	63	0.563	0.617
Egypt	1,002,000	0[b]	800	2,160	3,050	54	67	0.623	0.752
Ghana	238,500	1	800	1,230	1,640	52	60	0.473	0.522

Sources: World Health Report 2000, WHO; World Development Indicators 1999, and World Bank.

Notes

a Some local level elections.

b Local elections, but executive appointments can be over ruled by the center.

important source of reform ideas, and the central government referred to household farming or revenue-sharing systems successfully implemented at local level as national policy. Still today, the Chinese model appears to have a high degree of political centralization, mainly through the political organization of the Communist party. However, while political power is officially centralized, subnational units have acquired substantial autonomy in designing and implementing policy. Since 1978, the number of posts controlled directly by the central organization of the party declined, and central planning has largely been abandoned. Decentralization had a positive impact in terms of rapid growth in local economies in China (Jin *et al.*, 1999; Qian, 1999). The percentage of rural poor fell from an estimated 30.3 percent in 1980 to 13.9 percent in 1990, and 13.6 percent in 1994 (Khan, 1998). China also stands out for its high levels of education and public health services dating from the time of central planning. However, while major improvements of the income situation of the poor mostly located in rural Central and Western China, took place early on in the reform process, significant poverty remains predominantly in rural settings. Economic inequality – between urban and rural areas and coastal and inland China – significantly increased between the early 1980s and 1995.

India developed under a system of two-tier federalism until recently. A policy of liberalization began in 1991, and in 1992, India implemented a constitutional reform which determined the powers, authority and responsibilities of the panchayats; these are elected local-government bodies at the third-tier level (Rao, 2000b). The Van Panchayat Acts mandated elections for local authorities in 250,000 villages and towns, with special provisions to protect the rights of women, castes and tribes. Thus, the poor in India can exercise their voting rights directly at three levels, and can even participate in policy making on reserved seats at panchayat level. However, critics argue that pressure or interest groups try to influence both the government and the poor to shift policies in their favor. There are still patron–client relationships in some villages and the poor may have to vote according to the preferences of the landlords (Quibria, 1994). Thus, India combines persistent high poverty rates, illiteracy, and poor social indicators with democracy. Evidence from Karnataka shows that the poor benefited little from decentralization in terms of political influence. The scheduled castes were found to be in an even less advantageous position than before (Crook and Manor, 1998). The last decades brought only slow improvement in the living standards and social indicators of the poor. By the late 1990s, an estimated 340 million people were living in poverty, up from an estimated 300 million in the late 1980s. Some 43 percent of India's population is under the poverty line. India still suffers severe deprivation in education and health – especially in the North, where caste, class and gender inequities are particularly strong.

In *Ghana*, since 1983, institutional reforms towards decentralization at the district level were promoted. Although the committees and councils have been part of the decentralization process since 1988, they were established only in 1999 through the elections to the Unit Committees of which about 16,000 exist in Ghana – in addition to 1,276 Urban/Town/Area and Zonal Councils (Thomi *et al.*, 2000; Twum-Baah, 2000). For the poor and illiterate, access to political participation increased, although they were underrepresented at the local level (Crook and Manor, 1998). A survey of the traditional authorities shows that most traditional chiefs considered the District Assembly concept positively (Yankson, 2000). The overall decentralization process in Ghana has been classified as successful, despite deficiencies and problems involved. However, it is a process which is ongoing and needs to be kept on track to be sustainable (Thomi, 2000). It has also established the framework for successfully implementing projects that depend on participation with a strong pro-poor focus, for example, in the field of water access (Mastovak, 2000). While the overall incidence of poverty in Ghana has decreased, little benefits of the overall growth process have been felt by the poor (Twum-Baah, 2000).

Egypt has twenty-six governorates which are divided into 166 Markaz. Since 1975, the Markaz are autonomous local units supervising affiliated villages. There are a total of 4,358 villages, of which only 920 are local units with a local council, while 3,438 are satellites to Markaz. These satellite villages are divided into subsections with a police force or a mayor (Omda). Each of the levels has locally elected "local popular councils" and appointed "local executive councils," thus replicating the division of labor between parliament and executive from the national level. Elected local councils are supposed to monitor the performance of the local executive council, but the central executive in Cairo can override their rulings. Until 1988 there was a provision for one seat for a woman. Law 145/1988 cancelled that quota resulting in a drop of women participation in local councils. In the early 1990s, Egypt implemented a Comprehensive Economic Reform and Structural Adjustment Program (ERSAP) advocated a shift from a centrally planned to a decentralized, market- and export-oriented economy. The second phase of that program aimed among others at the social sector to safeguard the interests of the socially vulnerable groups during the reform process (Al-Mashat and Grigorian, 1998).

Administrative decentralization and poverty

Administrative decentralization redistributes authority and responsibility for spending among different levels of government. In order to be effective it establishes accountability structures. Public accountability entails at least two different mechanisms which are affected by both political and administrative decentralization: first, elected officials' accountability to the citizenry, and second, bureaucrats' accountability to elected officials (Blair, 2000). Through both mechanisms the poor can gain, but the problem of "capture" by local elite still exists. "The power wielded by the local elite is often in inverse proportion to the degree to which they are held accountable for their actions and decision making" (Narayan, 2000). One approach to reduce the probability of elite takeover of decentralized programs, is to strengthen poor peoples' own organizations within communities and through cross-community networks. But, the more effective and sustained approach is the strengthening of rule of law and of democracy in general, which is not just a matter of local initiative.

Are small countries doing better on poverty reduction?

Following Tanzi's critique (this volume), a simplistic aggregate test for the poverty reduction effects of administrative decentralization is to ask if small countries do better in poverty reduction than larger ones.

Small countries may be at a disadvantage due to limited economies of scale in industries and administrative capacities in the public sectors. However, small countries could have better, more coherent fiscal institutions, and show better performance in targeting the poor than large countries. If a territory is too large to be optimally administered by one government, it may be better to have several smaller governments. When we simply correlate population size of countries 'with poverty levels as expressed by the UNDP's HDI (an index composed of a country's per capita income, mortality and education), this does not reveal any significant association. Even if we look at small, medium and large countries at similar income levels, no correlation with HDI can be detected. However, controlling for rich countries (OECD and oil exporting countries) Easterly and Kraay (2000) find for a sample of 153 countries, that poverty and welfare indicators are significantly better in small countries (below one million people). Infant mortality is lower by 23 per 1,000 and life expectancy is 4 years longer. Moreover, school enrollment is 8 percent higher than in larger countries. Apparently, small states do better at poverty reduction, and this casts doubt on the widespread notion that small states and their citizens are more vulnerable than other countries.

Decentralization is of course a different concept to that of breaking up nation states into smaller independent nations. Administrative decentralization may demonstrate itself in the degree of subdivision of a nation, to the second or third tier (provinces, districts) or even further below. What are the associations between income level and this type of decentralization, and what is the performance of key public services, such as health and education and the poverty situation? Table 4.4 shows a diverse pattern for a set of developing countries. Again, simply subdividing a nation does not say much about local decision-making powers, and even less about the role of the poor. In each case the role of institutional arrangements regarding political and fiscal decentralization at the level of administrative units would need to be considered, if for instance (dis-) economies of scale for certain public services where to be explored. Further research in these scale economy issues might be interesting.

Selected experience with administrative (de-)centralization and poverty reduction

The direct effects of administrative decentralization for the poor depend much upon harmonious or conflicting goals at central and province level and beyond that at local levels. National anti-poverty programs, for instance, often rely on provincial governments to transfer resources to the poor. Outcomes will then depend on the behavior and capacities of provincial governments, and provinces can differ in relevant ways in their targeting performance (Ravallion, 2000).

China's approach to administrative decentralization relies on negotiation rather than rules to define relations between the central government and the four lower tiers

Table 4.4 Examples of countries' administrative decentralization, poverty and public services

Country	*Poverty %<\$/day*	*Persons per lowest admin. unit*	*HDI*	*WHO – Index*	*Illiteracy*
India	44.2	(4,049)[a]	0.563	0.599	46.5
Ethiopia	31.3	108,636	0.309	0.276	64.6
Bangladesh	29.1	26,685	0.461	0.675	61.1
Mexico	17.9	39,116	0.784	0.755	10.0
South Africa	11.5	47,769	0.697	0.319	16.0
Turkey	2.4	30,735	0.732	0.734	16.8

Sources: World Health Report 2000, WHO; World Development Indicators 1999, and World Bank.

Note
a 3rd tier only introduced in 1992.

(Shi, 2000). Thus, the allocation of responsibilities across tiers of government remains unclear, except for health and education, which are controlled by the provinces. Over time, this may threaten the success of the reform process. While administrative discretion had helped preserve the momentum for growth and reform, it had also created opportunities for corruption. The central government is taking steps to improve information flows and accountability.

Panchayats in *India* prepare and implement plans for economic development and social justice. The list of responsibilities reaches from the provision of health care and education to agriculture and housing projects and cultural activities. The small jurisdiction of the panchayats allows the communities to adjust to local social and cultural particularities. The short administrative process facilitates quick and focused responses to immediate needs in case of disasters and stable long-term planning. The panchayat, an informal committee of the village head and four village leaders, is widely respected for its ability to resolve disputes between villagers fairly. This means that conflicts can be resolved at the local level without resorting to the police or courts (Ahluwalia and Little, 1998). The downside of the decentralized administration is fiscal deficiency, lack of information, and scarce management capacity within the panchayats, missing supportive administration, politicized elections, and sometimes limited powers of the panchayats in specific states (Rao, 2000b). Party politics have influenced the composition of the panchayats significantly. Often the representatives of the panchayats belong to the ruling party in the States, and party policy dominates decision making instead of local needs. In rural areas in particular, local affairs are often still run along authoritarian lines. The elite, particularly that from higher castes, is mostly seen as including those who divert government resources for their own use. In some areas, local leaders are seen as selfish and corrupt and are cited as one of the reasons for lack of development in the area. In addition, the panchayats are not endowed with the human resources to provide expertise in all fields, and lack resources to employ outside experts on respective topics.

Comprehensive studies on West Bengal suggest that it is not just decentralization, but combinations of institutional reforms at a regional and local level that can be quite effective for poverty reduction. Land reform policies and the administrative decentralization to village councils have provided some of the most favorable conditions for overcoming traditional patterns of deprivation along the lines of class, caste and gender (Drèze and Sen, 1997).

The effects of decentralized decision making relevant for the poor do not stop at the lowest administrative level, but reach all the way to village and within village levels. For Bangladesh's community based Food-for-Education Program, which attempts to reach the poor in poor villages, Galasso and Ravallion (2000) find that the targeting success was due to pro-poor targeting within villages. The center's targeting of villages contributed less to overall targeting performance than intra-village targeting.

In *Ghana*, the administrative decentralization to the district level since 1983 promoted power sharing, and capacity building at the district level, reducing reliance on central government (ISSER, 2000). In 1993, the "Decentralization Law" or Local Government Act allowed for a Regional Coordinating Council and a four-tier Metropolitan and three-tier Municipal/District Assemblies structure. The geographical coverage of districts was restructured (from 65 to 110 districts). This did not necessarily lead to ethnic homogeneity within the districts as was intended, but rather sharpened ethnic conflicts; local political institutions (district assemblies and subdistrict structures) were established; and administrative, development planning and implementation, and budgeting decision-making were decentralized (Thomi *et al.*, 2000; Twum-Baah, 2000). Providing infrastructure in several areas like establishment or rehabilitation of school buildings and health centers reflects the major achievements of the District Assemblies (Yankson, 1999). A household survey conducted in 8 out of the 110 districts indicates how people perceive the District Assembly's performance: in improving education (18 percent of all votes), markets (13 percent) and sanitation (12 percent), and also health, but to a lesser extent (5 percent); an improvement of infrastructure was noted by some 81 percent of all surveyed; 12 percent of the people stated that there were "no achievements" with respect to the District's performance (Thomi, 2000a). Within the administrative context, decentralization is expected to increase allocative efficiency and responsiveness to local needs. The household survey was answered more negatively. However, this may reflect limited funds available to Districts relative to their needs (Thomi, 2000b).

In *Egypt*, the prerogative for changing the structure and responsibilities of governorates lies with the President. At town and district level, it lies with the Prime Minister. The governor can only change the structure and responsibilities at village level. As the system of local government came under attack due to increasing problems of uneven development in Egypt, more power was given to governors. But, the overall coordination of all local government affairs belongs to the Prime Minister. Thus, local units remain a tool for the implementation of centrally made public policies. Since 1994, even heads of the smallest villages have been appointed by the center. Local administrative units theoretically have their own local sources of information and their local information collection systems. Based on this information, they devise projects and ask for funding. Constitutionally, local government is part and parcel of the central government. However, most employees at the local levels lack legal and administrative knowledge, and existing training programs are outdated or irrelevant.

Fiscal decentralization and poverty reduction

Figure 4.2 depicts poverty in relation to fiscal decentralization in a set of developing and transforming economies. For the countries selected, the poverty levels show little relationship with the degree of fiscal decentralization. India and China both portray extreme cases in terms of the share of subnational expenditures (and are represented by the dots to the right in Figure 4.2). Apparently size plays a role here. India, however, is also an outlier in terms of prevalence of poverty, especially for the high level of subnational expenditures.

With an increased level of subnational expenditures, one might expect more pro-poor spending for public services, if (and only if) political empowerment for the poor comes into play. Table 4.5 presents groups of expenditure shares and health and education systems performance in terms of the WHO index and illiteracy. Health systems performance generally declines with increased subnational spending shares and education does too. Poor regions may have poor education, even if spending shares rise, but other factors must be considered, as in the multivariate analyses below (Table 4.6).

Public financing of services is a core element of poverty reduction policy and practice. But low-income countries generate low public revenues: in 1997 government revenues in these countries averaged about 17.5 percent of GDP (excluding China and India). In high-income countries, revenues amounted to almost 30 percent of GDP (WDR, 2000/01). There are also design and implementation problems, as tax collection is often poorly organized and taxation still lacks transparency, especially in rural areas. The

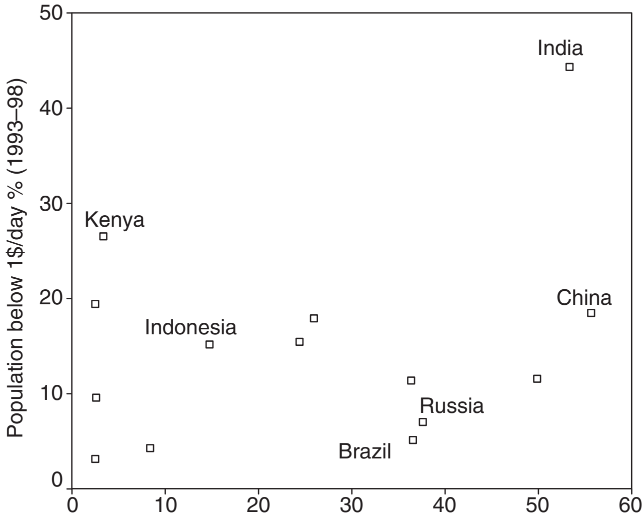

Figure 4.2 Poverty prevalence and levels of subnational expenditures.
Source: Own calculations based on data from WDR 1999/00.

Table 4.5 Subnational spending and health and education systems performance

Terciles of subnational levels of expenditures	*Health system performance*	*Education system (Proxy: illiteracy rate)*
Lowest	0.726	12.67
2nd	0.621	13.74
3rd	0.487	20.13

Source: Own calculations based on data from WHO 2000 and WDR 1999/2000.

costs of raising revenues in poor countries are very high, sometimes even outweighing the benefits of public spending. Often, however, the real problem is that the limited public resources are not spent on activities – such as education or health – that help poor people accumulate their assets. Many low-income countries are simply spending too much on areas like, subsidies to the nonpoor, loss-making or inefficient public enterprises and the military. In several countries, lower military spending permitted greater spending on health and education. Many countries – especially those having suffered from conflict – have some of the worst health and education indicators in the world, but spend more than twice as much on the military as on education and health combined.

In *China* 1994 tax reform appears to have failed to stop the trend towards worsening regional inequality (Pengcheng, 2000). As the fiscal system was directed to self-financing in the 1990s, the fiscal pressure increased especially at the county level. As higher governments were under fiscal strain themselves and not in a position to subsidize existing services, local rural governments started to impose a host of fees and levies. The distributional effects of these local taxes and fees is diverse, but clearly, poorer regions were less able to raise taxes and disparities between regions increased (West and Wong, 1995). That in turn may result in recentralization efforts in this regard (see Ahmad *et al*, Chapter 10 in this volume).

China practiced considerable decentralization in the provision of social services prior to the reforms of the 1970s, and state enterprises and communes played an important role in primary health care and basic education. China's public finance reforms in 1981 devolved almost all public finance of health services to the provincial and county level, limiting the central government's ability to redistribute funds from richer to poorer areas of the country. With fiscal decentralization, the poorest counties have become least able to finance public health programs. An analysis of public expenditure over 11 years shows that the allocation of public expenditure has become skewed toward richer regions, and within regions, to the provinces growing fastest in China (Hammer, 1996). Within provinces, government spending is concentrated on government health insurance and hospital care. Services that disproportionately serve the poor, such as the Maternal and Child Health Program and the Epidemic Prevention Service, have been constrained and increasingly forced to rely on revenue from user fees. Traditional public health activities achieve greatest coverage in the wealthiest provinces (World Bank, 1997).

In *India*, the fiscal functions of the panchayats have remained virtually unchanged. While the Constitution permits panchayats the right to levy taxes and duties, state legislation should determine this. Most states grant a lump sum payment for panchayats expenditures, and the state government approves the disbursement of funds for specific projects on a case-by-case basis. Even if states grant panchayats taxation rights, revenues would be to cover the assigned responsibilities. An equitable fiscal transfer system is needed for panchayats within the States.

In India, there are several successful examples, especially for decentralized primary education. In Madhya Pradesh under an education guarantee scheme, the state government provides funds, but schools are run at the local level by locally appointed teachers and administered by village education committees (Dethier, 2000; Ghai, 2000). However, over time, the education system has actually become more centralized in India. Many crucial decisions (curriculum, etc.) are made by the state and not local governments. The panchayats cannot appoint auxiliary teachers, adjust school hours to local agricultural cycle or authorize school building repairs. A recent survey of primary education found that 73 percent of primary schools in North India have leaking roofs so that classes are interrupted for weeks at a time during the monsoon (Probe, 1999). There is political resistance to decentralization, notably on the part of teacher organizations and the education bureaucracy. Teachers are employees of the state and are strongly unionized. In North India, for example, many schools used to be accountable to local bodies, but teacher organizations have pressed for transferring school management to the state government as they wanted all teachers to enjoy the same terms of employment and to be sheltered from local pressures (Dethier, 2000). Similarly, when privileged groups exist within the local society and set up private schools, this diminishes public pressure for efficient public services, as happened in Uttar Pradesh. By contrast, in Himachal Pradesh, the public schools function relatively well, reflecting a relatively egalitarian social structure (Probe, 1999). In Kerala, the voluntary sector, either on its own or with the support of the state, has played an important role in education. Schools run by religious organizations and charities have been important historically, but increasingly they are supported and regulated by the government (Ghai, 2000).

With respect to the health sector in India, poor people in many regions report widespread corruption. Health agencies are seldom used by the poor due to distance, lack of medicines and un-sympathetic attitude of staff (Narayan, 2000). People use private pharmacies and traditional doctors instead. Fan *et al.* (1998) analyzed the impact of different types of government spending on rural poverty and productivity growth in India. The results suggest that government spending on productivity enhancing investments like agricultural R&D and irrigation, rural infrastructure, rural development and welfare targeted directly on the rural poor have all contributed to poverty alleviation, but with large differences in their effects. Government expenditure on roads has the largest impact on both poverty reduction and growth. While government spending on welfare (employment and community development programs) for scheduled castes and tribes and also for health had a large impact on poverty, it has little impact on growth.

In *Ghana*, the common fund of the District Assemblies enabled the districts to provide basic infrastructure in the field of education, health, water, transport, etc., to previously neglected areas (Thomi, 2000b; ISSER, 2000). As a result, district expenditures on development, both per capita and as a share of total expenditure, increased (Crook and Manor, 1998). NGOs also contributed significantly to the funding of education development at the district level. As a result, there is an increased access of people living in remote areas to public services. In addition, the improved markets and transport facilities positively impacted on the economic situation within the districts, and created demand especially for construction services. However, with limited budgets, assemblies are forced to "invent" new taxes and to levy special development rates, thus coming into disrepute. In addition, the provision of services has considerably declined, and that health resources go disproportionately to hospital and curative care used more by better-off groups (Patrinos and Ariasingam, 1997). The richest quintile receives, for example, nearly three times the public health spending received by the poorest quintile (Filmer and Pritchett, 1999b). In total, there is little evidence that decentralization led to stronger responses to the needs of the poor (Crook and Manor, 1998).

The health care system has been decentralized for some time through the establishment of district-based health teams (DHT) in Ghana. They play an important role in ensuring the availability of cost-effective services, and can be authorized to make decisions on the location of new public and private health care facilities, determine which health services are to be provided by the center and the district hospital, set standards for health care facilities etc. To increase the capacity of DHTs, the government initiated a training program in 1988 which has been assessed positively (World Bank, 1994). In Ghana, costs of medical consultations are perceived as high, but the quality of hospitals are perceived as more competent in general. Subsidies for health services tend to benefit wealthier groups. In Ghana's Volta Region in 1995, less than 1 percent of patients were exempt from health user fees, and 71 percent of exemptions went to health service staff (Nyonator and Kutzin, 1999).

In *Egypt*, locally raised taxes go into the central tax pool before being reallocated to governorates. Local-levied taxes can be increased by the governorates, but they require the approval of the the finance minister and the cabinet of ministers. The biggest portion of local funding comes in the form of a donation from the central government. This is a 100 million Egyptian Pounds annual sum known as Joint Revenues Account of Governorates. Half of this amount goes into the budgets of governorates where import–export and industrial and commercial taxes are collected. The other half goes to the Ministry of Local Administration to be allocated to deprived governorates upon the approval of the Ministry of Planning. Central allocations cover mainly administrative expenditures. Local councils have the right to amend, change, and suggest new directions of the budgeting, but in reality, they do not have the competence. Further resources for the local units come from local taxes, service charges imposed locally as well as national taxes, such as from the Suez canal, international donations upon approval of Prime Minister, and from the special funds. These funds are financed from service charges and fees approved by the local council, governmental and nongovernmental donations and grants approved by the local council; rental income of housing units financed through the fund and profit from fund's income generating projects. The special funds are autonomous from the national level. The board of the fund headed by the local unit chief decides on policy and is subject to control of local elected councils. Special funds have the incentive of more flexibility as far as allocation is concerned. Local units have difficulty raising donations; so do NGOs. Donations have to enter the national treasury accounts. Thus, local communities often do not ask for cash donations, but for donations in kind. However, the use of special funds may also lead to problems due to lack of transparency and accountability.

Some general observations emerge with respect to the decentralization of basic social services. Any fiscal decentralization supposed to serve the poor has to be part of a larger, more general framework, that is, to generate appropriate incentives for accountable decentralized decision making. Ahmad (1997) further points out, that central government's concerns for uniform absolute standards, such as for nutrition and basic education would have to be met through special purpose transfers, which would be easily identified and monitored.

Fiscal decentralization does not lead automatically to more pro-poor spending. Political and administrative decentralization seem a precondition. Even higher public expenditure on social services may not translate into more or better services for poor. Programs for poor people are too often of low quality and unresponsive to their needs. Filmer and Pritchett (1999a,b) found that public spending is only weakly related to outcomes. The correlation between public expenditure in education per student and the percentage of people aged 15 through 19 who had completed grade five, appeared positive and significant at first, but after controlling for per capita income, the correlation was found to be fairly weak. In Latin American countries, for example, although public education spending rose in the 1990s, average primary dropout rates increased (Thomas *et al.*, 2000). Allocation within the sectors is most relevant. To support asset accumulation by poor people, distribution within sectors must favor basic services used more by the poor. Even when health services are publicly financed, poor people face constraints (for example, through complementary costs such as transportation to medical care) that limit their access to them. A community-managed school program named EDUCO in El Salvador shows that enhanced involvement of communities and parents has reduced student and teacher absences with long-term effects on achievement (Jimenez and Sawada, 1998). In the Philippines and in Pakistan, it has been found that community-managed schools achieved better results (Jimenez and Paqueo, 1996). The high failure rate of government projects, obvious mismanagement of government funds, and unfair practices in election of village heads mean that incentives for accountability are low. The preconditions for effective and pro-poor fiscal decentralization, that is, political and administrative decentralization were not fulfilled.

Exploratory multi-variant analyses on decentralization and poverty

We expand on the above analyses and country comparisons to assess the combined effects of political, administrative and fiscal decentralization poverty. We employ a multi-variant regression analysis for this purpose. Conceptually, we would like to control for human (C_{hum}) and physical capital stocks (C_{phys}) of countries, their natural resource endowments (C_{nat}), and institutional characteristics (INST):

$$\text{Poverty} = f[C_{phys}, C_{hum}, C_{nat}, \text{INST}, \text{DEC}_{pol}, \text{DEC}_{adm}, \text{DEC}_{fisc}].$$

Preferably, this function should be examined with time-series data, capturing effects before and after increased or decreased decentralization. Current data availability does not permit such comprehensive analyses. We therefore work with some approximations in this preliminary analysis:

- The dependent variable is the HDI, which is based on fixed effects-outcomes of physical and human capital (income, education, mortality).[4]
- Political decentralization (DEC_{pol}) is approximated by prevalence and extent of elections at (sub)national levels.
- Administrative decentralization (DEC_{adm}) is portrayed by size of country (the degree of administrative partitioning is not available for many countries) in terms of population.
- Fiscal decentralization (DEC_{fisc}) shall be approximated by relative subnational spending power (subnational public expenditure over total public expenditure). We expect that at the margin, fiscal decentralization effects for the poor may decline and therefore, we include a squared term. For this fiscal decentralization variable we have only fifty observations for (results see Table 4.6a), and we repeat the analysis for a larger sample (173 countries) without that variable (Table 4.6b).

Table 4.6 Regression analysis on decentralization and poverty (HDI)

Variables	*Coefficients*	*t-values*	*Signific.*
(a) *N*: 50; *R*-square: 0.495; *F*: 7.19			
ELECT0	0.0561	1.26	0.214
ELECT2	0.1050	3.45	0.001
ELECT3	0.141	3.69	0.001
POPSIZE (log)	−0.0321	−3.43	0.001
DEC_{fisc}	8.990 E-3	2.96	0.005
$\text{DEC}_{fisc}\text{SQ}$	−1.275 E-4	−2.39	0.021
Constant	1.151	7.64	0.000
(b) *N*: 173; *R*-square: 0.19; *F*: 9.88			
ELECT0	−0.0622	−1.69	0.091
ELECT2	0.114	3.12	0.002
ELECT3	0.262	4.39	0.000
POPSIZE (log)	−0.0198	−2.55	0.012
Constant	0.968	8.41	0.000

Source: Own calculations based on data from WHO 2000 and WDR 1999/00.

ELECT0 – No election held even at central level (=1, else = 0); ELECT2 – Elections held at 2nd tier government (=1, else = 0); ELECT3 – Elections held at 3rd tier government (=1, else = 0); POPSIZE(log) – Population of country (log); DEC_{fisc} – Share of subnational expenditure in total government expenditure; DEC_{fiscSQ} – (DEC_{fisc}) square

It should be noted that we do not control additionally for levels of per capita income and "age" of decentralization (recent or long-standing) in this simple cross-sectional analysis, as would be called for in a longitudinal analysis.

The two reported regressions in Tables 4.6a and 4.6b suggest that it may be useful to invest further in data that would facilitate such analyses. Of course, a number of usual econometric questions need to be raised about directions of causalities and the relationships of the right-hand side variables. The results seem to imply, however, that:

- administrative decentralization, approximated by size of population, seems to reduce poverty. Smaller countries do better in poverty reduction than larger ones (in line with Easterly and Kraay, 2000);
- fiscal decentralization, as captured by a larger share of subnational expenditures, tends to reduce poverty, but with declining effect at the margin;
- political decentralization, as portrayed by election tiers, shows mixed results: elections held only at the central level do not make a difference for the poor as compared to no elections, but elections at 2nd tier, and even more so at 3rd tier are strongly associated with the HDI.

This multivariant analysis may stimulate an assessment of more specific functional relationships by groups of countries and over time. It cannot serve as a substitute for the analysis of decentralization at a country level, which for the cases of China, India, Ghana and Egypt provided ample examples for outcomes quite different to these general patterns.

Conclusion

Findings and extrapolations

We asked at the outset: Does decentralization serve the poor? The general answer to this very question seems "Yes" but it certainly depends. An important result is that it is not sufficient just to look at any decentralization type, such as fiscal decentralization, in isolation, in assessing effects for the poor. Political, administrative and fiscal decentralization need to be considered simultaneously, and the sequencing and pace of the different types of decentralization seem to play an important role.

To come closer to meaningful answers to the general question, a typology would have to distinguish between:

- types of decentralization (political, administrative, fiscal – must be conceptually distinguished, but simultaneously considered because they strongly interact in their impact on the poor);
- types of country conditions (such as size, geography, population density, endowment with natural resources, cultural and political set-up, inter-regional solidarity, institutional and managerial capacities);
- causes and patterns of poverty (such as resource constraints and/or discrimination).

Different types of decentralization impact differently on different causes of poverty and consequently on different segments of the poor. The rural poor will not benefit if rural decentralization de-links the hinterland from urban and peri-urban growth centers. Children in poverty will not benefit if decentralization undercuts the capacity of large-scale child nutrition programs.

Political decentralization often benefits the poor, because involving civil society in planning, monitoring and evaluating public programs and policies is crucial to ensure steady progress and that is facilitated in a decentralized system.

Administrative decentralization alone does not add power and voice to the poor. We thus did not expect much of a link to poverty from merely breaking up larger or central units into smaller ones because there are dis-economies of scale of governmental regional units from a perspective of the poor. Still, some indications suggest that smaller units, for instance smaller countries, do better in terms of poverty reduction. While breaking up large countries is not politically feasible, there is need to improve public management systems to make public programs more efficient and accountable.

Fiscal decentralization shows even more ambivalent effects for poverty reduction. Minimum levels of subnational expenditures seem to be a precondition for poverty reduction, but the effect of higher subnational expenditures relative to total expenditures decreases at the margin in multi-country analyses. However, many country specific examples show that high subnational spending shares do not show significant associations with poverty reduction. The public services particularly relevant for the poor – health services, basic education – benefit or lose in terms of efficiency and quality from decentralization, depending on institutional and managerial capacities at a local level, and local political power of the poor.

Compared with China, India and Ghana, Egypt is a very centralized state and has large subsidy schemes. Still, Egypt shows superior results with respect to performance of social indicators. However, this relatively positive development might be due to very specific conditions, and maybe the results would have been even better if decentralization had taken place. With respect to Ghana, the overall decentralization process has been judged as successful despite of problems and deficiencies involved. In the two large countries China and India, regional inequality appears to have increased due to decentralization. However, India's political decentralization to panchayats, *ceteris paribus*, seems to have helped poverty reduction. In China, fiscal decentralization seems to have impacted negatively on the delivery of health services to the poor. Thus, it is necessary to differentiate between types of decentralization, country-specific conditions, target groups and even types of public services.

Even within a certain sector of public services relevant for the poor, there are types of services, which are more appropriate to decentralize than others. In the health sector, there are some programs like for immunization, which are calling for action at the central level. In the education sector, the development of curricula and quality control may be better to be allocated to the central level to avoid that regional inequalities occur.

In relation to the detailed questions at the outset, we conclude that:

- Political and administrative decentralization should precede fiscal decentralization. Otherwise participation and accountability are not assured.
- Improved participation by the poor may be facilitated by increased supervision power and improved governance due to political decentralization.
- At different scales of decentralization, patterns of quality and efficiency of public services – health and education – very much depend on institutional conditions and management capacities.

Research implications

There are important research implications which need to be addressed simultaneously from an economic, and political-economy perspective in order to identify poverty effects of decentralization. Some of these are the following:

1. Under which conditions of countries' economic and administrative capacities can decentralization be designed in pro-poor fashions? Can typologies be further developed, as hinted at above, and in that context, to what extent do cultural and political factors matter for optimal timing and scale of decentralization?
2. Concepts for fiscal relations and definition of the functional domain of various government tiers remains a large problem. Research may assist in providing decision frameworks.
3. Political economy research needs to further address problems of "capture" of economic benefits by elites; ill-defined control rights; conditions to overcome political power structures at local level, which often lead to social and economic outcomes that are highly inefficient and adverse for the poor.
4. Dynamic issues in decentralization processes call for in-depth research: Constraints of the poor to get access to public services seem to increase in the context of transition from centralized towards decentralized governance, thus there is a need to manage transition towards more optimal decentralization in a pro-poor fashion.
5. In the majority of sectors that are of particular relevance for poverty reduction, a good case for complementarities between decision making at the local and central levels can be made. In education, some parts of the system (e.g. curriculum) are best provided by central authorities with democratic control and oversight. Some tasks (such as fixing leaky roofs) can be better taken over by local authorities. The identification of optimality of such specific decentralizations requires sound analytical frameworks.
6. The most meaningful decentralization effects for the poor seem to occur at the local and community level (3rd and 4th tier of government). Research at that level has to be strengthened, as we know very little about decentralized raising of revenues and levels and allocation of expenditures at the level below provinces in many countries. That hinders comprehensive assessments of fiscal decentralization effects for the poor in particular.

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Notes

1 According to Smith (1996), a government has not decentralized unless the country contains "autonomous elected subnational governments capable of taking binding decisions in at least some policy areas." This can either mean that such local governments have to be established or that their powers and responsibilities need to be increased.

2 Scholars of the technocratic and of the institutional approaches, currently working separately, need to integrate their concepts in order to address decentralization policies for poverty reduction in specific contexts.
3 Country and community contexts matter, however. Galasso and Ravallion (2000) argue that the enthusiasm for community-based targeting has clearly run well ahead of the evidence.
4 Including a proxy for natural capital endowment (crop land per person) did not show significant parameter estimates.

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Part II

The European Union

5 Decentralization and supranationality: the case of the European Union

Pierre Salmon

Introduction

The European Union (EU) and its member countries are experiencing a double movement of centralization and decentralization.[1] Centralization consists of a partial transfer of national decision-making to collective decision-making at the level of the EU. So far, it has affected all the member countries in a fairly uniform way – with some exceptions such as European Monetary Union (EMU) or Schengen.[2] By contrast, decentralization, which concerns the powers and activities of subnational government, takes forms and has an extent that differ considerably across countries.

The theory of fiscal federalism says much that is useful to improve our understanding of the processes of centralization or decentralization in the European context.[3] The analysis that follows is partly inspired by its insights. However, that analysis is based on an interpretation of governmental systems that departs from the theory of fiscal federalism by putting more weight on competition among governments, both those situated at the same level of jurisdiction (horizontal competition) and those situated at different levels (vertical competition).[4] Even though some issues could be dealt with under both horizontal or vertical competition, the organization of the paper reflects this distinction.

Some general characteristics of the two kinds of competition are spelled out in the next section. The very peculiar nature of European integration is not only a reason to avoid a mechanical application to the question of decentralization in the EU of the insights of the theory of fiscal federalism, but also of the analysis of competitive government exposed in the next section. The section on The European Union stylized presents facts from the EU, whereas a discussion of three sets of important issues that have a bearing on horizontal competition in the context of the EU takes place in the three sections after that. These issues are the effects on the capacity of governments to compete, first, of a "level-playing field" logic that purports to eliminate all causes of fragmentation and distortion of competition within the EU internal market, second, of tax-induced mobility and tax competition, which affect what governments can supply, and, third, of the implications of the rules adopted in the wake of EMU to limit in each member country public sector deficits and borrowing. The penultimate section focuses on vertical competition aspects of the EU considered as a multi-level system. The last section is a short conclusion.

Types of competition among governments

We begin the analysis with vertical competition, between governments at different levels, which is more complex than horizontal competition between governments at the same level of jurisdiction.

Horizontal competition

In the literature, horizontal competition among governments is associated with the interjurisdictional mobility of factors, individuals and firms. At the limit, its effect is to compel governments to equate the taxation of interjurisdictionally mobile factors with the benefits they provide these factors (Oates and Schwab, 1988). In other words, mobility-based competition does two things: it compels governments to be efficient, and it erodes the tax bases available to them for the purpose of redistribution. Probably all economists like the idea of competition constraining governments to be more efficient. But the profession is divided with regard to the reduced scope for redistribution. Economists who strongly distrust governments may welcome this prospect whereas those who assume governments to be benevolent may regret it. Most economists, however, stand somewhere in between.[5] They do not fully trust governments to engage exclusively in "legitimate" redistribution, but they do not like the idea that redistribution and other policies that they do find "legitimate" or "useful," may be precluded as a consequence of mobility-based competition. Thus, they typically advise that competition be somehow either complemented or bounded. The traditional solution in public finance is the intervention of a higher level of government, not itself subject to the same kind of competition. Following Richard Musgrave (1959), redistribution should be assigned to central governments, even if, by the means of various kinds of grants, its implementation may be entrusted to subcentral governments. The problem is that, as a result of globalization, "central governments" are themselves engaged in mobility-based competition. The same logic then leads to the proposal of a world fiscal organization. A variant of this solution, also discussed extensively in the setting of public finance, is "harmonization," that is an agreement among governments located on the same level to limit competition along some dimension, taxation for instance.

Less well known, there is a kind of horizontal competition that does not raise the problems associated with mobility-based competition. It is based on comparisons of performance and can be specified either as a tournament or as yardstick competition. The mechanism (in the case of a tournament) is very simple (Salmon, 1987). A voter in jurisdiction A, in the policy areas she is interested in, compares outcomes (in these areas) as she can observe them in A with what she knows of outcomes (in the same areas) in (to simplify) another jurisdiction B, situated at the same level (e.g. municipal, regional or national). If she considers the relevant outcomes in A to be superior to what they are in B, this will on average increase somewhat the probability that she will vote for the incumbents at the next election. If she perceives the performance of her own government in A to be relatively inferior, this will on average reduce somewhat the same probability. Elected office-holders do not know how each voter will vote.[6] They do not even know each voter's priorities, nor what are the jurisdictions that each voter compares with her own. But their awareness of all sorts of comparisons being made by voters and influencing their votes is enough to provide them with an incentive to exert themselves in as many areas as possible.

The policy areas or outcomes that are relevant depend on the level of jurisdiction. They are not the same at the level of municipalities and at that of national governments. In all cases, however, they must be understood as rather inclusive: concerning not only the goods and services that the jurisdiction's government provides, but also the taxes and fees that it collects, the rules or regulations that it enacts, and the economic and social conditions it may be responsible for, in terms of aggregates such as income per head, growth, or unemployment. Another important observation is that tournaments or yardstick competition take place in a dynamic setting. Thus, perhaps their strongest effect is to induce governments to innovate and to imitate innovations introduced by other governments. Performance competition not only increases accountability and efficiency, it is also a major source of experimentation and innovation.

Apparently, competition based on comparisons of performance has no disadvantage and is thus under no circumstances likely to inspire the mixed feelings noted above with regard to mobility-based competition (it is perhaps more likely to be received with a touch of skepticism – see Bird, 2000). In fact, this is not exactly true. The source of the problem is that some types of policy outcomes may be much more amenable than others to interjurisdictional comparisons. This creates an incentive for the competitors to concentrate their efforts on these types and sacrifice other worthy policy objectives.

In labor economics and related disciplines, there is some work (e.g. Holmstrom and Milgrom, 1991) that addresses exactly that kind of problem. One solution this literature offers is to give up "high-powered" incentives and remain satisfied with "low-powered" ones. In the setting we are concerned with, this suggests that the absence or impossibility of comparison-based horizontal competition among governments may be a good thing in some circumstances. Such impossibility may result from the assignment of the relevant policy area to a multinational authority, or to a body made up of non-elected officials whose career is independent of performance (e.g. the *Conseil d'Etat* in France). Another solution spelled out in the literature is the separation of tasks among different agents. In the setting of competition among governments, it provides a good reason to have many levels of government and try to differentiate the tasks among them. For instance, if national governments compete in terms of some macroeconomic variables, such as economic growth, this may lead them to sacrifice some important social objectives, which suggests that these social objectives might be better served if the responsibility for pursuing them were assigned to lower-level governments competing for relative performance on social policies.

These considerations suggest a rationale for the division of responsibilities among levels that is likely to be different from that of the theory of fiscal federalism. Because the latter, which stresses mobility-based competition, does not cease to be relevant, an interesting albeit difficult question is to what extent the two forms of competition complement or harm each other. The question cannot be addressed in a systematic way in this paper but it will underlie some of the issues discussed below in the context of the EU. Inasmuch as the form of competition we are the most interested in is comparative performance competition, which is largely based on the capacity of governments to innovate, we will see that the question often arises of whether this form of competition is not hindered by the effects of the other form, that is, competition based on mobility and in particular tax-induced mobility.

Vertical competition

Contrary to horizontal competition, vertical competition cannot be based on mobility. Two other types are conceivable. One involves some rivalry over the same tax base – as when both a central government and a junior government share the tax income base and independently set the tax rates.

The other is, again, comparative performance competition. If A is a country and B a region of that country, voters in B compare the performance of B's government with that of A's. If they are pleased with the performance of B's government more than with the performance of A's government, this makes them on average more likely to vote for the incumbents in the next *regional* election and less likely to vote for the incumbents in the next *national* one. This provides elected office-holders with the same kind of incentives as those noted above in the context of performance-based horizontal competition.

For performance-based vertical competition to be possible, it is preferable that the different levels of government do not fulfill completely different and separate functions.[7] It is better if there are some shared attributions – designed as such, or the result of an imperfect and flexible assignment of tasks among levels (as is the case in all governmental systems). Admittedly, there are limits to the positive effects citizens can expect from that flexibility. Pushed too far, a confusion of tasks among levels would increase rather than mitigate the problems that citizens encounter to get what they want from the public sector as a whole.

Without proper arrangements, vertical competition may also be highly unstable. Competition in general suggests some kind of symmetry or equality between the competitors, whereas vertical relations between levels of jurisdiction are typically asymmetric and unequal. This explains that the distinction between merely decentralized and genuinely federal systems becomes relevant mainly in the context of vertical competition. In federal systems, level-2 governments enjoy some constitutional protection against the deeds of the central government. In addition, they typically organize as they wish their non-federal relationship with level-three governments. To some extent thus vertical competition between level 1 and level 2 is among equals. In systems that are not federal, even when they are decentralized, level-2 governments are more like simple agents of the central government. In addition, they typically do not enjoy the right to deal as they wish with level-3 governments, which are also more or less like agents of the central government. That distinction is somewhat blurred by the use of discretionary grants and the existence of limits to tax autonomy.

The European Union stylized

Decentralization in the EU includes both the question of decentralization within member countries and that of the way responsibilities are distributed or shared between these countries and the European institutions in Brussels, Luxembourg, Strasbourg, or Frankfurt (hereafter "Brussels"). These two questions are not unrelated.[8] To discuss them within a common framework, central and subnational levels of governments in the member countries together with the European level of decision-making will be considered as elements of one single governmental system, stylized as a four-tier governmental system. At the bottom, so to say, the local or municipal level (level 4) is very, and perhaps increasingly, important in the eyes of citizens. At the same time, in several of the countries, it faces financial difficulties or obstacles to gain or maintain its fiscal autonomy. Between this level and that of the central governments of the member states, it will be convenient to assume one level and refer to it as the "regional level" (level 3).[9] The importance of this level is a central characteristic of federal countries and is increasing in most others. Still, national differences remain considerable. The level of the countries' central governments (level 2) remains by far the most important, especially with regard to fiscal matters.

The interpretation of decision-making at the level of "Brussels" (level 1) is the most controversial. The EU is a hybrid. Ackerman (1997) claims the existence of a continuum between international treaties and federal constitutions, and thus between international organizations and federations. It is clear, as Ackerman notes, that the European Community/Union has moved a long way, along the continuum, towards the latter. This is true mostly with regard to the capacity to legislate or regulate. For some time the main mechanism enhancing that capacity was the remarkable way the European Court of Justice succeeded, together with the (non-constitutional) courts in the member countries, in imposing an interpretation of the Treaty of Rome that implied the supremacy of European law over national law, in the vast policy areas covered, directly or indirectly, by this Treaty, as well as the "direct effect" of a large subset of European law in legal proceedings in the member countries. This established a hierarchy of laws typical of federal systems (Weatherhill, 1995). Since the Single Act of 1986, the capacity to legislate is also enhanced by a much enlarged room for qualified majority voting in the Council of Ministers. Finally, new regulatory powers on fiscal discipline have been introduced in the wake of the EMU. The institutions in "Brussels," however, are still far from constituting a federal government, particularly because of the very limited amount of financial and human resources they can avail themselves of.

Among participants in the political debate on the future of Europe, the preferred distinction is between "supranational" and "intergovernmental" decision-making. Both kinds of decision-making mechanisms currently play a role in the current EU arrangements, and will continue to do so in the foreseeable future.[10]

Elements of supranationality in "Brussels" include the European Court of Justice, or more generally the hierarchy of laws referred to above, the European Parliament, and, now, the European Central Bank; they also include the Commission, with its bureaucracy, and the use of majority-voting in the Council of Ministers. Elements of intergovernmentalism are the requirement of unanimity-voting in the Council of Ministers in many policy areas and the strategic role of the European Council – a regular "summit" among the heads of government and the president of the Commission. As a consequence of supranationality, there are many things that can legally be imposed on any country against its will, but as a consequence of intergovernmentalism, there are also many decisions that any country can veto if it wishes.

This does not mean, as if often believed, that there is a precise dividing line between two sets of issues, depending on whether they can be decided by majority-voting. In a setup in which the same decision-making institution operates in many areas, even if it can have recourse without restriction to majority-voting, there will always be a strong incentive among decision-makers to bargain and engage into trading positions over issues (Cooter, 2000). The fact that, for some types of decisions, majority-voting is unavailable and unanimity required can only strengthen that incentive. The consequence, in the EU context, is that the representatives of countries will often accept measures that they do not like and, because they belong to the "unanimity requirement" category, could oppose. Conversely, a qualified majority, even when it is entitled to do so, will typically avoid imposing on a country a solution that its representatives intensely disapprove of (and which they consider as important). This does not imply that the extension of the domain of qualified majority-voting is unimportant. When the representative of a country is opposed to a proposal and a majority does not impose its adoption even though it could, a cost is incurred, a debt is subscribed which will have to be repaid in the form of a concession in another area or on another occasion. Majority-voting sometimes exerts its power in a straightforward way. On other occasions, decision-making will require complicated bargaining and the reliance on the leadership of some member countries.[11]

The intricate combination of bargaining over several issues simultaneously and of voting, which is thus a fundamental characteristic of current arrangements, is not likely to be clarified in the near future, and even less likely to be replaced by a well-designed "federalist" constitution. The most obvious reason is the well-known divergence, among the different countries, of conceptions about European integration as a whole. But, more fundamentally, keeping in the dark the final aims or destination of European integration, as well as the significance of its major steps, has always been and is likely to remain central to the whole undertaking even in the countries that are the most favorable to it.[12] Supranationality has gone quite far in some areas because it seemed clear that intergovernmentalism was not seriously challenged in principle and remained available if really needed.

The most important point to keep in mind is this availability of intergovernmental decision-making when it is really needed. It offers each country a safeguard with regard to its most basic interests. But it also implies that if a majority is frustrated by the rule of unanimity of a collective decision to which its members give a high priority, it will often be able to overcome that obstacle by the means of exchanges and side-payments. Sometimes the intensity of interests and preferences is symmetrical, and relative power will settle the matter, or the status quo will prevail and there will be talk of a deadlock. Often though that deadlock will be only apparent, and the apparent impotence of the majority reflect or hide half-hearted demands or insincere priorities.

The "level-playing field" logic and horizontal competition

A benefit that one may expect from horizontal competition is that governments experiment and innovate, that is, try to make new services available to citizens or to implement new or more efficient ways to deliver the existing ones. This has been called "laboratory federalism" (Oates, 1999). However, a government that departs from what other governments are doing almost always fragments the economic space.[13] As a result of its innovativeness, it creates a non-tariff and non-border barrier to trade – implying additional transaction costs for private-sector activities that straddle jurisdictions and rents for those that do not – and/or a distortion. Examples include the side-effects of domestic regulations or the distortions of competition among firms stemming from subsidizing some of them. Differences in tax systems or in legal systems across jurisdictions, even though they seem almost essential characteristics of autonomy, are also a source of fragmentation of the economic space and of additional costs for interjurisdictional activities.

In Europe an increasingly ambitious agenda elimination of all barriers to trade and distortions of competition has been adopted. Domestic policies constitute a target of that program as a result of the emphasis on the elimination of "non-border" barriers to trade. Subsidies to firms are another equally important target as a result of the program attempting to implement "fair competition" and a "level-playing field." This may seriously limit the autonomy of national and subnational governments. The question is whether the decision-making capacity that they lose mainly goes to the private sector (deregulation) or to collective decision-making in Brussels (centralization). Ironically, the more ambitious the content given to the objectives of free trade and level-playing field, the more centralization will tend to prevail over deregulation.

Until the Single Act of 1986, the judicial interpretation of the dispositions and legal rank of the Treaty of Rome was essential. It gave the principle of freedom of trade and movement a constitutional status comparable to that of the Commerce Clause in the US Constitution (Majone, 1996). At the same time, the capacity to regulate at the European level was hampered by the rule of unanimous decision-making. In this setting, everything depended on the activism of the courts – and of the part the European Commission that plays a role akin to that of the courts. With sufficient activism on their part, many activities of national and subnational governments could be prohibited or curtailed. This process of "negative integration," or "integration by law" thus gave some apparent plausibility to the prospect of a European Union resembling the US economy of the nineteenth century in the two characteristics that made it successful, according to Barry Weingast's "market-preserving federalism" (1993): "the authority to regulate markets … not vested with the highest political government in the hierarchy," and "the lower governments … prevented from using their regulatory authority to erect trade barriers against the goods and services from other political units." However, if trade barriers are interpreted as including all the side-effects of interjurisdictional trade of the activities of national and subnational governments, Weingast's two requirements imply a down-sizing of government in general that is, clearly given what is expected from it in modern societies, clearly unrealistic in the European context.[14]

In any case, the perspective introduced by the Single Act of 1986 and the 1992 project is completely different. Its two main ingredients are, thanks to greater allowance of majority-voting in the Council of Ministers, a much enhanced capacity to make laws or regulate at the level of the EU and a renewed emphasis on the achievement of a perfect internal market, implying the eradication of all barriers to trade and competition distortions.[15] The combined effect of these two ingredients has been an extensive process of harmonization or standardization of regulation. Member-state and subnational governments have been deprived of much of their autonomy in some areas, but the main regulatory capacity has been firmly relocated at the center – not quite the division of responsibilities prescribed by Weingast as a condition for "market-preserving federalism."

The principle of subsidiarity introduced in the Treaty of Maastricht reflects a new concern with the protection of some decision-making capacity at the subcentral levels of government (i.e. national and subnational levels). But, it is not clear that the contradiction between extensive interpretations of subsidiarity and subcentral government autonomy on the one hand, and the single-market and fair-competition agenda on the other hand is as yet fully perceived. Centralization is still widely imputed to the bureaucrats in Brussels, not to the partisans of unfettered markets in London and elsewhere.

The experience of federations such as the United States, Canada or Switzerland, however, shows that fairly unified internal markets are quite compatible with states, provinces and cantons remaining free to implement policies that, as side-effects, generate non-border barriers to trade among them. In similar fashion, both the normative principle that competition must be enforced for the benefit of consumers rather than for the convenience of competitors (Mueller, 2000), and, the practices in existing federations suggest a relative tolerance of subcentral government subsidies to private firms, whether for stabilizing local employment or for other possibly legitimate purposes.[16]

Tax competition and the erosion of governments' capacity to compete

The mobility of factors of production, firms and individuals may erode the tax resources available to subcentral governments. It may compel governments to engage in tax competition, that is, in a game in which each government reduces the taxation of mobile tax payers in view of attracting more of them. This may hinder the capacity of governments to act and compete along other dimensions. Governments could be prevented by this mobility to implement social or redistributive policies for instance. Thus, governments may want to limit tax competition.

The reassignment of significant taxation powers to the level of the Union, as would be recommended by the theory of fiscal federalism, is not on the political agenda, and will not be in the foreseeable future. However, the same is not true of tax harmonization, espoused in principle by governments of the EU member countries, as well as the Commission itself.[17] We saw that with respect to regulation, member countries and the Commission are able to harmonize their policies and limit competition when they want to, even if that implies for instance moving from unanimous to majority voting in the domain concerned. There has been, however, relatively little tax harmonization so far in the EU.[18] This raises an interesting question, almost a puzzle, whose discussion introduces some of the major issues.

In the EU, decision-making in fiscal matters is still subject to the rule of unanimity. And tax competition, contrary to what is sometimes believed, is not a prisoner's dilemma, that is, a game in which every participant loses in comparison to what would result from the adoption by all of a cooperative strategy (Dehejiya and Genschel, 1999). To simplify the exposition, let us neglect for a while the existence of a government-output counterpart to taxation but assume nonetheless that tax-induced mobility is not perfect (Wildasin, 2000). This allows that, at equilibrium, taxes on mobile taxpayers are unequal across countries – in particular, not equal to zero – and that some, typically small, countries obtain more tax resources than they would without tax competition, whereas others, typically large countries, get less. Hence an apparently straightforward explanation of the deadlock over tax harmonization: some member countries profit from tax competition and veto anything that could be done to limit it (see, e.g. Scharpf, 1999, p. 114). Actually, countries like Luxembourg profit from tax competition and thwart the adoption of various schemes demanded by countries such as Germany or France to limit it.

The main objection to this explanation stems from the nature of decision-making in the EU when issues are really important, and whether or not a rule of unanimity applies. As we saw, issues are or can be connected, and positions over them traded. This implies that if a majority intensively wishes something, it usually finds ways (interpretable as side-payments and/or as forms of arm-twisting) to overcome the opposition of a minority. Thus, if Germany, Italy, France and most other countries strongly wish that a policy of tax harmonization be implemented at the level of the EU, the opposition of a few countries (even including the United Kingdom) will not be able to block it forever in spite of unanimity rule. This suggests that the explanation of the enduring absence of tax harmonization should also, or perhaps mainly, be sought in the calculus of the countries that apparently press for it. In other words, the question is of how strong or intense is the interest of the governments of countries such as Germany, France or Italy in having real tax harmonization at the level of EU.

This brings us to a second answer, which assumes that mobility-based competition operates not only over taxes but also over benefits, that is, of public sector outputs. Firms deciding about the location of an activity look not only at taxation but also at the supply of public services and infrastructure, the security of transactions, the living conditions for their personnel, all matters that are, as a rule, positively related to public spending and thus to taxation. Individuals who decide about where they will live reason more or less in the same way. The logic of the Tiebout and of the Oates and Schwab models implies that some firms and individuals will choose a location in which the level of both taxes and public services is high and others will choose locations in which this level is low. According to models of perfect mobility such as these, we should not expect to observe at equilibrium a positive difference between what mobile tax payers pay and what they receive.

How important would this difference be in the absence of tax-induced mobility? In other words, how much discretionary financial power, or redistribution power, is lost for governments as a result of tax-induced mobility? Clearly a lot, in the opinion of all the authors, like Hans-Werner Sinn (1997; 1998), who express the fear that the whole welfare state, typical of the socio-economic systems of the member countries of the EU, will not survive unlimited mobility-based tax competition (see, e.g. Sinn, 1997; Fitoussi, 2000). However, one feels inclined to doubt this, and may argue that true redistribution typically involved in the welfare state, and, more generally, in the government policies of the member countries of the EU, is, and has always been, relatively small. Thus, a large part of the schemes under the welfare state are either financed by those who directly benefit from them, or enter more indirectly into the aggregate benefits that mobile tax payers typically consider before making their decision. The bulk of social insurance, pensions, unemployment benefits, etc., is largely financed directly, or indirectly in the form of lower direct remunerations, by the wages-earners themselves – a fact, incidentally, that allows considerable variation in the social systems of the member countries and explains that such variation does not raise the major problems one might have expected. Less obviously, government outputs such as education, assistance to the poor, housing, cultural policies, etc., may also enter the set of benefits that motivates the decision to move to or remain in a particular place.

I will not try to provide empirical evidence to support that alternative view, except the salient fact that, so far, the welfare state is still not doing so badly in several of the member countries (certainly France, for instance). In any case, this alternative view does not purport to account completely for the relative passivity of member countries with regard to tax competition. First, it does not deny the existence of an important residual of true redistribution at the heart of the ambitious, apparently redistributive, programs making up the welfare state. Second, it glosses over a number of difficulties raised by tax competition even when the purpose of a policy is not redistributive – with for instance moral hazard leading to “fiscal nomadism,” that is, to people moving from one jurisdiction to another at different moments of their life (see Sinn, 1998; Le Cacheux, 2000). What the argument does is only to suggest one reason why governments may not find the problem of tax competition as dramatic or pressing as it looks.

The third conceivable answer to our question can be summarized as follows: because of globalization, tax harmonization at the level of the EU would be ineffective. Perhaps there is no setting, short of the whole world, in which tax harmonization would be really effective (see Breton, 1998; Tanzi, 1999). But, in any case, the OECD seems to provide a more appropriate setting than does the EU (see, e.g. Avi-Yonah, 2000). This reasoning mainly concerns the taxation of income from financial capital, because the latter is very mobile and able to move almost costlessly, it seems, to places out of the reach of the EU, if tax harmonization is attempted there.

This widely-held argument does not account as much as it seems for the relative inaction observed at the level of the EU. The reason is that it assumes taxation according to the source principle, which renders possible tax avoidance without residential mobility. According to that principle, a resident in jurisdiction A, owning an asset located in jurisdiction B, pays taxes on the income generated by this asset, and/or taxes on the value of the asset itself, exclusively to the government of B. This allows the resident in A – perfectly legally and openly (as indicated by the use of the term "tax avoidance") and without having to leave jurisdiction A – to choose, as a location of the asset, a jurisdiction in which the tax is as small as possible.

Nothing compels the government of jurisdiction A to accept this system and, in fact, many governments do not.[19] It could unilaterally adopt the residence principle, in which case the same resident in A would have to pay the government of A a tax on the income and/or the value of the asset located in B, in addition to the tax it pays the government of B – if there is no double taxation agreement between A and B, and if the government of B adopts the source principle.[20] If the tax is smaller in B than it is in A, to profit from that difference, the resident in A would now need either to move out of jurisdiction A or to engage not in tax avoidance but in tax evasion, an illegal and covert activity.

This reasoning can be extended to firms.[21] Profits are either distributed or retained. Distributed earnings can be dealt with as above. Retained earnings are normally reflected in an increase in the value of equities, and can thus be reached by the means either of a capital gain tax or of a general wealth tax, again levied by the government of the jurisdiction in which the owners have their residence.

When the residence principle applies, only fraud (tax evasion) and residential mobility account for the erosion of the tax base. However, neither fraud nor residential mobility are costless. In particular, governments have many means at their disposal to make fraud costly. Among these means, a particularly powerful one is to compel banks to report certain operations to fiscal authorities, or to act in part as agents or representatives of the fiscal authorities and implement certain rules. The US government, for instance, is very active and fairly successful in dissuading its residents to use tax havens abroad to evade taxes that they owe it (the US government) according to the residence principle. Of course, the US government's exceptional might allows it to exert on international banking an influence and obtain from it concessions that other governments, acting separately, cannot also hope to obtain. But, this is precisely where a common EU policy aiming at a broader implementation of the residence principle, and a more effective fight against tax evasion on the part of its residents, could be effective. Furthermore, if such an EU policy existed along the American one, the pressure on the rest of the world – in which most tax havens already are located, could be much strengthened. Again, what looms is the suspicion that the EU governments, whatever they say, do not give a very high priority to this matter.

A fourth answer is inspired by the empirical work done on tax competition in Switzerland by Lars Feld, Gebhard Kirchgässner, and the late Werner Pommerehne.[22] As stressed also by David McKay (2000), Switzerland is a very decentralized federal system in which the three levels of government (communes, cantons and the federation) enjoy a large degree of tax autonomy, in which, at least originally, the central government could rely only on indirect taxes (as in the EU, direct taxation on income and wealth were for a long time allowed only at the lower-tiers of government), and in which social and redistribution policies are to a relatively large degree decided or implemented in a decentralized way.[23] Thus, in this case, there is simultaneously: first, tax competition and significant differences in tax rates across jurisdictions; second, a significant effect on the residential choices of wealthy citizens and the location of firms; and third, although a few systemic adjustments have had to be made, no strong tendency toward the erosion of the tax base available for discretionary spending by the two lower tiers of government.

The EU will not emulate Switzerland. Among the major differences, one must note that the policy implementation of interjurisdictional equity considerations (inspiring fiscal equalization, vertical grants, national minimum standard of quality in the provision of public services and social insurance, etc.) – even though not as important as in most other federations – is a characteristic of the Swiss system that the EU will probably not share for a long time.[24] Redistribution across member countries of the EU is and will remain limited – as we will see, the cohesion and structural funds are motivated mainly by other considerations. What the example of Switzerland shows, however, is that substantial tax-induced mobility is sustainable without reducing dramatically the policy-making capacity and autonomy of the governments that are submitted to it.

There are reasons to think that financial problems raised by mobility may become more serious in the medium term. These reasons are: enlargement, with accession of Eastern European countries, which may induce a large immigration in the richest parts of the EU (Sinn, 2000); English becoming a common second language spoken by almost all in the younger generations, which may eliminate a major obstacle to labor mobility; homogenization of "Euroland," in the wake of the EMU, which may also increase mobility and encourage comparisons; and delayed effects first of Schengen and then of the EU "citizenship" included in the Treaty of Maastricht, which gives the citizens of the member countries the right and the enhanced incentives to move to any place in the EU.[25] However, if the problems were to become really serious, with for instance the welfare state systems really at stake, as suggested by Sinn, it is very likely that the decision-making system of the EU would ensure that it be effectively dealt with.[26]

EU-induced constraints on deficits and borrowing

Until the Treaty of Maastricht and the EMU, member countries were perfectly free to run public deficits and to accumulate public debt as they wished, and some of them, Belgium and Italy notably, used that freedom to a degree often considered as excessive. This did not mean that no constraints were imposed by central governments (or, in some cases, by constitutions) on the deficits and borrowing of subcentral government. Finland, France, Portugal and Sweden had no such control but all the other member countries had, of one kind or another (see Ter-Minassian and Craig, 1997). Each country could adopt in this matter the rules that it found best, even with regard to borrowing abroad.

The Treaty of Maastricht changed the situation, at least for the countries that have joined the monetary union. Its provisions have been specified and made more stringent in the Pact for Stability and Growth agreed in 1997. The Pact specifies the conditions under which a country will have the right or may be authorized by the Council of Ministers to exceed the ceiling of 3 percent of GDP for its public deficit. It also spells out an enforcement mechanism, which includes a mandatory deposit transformable two years later into a fine. Finally, it also prescribes balanced budgets or budgets in surplus in normal times or on average.

A first question is whether these constraints are really necessary from a macroeconomic perspective. The opinion of specialists is divided, but there seems to be a growing consensus that they are not. Given the independence of the European Central Bank (and in particular its commitment to a non bail-out rule), the excessive indebtedness of a member state or of a subnational entity is not likely to be inflationary, through monetization of the debt or otherwise (this was the main fear underlying the Pact), nor, given the fact that financial markets are global, to significantly affect other countries in other negative ways (see Eichengreen and Wyplosz, 1998). The demonstration that the Pact, and the limitations included in the Maastricht Treaty itself, are unnecessary is fairly convincing. Still, the means of control (or interference) provided the collectivity of member countries and the EU institutions over the behavior of any single country may turn out to be useful in some unforeseeable circumstances (the coming to power of a populist party, for instance).

Alternatively, the question is whether the fiscal constraints may not be seriously harmful. At a time when member state governments are deprived of their monetary policies, is it not dangerous to limit also, as the Pact does, their capacity to act by the means of fiscal policy? How will they face idiosyncratic shocks? This is a good question, although the likelihood of supposedly devastating idiosyncratic or asymmetric shocks is not that obvious in the case of the EU. Again, Barry Eichengreen and Charles Wyplosz[27] suggest that the Pact is not likely to be more than "a minor nuisance" as it embodies a lot of flexibility, not so much because of its dispositions, but mainly because this is the way things work in the EU.

A third set of questions concerns the implications of the Pact for subnational governments and their relationship with national governments. This aspect is perhaps the most interesting, even though there is (or I have found) not enough material as yet to discuss it with a minimum of confidence (but see other chapters in this volume). How will the various levels of government in a given country decide how to share the amount of deficit available for the country as a whole? This amount is not necessarily equal to 3 percent of GDP because the Pact includes also a prescription (no deficit or even a little surplus) for normal times and, in case of the deficit exceeding 3 percent, a treatment that varies with the extent of the excess. Thus, a national government should maintain a kind of target or view about the overall deficit or surplus that it would be reasonable to have. The lower-tier governments are not likely to concern themselves directly with that question. However, at any moment of time they share among themselves and with the national government what comes down to a single budgetary constraint. Thus, there may be a common pool problem.

As noted, in many member countries central governments already had large powers of control over the deficits and/or the amount of debt incurred at the lower levels of government. It is possible that the Stability Pact, in the future if not immediately, will lead to new controls, or forms of control, in the countries that had none, or in those in which they were relatively lax. This would reduce the autonomy of subnational governments. Perhaps the main risk then is that national governments might use their enhanced power of control over deficits and borrowing to crowd out the capacity to borrow of the lower-level governments. This would be a serious problem in the countries in which these lower-level governments or jurisdictions are responsible for a large part of public infrastructures and capital formation. It would significantly hamper the capacity of governments at the same level to compete among themselves.

In the case of countries in which, at least for the time being, there is no central control of deficits and borrowing at subnational level, or where there are only general rules (e.g. the exclusion of some forms of borrowing or of some types of lenders) which do not constrain these variables in quantitative terms, there is an intellectually challenging indeterminacy about what will happen. From a theoretical point of view, one may think of various games (Stackelberg, cooperative games, sequential bargaining, etc.) that governments can play in such a setting.[28]

Vertical competition in the EU multi-level governmental system

In the section The European Union stylized we characterized the set of political authorities in the EU as a four-tier governmental system. There is still an element of anticipation in that characterization, but much less than only a decade ago. The system evolved rapidly away from a situation in which the domination of level 2 – nation-states' governments – was overwhelming almost everywhere (only a little less so in a federal country like Germany). Level 2 remains the most important, but it has lost many attributions in favor of the EU level – in which, however, national governments are also active actors. Two current transfers of power are in the area of monetary policy and, to a lesser extent (as we saw) in the area of aggregate fiscal policy. An interpretation was offered in the section on Tax competition and the erosion of government's capacity to compete of why progress in the area of tax harmonization has been so slow, and reservations formulated in the section on The "level-playing field" and horizontal competition about the degree to which the freedom of governments to attempt original domestic policies is being constrained in the name of an eradication of barriers to trade and distortions of competition. Several other areas are candidates for upward reassignments of competence. Perhaps the most promising among these areas in the near future is immigration policy. Because of the Schengen agreement, for authorizing temporary entry in the space of the EU each country is in a sense the agent of all the others, which creates a free rider problem. Although less pressing, this time not because of Schengen but because of the freedom to reside anywhere in the EU, the same issue arises with the awarding of rights of residence. In most cases, transfers of competence will remain partial and result in shared attributions – which facilitates vertical competition and, up to a degree, also horizontal competition.

Because level 2 will remain the major one, and because emphasis was put above on performance-based competition – which includes competition by innovation – it must be stressed that, in spite of the problems discussed in the previous sections, competition among national state governments remains very active. They have lost some of their powers but this is compensated by comparisons having become easier. Citizens of the member countries are more able than in the past to compare what obtains in their own country with what obtains in the others with regard to unemployment, overall level of taxation, incomes per head and rates of growth, etc., and the governments of member countries do their best to perform – and make known that they perform – as well as, or better than the neighbors along these dimensions.[29]

Admittedly, some aspects of horizontal competition have emerged at the level of the EU itself. Comparisons of the performance of the EU as a whole to that of the United States are not unusual anymore in some areas (unemployment, exchange rates, etc.) and may have some influence on the degrees of satisfaction or of dissatisfaction that people express towards the EU or towards their own national governments. This still embryonic phenomenon, however, is not a serious challenge to the relevance of horizontal competition at the member-state level.

Another level on which horizontal competition is, as a rule, extremely active is level 4, that of municipalities, especially the large cities. They compete in many dimensions – most of them important to voters or to some influential categories of voters. Thus, they compete in terms of amenities, urbanism, transports, cultural facilities, exhibition and conference centers, the attraction of tourists and businessmen, economic activities, and, where they may, levels of taxes and subsidies. Competition among municipalities is increasingly less segmented by national borders. Urbanistic innovations (roundabouts, pedestrian zones, tramways, etc.) spread across national borders with amazing rapidity. Citizens typically heed what happens in their city and willingly compare it to what they know or have seen of others. In several of the member countries, the mayors of large cities (or their equivalents) are important persons, known and influential nationally. Thus, maintaining as much autonomy as possible at that level seems clearly advisable.

Level 3, for the EU as a whole, is very heterogeneous. The powers and resources available to governments situated at this level ("regional" government in our stylized account), as well as the tasks they are delegated to implement on behalf of the central government, vary considerably across member-countries (and in some cases – not only the United Kingdom – even within a single country). So does the intensity of the level-3 horizontal competition that takes place within each country. This is a major obstacle to the development of level-3 competition across national borders. This is also a disincentive to attempt a description of the situation here (especially since comparative quantitative indicators are very misleading as means for gauging the degree of autonomy of the governments situated at this level). Level 3 will consequently be considered here only inasmuch as what happens on it is fairly directly related to mechanisms operating at the level of and in relation with the EU.

The following seven points concern vertical competition.

1. To understand the centralization trend always present in the EU, one must be aware of an important factor: the existence, since the early days of Jean Monnet, Robert Schuman, etc. of a European integration or construction, or "ever-closer-union," project, whose advancement is always in the back of the mind of the Commission in Brussels, and, behind the Commission, of majorities or influential minorities (of citizens, elites, opinion, etc.) in a majority of the member countries of the EU (Salmon, 1995). Those who support this project will tend to welcome occasions to transfer new responsibilities to the Brussels level. For that purpose they will be prone to conclude alliances with various other constituencies, pursuing completely different objectives. Thus, depending on the circumstances, they will ally with groups and politicians mainly concerned with continuing redistribution in favor of farmers, with constituencies anxious to save the welfare state, with large firms concerned with reducing transaction costs, with regional actors thirsty for subsidies, or with the supporters of competitive markets who demand that national public services monopolies be dismantled.[30] There is also an active opposition to that project, although it must be stressed first that the expression "ever-closer-union" is included in the official documents agreed on by all the governments, and, second, that the politicians and other individuals who oppose increased supranationality often justify their position by the claim that it is too early for it, that public opinion is not ready, that there is no European identity yet, etc. – which shows that they do not contest at least openly the direction in the absolute.

Other factors of centralization are subsidiary to this main one. This is the case of the natural or predictable expansionism of the bureaucracy of Brussels and activism of the European Court of Justice, of the logic of the "level-playing field" and "completion of the internal market" whose centralizing effects we discussed in the section on The "level-playing field" and horizontal competition, or of the launching of the EMU. None of these factors of centralization would have been left free to exist or to develop their effects as they have if there had been no European construction bias in the background. It is probably true that the establishment of a real federation, with powers constitutionally owned by the two levels of government, and vertical fair competition between the two, would put an end to this centralization bias (see Breton, 1996; Breton *et al.*, 1998). But that would mean that the construction of Europe, helped by the centralization bias, has achieved its ends, which in a sense begs the question (see section on The European Union Stylized and Salmon, 1995).

2. Subsidiarity, introduced in the Treaty of Maastricht, is a welcome signal that limits to some of these tendencies need be kept in mind, but not too much should be expected from it as long as the EU is not a real federation.[31] With regard to the relation between Brussels and the member states, subsidiarity may have influenced a little the rulings of the European Court of Justice, inspired some acts of restraint on the part of the Commission, and strengthened somewhat the arguments of those who were hostile anyway to new steps in European integration. With regard to decentralization within member countries, towards subnational government, a process which the principle of subsidiarity prescribes, one must admit that the momentous movements of decentralization or devolution that took place in Belgium and Spain, the more limited ones that took place in Italy and France, or more recently, in the United Kingdom, the devolution in favor of Scotland and Wales, have nothing or almost nothing to do with it.

3. More generally, the intervention of the institutions of Brussels at the level of subnational government has had a modest impact so far, except for a few countries. An important factor, of course, is the relative modest level of the funds available to Brussels, and their dependence on the acquiescence of the member states. Thus the history of EU support to regional development reads largely like a series of side-payments – in the 1980s (the so-called Integrated Mediterranean Programs), to compensate France, Greece and Italy for the impact of competition by the agriculture of the new member countries, Portugal and Spain; in 1988 (doubling of the budget of the structural funds) to secure the adhesion of the poorer member countries to the Single Market Program; in 1992 (cohesion fund), to get the agreement of Spain and other countries on the Danish opt-outs from the Maastricht Treaty.

Still, in 1988, a relatively ambitious policy of intervention via the structural funds was initiated mainly under the influence of Jacques Delors. His purpose was, it seems, to build up the influence of the EU on subnational government and to induce governments at the subnational level to become active participants in the working of the EU (see Hooghe, 1996). This new orientation of EU policy-making has made that the allocation of funds from Brussels to regional projects has become much more autonomous with regard to the regional development programs of the member states. This has effectively induced, together with other reasons, many regional governments to establish direct links with Brussels. It has also fostered the organization and strengthening of the regional level in some countries (e.g. Greece, Portugal, Ireland) that could qualify for support but in which governments at level 3 were nonexistent or weak. On the other hand, its impact in countries in which the regional government level was powerful (e.g. Germany, with its Länder), or regional programs very large (e.g. Italy, with the programs for the Mezzogiorno), has been limited.

The programs based on the structural and cohesion funds have been given a less ambitious interpretation on the occasion of two reforms, in 1993 and 1999. According to a recent assessment, these reforms, however, have not led to a renationalization of the distribution of the funds (Suttcliffe, 2000). Delors's strategy could have led to the creation of a fairly strong direct channel of influence between level 1 and level 3, by-passing level 2. This has not happened so far. The creation, in the wake of the EMU, of a consultative assembly, in which both the regional and the municipal governments are represented, in proportions decided by the member states, has had a limited impact. Things may change, but for the time being, the member countries still organize as they want the relations between levels within their borders.

One possible factor of change, noted also in contexts other than EU (Canada, for instance), is that the supranational organization slowly replaces nation-states in a number of functions and thus makes separation of subnational units from these nation-states much less costly or risky for these units. But this widely noted mechanism can also play against decentralization. It may induce the governments of the nation-states to give as little powers as possible to subnational levels. Again, for the time being, the phenomenon is not very significant, it seems.

4. In member states that are unitary, the organization of relations between the three levels below "Brussels" is left to national governments. In the perspective of a vertical competition between the central government and the two lower levels, this may create a conflict of interest. A central government (level 2) that is losing this competition may be inclined to deprive its competitors of the resources they need to compete, or may be tempted to re-centralize a number of policy areas it conceded them or shared with them. This danger is particularly serious if lower-level governments have little tax autonomy and are very dependent on grants. Still, one must note that there has been substantial decentralization in several unitary member states – for example, Italy and France – and with the exception of the United Kingdom in the 1980s, nowhere any serious tendency to re-centralize. In some cases, constitutional courts have played a role to protect junior governments (against the infringements of their autonomy by the executive branch of the central government mainly, not, as a rule, against the legislative branch). But more general mechanisms of protection are the monitoring of decentralization by public opinion and the voters themselves, and the power and influence of locally active politicians (Salmon, 2000). The fact that member state governments are themselves engaged in tournaments or yardstick competition can also help to explain that they choose to decentralize some tasks. Thus, decentralization in one country may be imitated in other countries, both because the level of decentralization *per se* may be for voters an object of comparison across countries, and because decentralization may be seen by politicians as a means to improve their comparative performance (across countries again) regarding the policy outputs (education, health, etc.) assessed by voters.

5. In federal, quasi-federal or would-be federal member countries (Germany, Spain, Belgium, Austria, UK in part), the relationship between level-2 and level-3 governments are more like that between equals. This certainly makes vertical competition between levels 2 and 3 much more straightforward. An important question is how level 4 fares in federal systems. In Salmon (2000), it is argued that, ironically, the level of local government may be better protected in unitary states than in federal ones (see also Conseil de l'Europe, 1998, p. 43). As noted, it is typical of federal arrangements that regions are

not themselves federal systems, and that regions are left the responsibility to define the role of cities and organize their relations with them (especially with regard to taxation and grants) without too much interference from the central government. In Germany, in spite of some protection of local government by the federal constitution, this has allowed, for instance, a drastic consolidation of communes to be forced on them by the Länder – an act of authority which, according to Linder (1994), would not have been possible in Switzerland, whose system is much closer to a real three-level federation. Strangely, attempts at the consolidation of communes have also aborted in a unitary country such as France.

6. More generally, how far can we move in the EU to multi-level federalism? If some day, a three-level federation such as Switzerland became a member of the EU and if the relationship between levels 1 and 2 became more clearly federal, we would have a four-level federation. Does that exist elsewhere? Is it possible? How would it work in a context of vertical competition? Is there an optimal number of levels? These issues have not arisen too much in the theory of fiscal federalism, which does not make a strong distinction between federal arrangements and decentralization. They are necessarily important in theories that stress vertical competition. Very decentralized forms of federalism at all levels seem unlikely. At the limit, if level-3 governments (e.g. Catalonia, Scotland, etc.) become really very autonomous, this may raise serious problems to the EU system (e.g. how commitments made in Brussels by level-2 governments bind level-3 governments, a problem that already arises in a mild form, in Germany notably) and lead to a secession of some level-3 regions from level-2 national states, the former regions becoming full member states of the EU.

7. These reflections inspire rather mixed feelings toward the federalization of member countries which are still unitary states (a perspective which is topical in Italy in particular). One consideration already stressed is that, currently, the communal or municipal level is perhaps the most interesting level of government, and that, possibly, it is better protected against unfair vertical competition when the level responsible for monitoring that vertical competition is the national government rather the regions. Another consideration is that, in the case of a given country, three-level federalism may turn out not to work well. The country might then, in the end, have to decide between federalization upward or federalization downward. This dilemma may also result from another mechanism. For member state governments, both the transfer upward of responsibilities to the EU and the transfer downward of responsibilities to subnational governments are sources of disruption or stress. Each requires the devotion of considerable political resources. In addition, the central bureaucracy in member governments loses attributions, prestige, and incentives as a result of both reassignments. Thus, because political resources and the costs that the bureaucracy can bear are both limited, a priority must be defined. Because the centralization process is a common undertaking, a kind of public good, whereas federalizing downward is a kind of private good, there is an externality involved when a country chooses to slow down the process of integration for the purpose of concentrating on its own project. Currently, then, and from the perspective of the collective, there are reasons to give the priority to European construction.

Conclusion

Federalism, or more generally multi-level government, is a way to unify what must be unified and to allow the rest to be as diverse as possible. What should and what need not be unified? The answers that economic reasoning suggests have rarely coincided with those that policy-makers have given in the case of Europe. This has often proved frustrating to economists. One cause of this discrepancy, observable also in other domains, is that economics is not very much at ease, as yet, with the way politicians manage to pursue objectives with which they themselves, the economists, in fact agree or do not disagree. For example, the main economic effect of the Common Market has been to introduce competition and market forces in systems that it was not politically feasible to liberalize in a wider setting, as many economists recommended. Inducing pacifically or, at the limit, surreptitiously, each year, a large percentage of the poorest, most deserving, farmers to leave the farm, is an achievement of the Common Agricultural Policy, which economics, even public choice economics, is ill-equipped to appreciate.

The main cause of the discordance, though, is more specific to characteristics of the European integration process. The paper has emphasized the peculiar characteristics of decision-making in Brussels and the importance of a European construction bias. In combination, these two characteristics – constitutive of "the European method" to the assignment of responsibilities – explain that occasions are seized, as when a Socialist President of the Commission puts all his weight behind a very market-oriented program, that the natural or rational order of things is not adopted, as when the elimination of intra-European border checks precedes the adoption of a common immigration policy, or that ominous but not imminent perspectives remain unheeded, as is the case with regard to the possibility that progressively tax bases vanish and the welfare state be dismantled.

This EU method has proved its worth but has some drawbacks, especially under a perspective that emphasizes competition among governments. Because the EU method includes a bias as an essential structural characteristic, it is prone to lead to centralization to a degree that will be deemed excessive if the purpose of the bias, European construction, is not taken into account. The paper includes an examination of three areas in which the question of centralization in favor of the EU institutions arises, together with the question of whether competition and experimentation at the level of member state and subnational governments is affected. With regard to the side-effects of governments' domestic policies that may hinder trade or competition, the argument developed in this essay is that the EU policy in this area, for the purpose of eliminating all non-border barriers to trade and distortions of competition, may affect negatively the capacity of governments to innovate and compete. In the case of tax competition, the problem is the opposite. The EU has proved relatively inactive. One form of competition, mobility-based competition, affects negatively another form, performance-based competition. Among the reasons that may explain relative inaction, the one stressed in the paper is that the problems created by tax competition for the moment are not serious enough for action to become compelling. The third case concerns the fiscal discipline introduced to accompany EMU. The main conclusion of our discussion has been that, given the "European method" referred to above, the fiscal constraints will probably prove inconsequential, except perhaps with regard to the decision-making capacity of government at the subnational level. Finally, with regard to downward decentralization, from the national governments to the subnational governments, we observed that the influence of the EU is still relatively limited, which explains the variety of the arrangements adopted by the various member countries. Tentatively, the paper suggests that the upward movement of building up the EU level may be an inducement to move more cautiously in the downward direction.

Notes

* Although they are not by any means responsible for the statements and views submitted here, I wish to thank Alain Wolfelsperger as well as Giorgio Brosio, Pierre Pestieau and other participants in the IMF Conference on Fiscal Decentralization for helpful comments on an earlier draft.

1 "Centralization" and "decentralization" can be understood either as processes or as states; "decentralization" is in addition the name of the field or subject and may consequently cover references to all of these processes or states – which, although we will discuss centralization, explains the reference to decentralization only in the title of our paper.

2 These exceptions may become the rule as an outcome of the currently discussed institutional reform.

3 See, for example, Hemming and Spahn (1997).

4 See Breton (1987, 1996), Salmon (1987, 2000).

5 A position whose theoretical expression can be found, for instance, in Edwards and Keen (1996) or Fuest (2000).

6 Hence the plausibility of the theory of probabilistic voting, which more generally accounts for the fact that politicians try to please all categories of voters, even those whose vote is mainly for their competitors.

7 Preferable but not strictly indispensable. One may find the officials of B generally more diligent or friendly, less corrupt, and so on, than officials of A. Even if both groups accomplish completely separate tasks, this observed ranking may make one a little more inclined to vote for the incumbents at the next election in B and a little less inclined to vote for the incumbents at the next election in A.

8 Spahn (1997b) writes: "The European Union has emerged as a vehicle for both supranational policies and the devolution of powers to regions" (p.103). One may find the statement a bit excessive in the second half of the proposition, but must certainly agree that the two movements are connected.

9 In reality, this level is missing in Finland and Luxembourg. It is divided into two in Belgium, France, Germany, Ireland, Italy and Spain. The case of the United Kingdom is more complicated. See DEXIA, 1997.

10 On this topic, see also Ludlow (2000).

11 For an analysis of leadership in federations and in the context of integration, addressing the question of whether unified Germany was likely to play this role, see Salmon (1992).

12 In this sense, it is true that European integration is a kind of conspiracy, but not in the way or for the reasons that are usually implied when this term is used. See Salmon (1995).

13 See Breton and Salmon (2001) for a more elaborate analysis of several points made in this section. See also Breton (1996), Mueller (2000), Trebilcock and Howse (1998).

14 For a persuasive criticism of Weingast's market-preserving federalism, see Rodden and Rose-Ackerman (1997).

15 The "mutual recognition" principle, as spelled out notably by the European Court of Justice in its famous *Cassis de Dijon* ruling (1979), is also part of the "new approach" adopted in the Single Act. It says that, although the production of a good remains regulated by the government of the jurisdiction where this production takes place, the good can be freely exported to another jurisdiction whatever the regulation applicable to its production in that other jurisdiction. This clearly eliminates one barrier to the free trade of goods. The economic space remains, however, fragmented in the sense that imposed modes of production of the good are different across jurisdictions and this may distort the choice between producing in one jurisdiction or in several. It may for instance protect a local firm from a firm from another jurisdiction opening up in its own jurisdiction. It may also distort the trade of intermediate goods. Thus, if the objective is a completely unique market, mutual recognition will have to be superseded by full harmonization.

16 See also Besley and Seabright (1999).

17 For a somewhat polemical account and interpretation of this expression of interest, see Radaelli (1999).
18 There is some harmonization regarding VAT, excises and financial relations within multinational firms. In November 2000, a tentative agreement on the taxation of interest rates was reached among all member states, including (conditionally) Luxembourg.
19 Thus: "Both countries [Japan and the USA] tax income on a residence basis, which means that corporations and individuals owe tax on their worldwide income, whether earned domestically or abroad. Both countries also allow foreign interest income taxes to be credited against the domestic tax liability to prevent double taxation" (Eijffinger *et al.* 1998, p. 312).
20 As analyzed originally by Gordon (1992), the coexistence of countries that work under the residence principle and of countries that adopt the source principle may raise difficult problems when taxes paid according to the source principle can be claimed, up to a limit, as credits to reduce taxes due on the same income according to the residence principle (see the previous footnote). But, if residence-based taxation can be difficult to bear in the absence of double taxation agreements or unilateral concessions, these concessions can be withheld, and agreements are always negotiated. Thus, in addition to considering the withholding tax as only a credit against the residence-based tax, the system adopted after some bargaining and arm-twisting can, first, allow (as contemplated in the EU, among member countries) the owner of the financial asset to opt out of the withholding tax and pay instead the tax based on the residence principle directly to her own government, and, second, ensure that the bulk of the withholding tax be reversed to the country of residence. Such provisions, or others of the same kind, negotiated among the governments concerned, can bring practical arrangements quite close to what would obtain under pure residence-based taxation (but see Avi-Yonah, 2000).
21 Corporate income taxes can be given, at least to some degree, the nature of a withholding tax and dealt with, as other withholding taxes, by double taxation agreements.
22 See Kirchgässner and Pommerehne (1996), Feld (2000), Feld and Kirchgässner (2000).
23 See Spahn (1997a).
24 This difference between Switzerland and the EU is somewhat glossed over in the otherwise excellent papers of Kirchgässner and Pommerehne (1996) and, to a lesser extent, of Feld (2000).
25 In fact, Sinn typically refers to what may happen in the future rather than to what is happening now. He writes for instance (Sinn, 1998): "Traditionally, the taxation of capital has been a major source of revenue out of which welfare programmes could be financed. However, there is a risk that this source may, with the passage of time, progressively die out."
26 There may, however, be something deliberate in the toleration of tax avoidance associated with the absence of an EU policy, for instance concerns with economic growth, saving, the size of the capital stock, etc. See also Agell and Persson (2000) on tax avoidance in Sweden.
27 See Eichengreen and Wyplosz (1998), p.101.
28 For a preliminary reflection along these lines and an application to the case of France, see Guengant and Josselin (1999).
29 When the German Government launched a program of reduction, over several years, of the level of taxation, this was widely noticed and commented on in France, so much so that the French government felt literally compelled to follow suit and announce a program of almost the same magnitude.
30 The best illustration of what we have in mind here is the Single Act of 1986, agreed on, among others, by Jacques Delors, François Mitterrand and Margaret Thatcher.
31 See Breton *et al.* (1998), Inman and Rubinfeld (1998).

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6 Consensus democracy and interjurisdictional fiscal solidarity in Germany

Paul Bernd Spahn and Oliver Franz

Ten years after Germany's reunification, the nation finds itself compelled to choose between even greater interregional solidarity and subsidiarity, or greater financial autonomy of the states.

While the economy in the East still has higher unemployment, is less productive, and revives slowly, it is time to assess the past transformation policies. The 1.4 trillion Deutsche Mark (DM) net transfer to the East since 1990[1] did not have the expected positive effect on the economy and might rather be part of the problem. Some analysts already fear that the East might turn into another *Mezzogiorno*, that is, a region incapable of sustaining itself despite prolonged transfers of resources.[2]

Germany's complicated system of fiscal equalization has become one of the main fields of discussion. In particular economists, but also scholars from other fields, feel that interjurisdictional solidarity might have gone too far. A more devolved system and greater accountability of regional governments might be called for in the spirit of subsidiarity.[3]

German federalism: a brief overview

The present state of German federalism can only be understood against its historical background. During most of the nineteenth century, Germany consisted of a patchwork of mini-states subject to hegemonial interests of both German-speaking superpowers (Prussia and Austria), and of European nation states (France, Russia, and the United Kingdom). The German ambition at that time was the creation of a strong nation state to match competing European interests, both politically and economically. When the German Reich was finally established in 1871, Prussia controlled about two-thirds of economic resources in Germany, forming a highly asymmetric federation, vulnerable to centripetal tendencies and abuse of power.

Although formally a federation, with representatives of the constituent German states cooperating in a similar way as today's Council of the EU, the system had all characteristics of a monarchy with the Emperor, and his nominated cabinet, exerting the sovereign power of the Reich. While there was an elected parliament, which became a source of continuing conflict, it remained virtually powerless and without significant political influence.

After World War I, the Weimar constitution aspired to establish accountability of government to an elected parliament, but failed. A highly fragmented party system fell prey to the Nazis, which ended the short-lived democracy between the two wars. Hitler's ascent proceeded via Berlin and through Prussian institutions, the other states of the federation being impotent or unwilling to counterbalance his usurping of power.

This is why the Allies abolished the state of Prussia immediately after the War, eliminating an important asymmetry and source of political instability.

The Allies divided Germany into occupation zones that did not necessarily respect historical boundaries. These zones were basically independent from one another as each military governor was responsible to his government only. This caused a number of problems, as solutions for the whole country were possible only if the "Big Four" reached a compromise – and the Soviets and French were not inclined to do so. The Allies all agreed to the creation of *Länder* or states, and the legalization of political parties. Elections were held in the newly created states in 1946 and state constitutions were passed in the following months. However, after 1947, the relations between the Soviets and the other three Allies deteriorated, the latter by then felt that West Germany was needed as a barrier against Soviet influence.[4]

The West German states were directed by the Western Allies to constitute a federal entity. They also made it clear that the new German federation would not reach full sovereignty, but remain under Allied control in certain policy areas.[5] The Western Allies had clear perceptions of the constitution the Germans were expected to draft, which caused conflicts in preparing the new constitution – termed "Grundgesetz" (GG) to highlight its transitory and provisional character – in the hope of unification of all Allied zones into one Germany.

Federalism

The Allies had called for a federal form of government, but soon it became apparent that the perception of federalism by Americans was quite different from the German concept of *Föderalismus*.[6] The American position survived in Article 30 of the GG, which reads:

> Except as otherwise provided or permitted by this Constitution, the exercise of governmental powers and the discharge of governmental functions is incumbent on the States.

This general rule is repeated in Article 70 I GG:

> The States have the right to legislate insofar as this Constitution does not confer legislative power onto the Federation.

But there is a qualification to this general rule in paragraph two of the same Article, which has proven to be decisive during the past fifty years:

> The division of competencies between the Federation and the States is determined by the provisions of this Constitution concerning exclusive and concurrent legislative powers.

The exclusive legislative powers, listed in Article 73 GG, include defense, currency as well as weights and measures etc. all of which would be managed by the federal entity.[7] The concurrent legislative powers have proven to be extremely complex as Article 72 GG states that

> … in the field of concurrent legislative power, the States have power to legislate as long as and to the extent that the Federation does not exercise its right to legislate by statute.

In itself this constitutional provision would not be a problem, but when the constitution was drafted in 1949 the country was still devastated from the war and regional asymmetries in the supply of goods, infrastructure endowment, and local needs (e.g. the necessity to house refugees) were common. Therefore the usage of concurrent legislation was invoked in cases in which (Article 72 II GG):

> "… the establishment of equal living conditions in the federal territory or the preservation of legal and economic unity necessitates, in the interest of the state at large, a federal regulation."

Article 74 GG explicitly lists 26 policy fields in which concurrent legislation might apply. This potential for federal legislation has strengthened the position of the federal government, although the provision was originally designed to protect the sovereignty of the states. The federation has made extensive use of concurrent legislation since "balanced regional development" and "uniformity of living conditions throughout the nation" have always been (and still are) attractive features for policy making and institution building in Germany. Also solidarity between the federation and its member states, and among the member states themselves, is an important principle in almost all realms of policy.

In addition to the exclusive and concurrent legislation, Article 75 GG enables the federal government to enact framework legislation in areas under the jurisdiction of States. Thus, law making has become a federal affair in Germany whereas the administration of laws and enforcement are almost entirely organized by the states. In view of this sharing of responsibilities, the division of expenditure between the states and the federal government is not straightforward. Instead there is almost always some form of joint financing among tiers of government.

A specific instrument of joint responsibility and cofinancing was written into the constitution in 1966: Joint Tasks (Article 91a GG), similar to matching grants in the United States.[8]

Under a joint tasks program, decisions on public investment projects are taken jointly among states and the federal government within a coordinative body. Regional priorities are established through interjurisdictional negotiations and in accordance with the "uniformity of living conditions." In order to foster consensus and to express national priorities, the federal government carries a 50 percent share or more of any state's project costs under the program.[9]

Although political scientists heavily criticize joint tasks in Germany on the grounds that they blur accountability within a democratic system,[10] they can also be seen to represent a sound institutional approach to dealing with interjurisdictional spillovers and externalities in a framework of interjurisdictional contracting.

In order to preserve the sovereignty of states, there is an institutional safeguard within the process of central legislation: all important laws affecting state interests need the approval of the *Bundesrat*, the Upper House (State House or Senate), where all states are represented. However, unlike the senators in the United States, members of the *Bundesrat* are not elected, but appointed by state governments and can be recalled by them. The states' votes in the Upper House depend on the number of their inhabitants and can only be cast "en bloc."[11] As state governments are composed of the same political parties as the Lower House, or *Bundestag*, the federal government may have to deal with a second chamber whose majority is either in favor of its policies or not. Since elections are spread over the years, the majority in the Upper House might change more than once in the four-year term of a federal government.[12] If the two chambers of parliament cannot agree on a certain matter, both sides have to negotiate. This negotiation process is institutionalized in a joint Intermediation Committee, or *Vermittlungsausschuss*.[13] This institution points to another important feature of policy making in Germany: compromise and consensus.

Consensus democracy and political reality

In Germany important decisions are based on broad majorities involving virtually all relevant groups of the society. The experience of the Weimar Republic and the results of political fragmentation are still present and act as a corrective. German elections for the Lower House are based on a combination of direct voting for about 50 percent of the seats, and of indirect voting for the other half.[14] It is, therefore, hard for any one party to achieve a workable majority of its own. Instead coalition governments either led by the CDU (conservatives) or the SPD (social democrats) for over forty years now, leading to compromises within the coalition government before compromises with the Upper House.

It is argued that[15] democracies ruled by coalition governments tend to generate higher fiscal deficits and higher spending, the tendency increasing with the number of parties involved in government. As more interests have to be taken into account, policy making becomes more complicated and costly.[16] In Germany there are also strong interest groups and NGOs, such as trade unions, employers' representative bodies, and churches. Compromise is pervasive in almost all aspects of society, including in semi-autonomous public institutions.[17] This is part of a "democratization" process that started in the 1960s and remains an important policy objective.[18]

Key elements of Germany's political reality and traditions include the desire to regroup the nation in line with language and cultural heritage[19]; the readiness to share equally the fruits of national economic development and growth based on interpersonal, sectoral, and regional solidarity; and acceptance of uniform standards throughout the nation including a homogeneity of policies at lower tiers of government. German federalism is highly symmetrical as to potential outcomes. At present, there are, however, vast asymmetries in the functioning of institutions and the workings of political and bureaucratic procedures.

The uniformity of living conditions and homogeneity of policies require uniform – typically centralized[20] – guiding principles for the whole nation. This introduces a new type of asymmetry at the vertical level, leading to asymmetrical power sharing. The federation sets out a general framework for policy making for all states (and eventually municipalities), while the latter implement and administer policies within the general setting. In particular, the tax law is identical, even for state and municipal taxes,[21] and states are denied any form of own-taxation. Tax revenue is typically shared and apportioned among layers of government according to the constitution (income taxes) or law (VAT), and disbursed horizontally among regional entities according to formulae with strong equalization components.

The almost complete lack of policy discretion at lower tiers of government, and the "emptiness of the agenda" of state parliaments combined with the inability of states to use own tax instruments is exacerbated by a host of intergovernmental transfers that are all destined to foster national homogeneity and uniformity of living conditions. The equalization law, see next section, is not an aim in itself, but is a necessary and sufficient condition for the German brand of federalism, as it exists today.

German fiscal federalism – the equalization law

As numerous scholars (and one of the authors of this paper) have argued before, the German system of intergovernmental fiscal relations (i.e. the equalization law) is overcomplicated, and generates adverse incentives for the federal and state governments. The amount of redistribution involved, that is, the money transferred horizontally between states, is a major part of the problem. A recent ruling by the *Bundesverfassungsgericht*, Germany's Constitutional Court, acting on challenges by the States of Bavaria, Baden-Wurttemberg and Hesse, the so-called "paying states," has brought this question back to the policy agenda.

The rules of the Finanzausgleich *since* 1996

The equalization law was last reformed in 1992, when a new system was agreed to incorporate the Eastern states from 1996 on.[22] Under the new rules, vertical equalization among the federation and the states is based on Article 106 III–IX GG. It defines "necessary expenditures" at both state and central government levels derived from a medium-term financial planning exercise, to achieve a "fair compensation" (*billiger Ausgleich*) between both levels of government (Article 106 III). According to the objectives of the constitution, there is no "vertical fiscal imbalance" in Germany as in other federations with exclusive tax assignments (such as Australia or Brazil). This may be considered an advantage although the political and technical implementation of this constitutional rule is fraught with problems.

The constitution assigns half of the revenue from income taxes to both the federation and the states – with municipalities participating in the share of personal income taxes. This rule is technically simple as the shares are fixed and the horizontal apportionment of the revenue strictly follows the residence principle.[23] However, the vertical splitting of the proceeds from VAT is governed by a federal law requiring the consent of the *Bundesrat*. VAT sharing assumes the decisive role in securing "fairness" among the federation and its constituent states, and is, therefore, highly politicized. At present, the federal share of VAT is 50.5 percent with the states getting the remaining 49.5 percent of a base adjusted for specific needs of the federation and municipalities.[24]

Horizontal solidarity

As a first step, three quarters of the VAT due to the states is apportioned among them according to population. Another quarter is reserved for those states considered "financially weak." They receive supplementary transfers from the VAT share in order to bring their fiscal potential up to at least 92 percent of the average of total state taxes[25] per capita. The implicit redistribution effects of VAT sharing are often underestimated. When considering only the new states of the East (without Berlin), their tax potential was only 43.8 percent of the national average per capita before VAT distribution, but this reaches a level of 84.6 percent of the national average after VAT revenues are included.[26] Thus, Eastern states receive roughly twice as much VAT revenues per capita than their Western counterparts.

At a second level, there is the *Finanzausgleich* scheme, a redistribution of resources among the states, which works well where there are no vertical fiscal imbalances. Thus, regional equalization must be arranged horizontally among the participating states. Germany is unique in having created such a system, because of the federal law requiring uniform rules.

The definition of differentials in tax capacities is based on a standardized "equalization yardstick" (*Ausgleichsmesszahl*) for state fiscal potentials, which is roughly the average tax revenue per capita multiplied by the population for each state. The procedure is, however, more complex. In particular, it comprises an asymmetric bias in favor of city–states whose populations are weighted by a factor of 1.35 (compared to one for the other states). In addition, some – but not all – of the northern states are allowed to reduce their calculated tax potential as they provide services to the nation through their harbors.[27] This yardstick is compared with the effective financial situation of each state, and the gap is subsequently equalized according to a formula. States below the average (*ausgleichsberechtigte Länder*) receive a compensation that is to be financed, in progressive steps, by the states above the average (*ausgleichspflichtige Länder*). The sum of payments received always equals the sum of disbursements. The progressive "tariff" of the redistribution scheme reflecting the degree of interregional solidarity among states is depicted in Figure 6.1.

As Table 6.1 illustrates, the equalizing effects of the *Finanzausgleich* are considerable. The program guarantees that the fiscal ability of all states attains at least 95 percent of the average tax capacity. The marginal burden on the contributing states reaches 80 percent, and it may even exceed the 100-percent mark under certain conditions.[28]

Vertical solidarity

At a third level, there is the distribution of public resources in the form of asymmetrical supplementary grants by the federal government (*Bundesergänzungszuweisungen*). Such

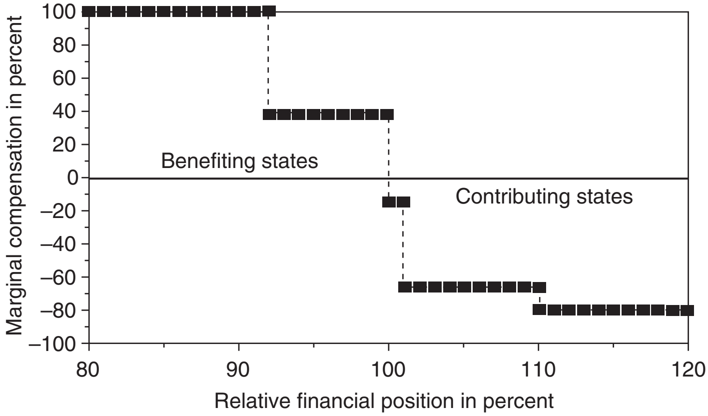

Figure 6.1 The equalization schedule. Marginal rates of compensation attained through *Finanzausgleich*.

Table 6.1 The impact of the equalization on states' relative tax capacity and on their marginal burden of own revenue

State	*Rank before FA*	*Relative tax capacity per capita (%)*			*Rank after grants*	*Marginal burden (%)*
		Before FA	*After FA*	*After Grants*		
Hesse	1	117.6	104.4	104.4	9	79.8
Baden-Wurttemberg	2	111.3	103.5	103.5	10	68.2
Hamburg	3	109.8	103.5	103.5	11	97.8
Bavaria	4	108.5	103.0	103.0	12	62.1
North Rhine-Westphalia	5	106.3	102.3	102.3	15	58.4
Schleswig-Holstein	6	100.3	100.3	103.0	13	50.9
Lower-Saxony	7	93.8	96.1	100.7	16	85.1
Rhineland-Palatine	8	93.4	95.9	102.7	14	89.3
Saarland	9	90.1	95.0	138.5	2	98.7
Brandenburg	10	85.6	95.0	118.9	7	97.0
Saxony	11	84.7	95.0	118.4	6	94.6
Saxony-Anhalt	12	84.6	95.0	120.0	4	96.8
Thuringia	13	84.1	95.0	120.0	5	97.1
Mecklenburg-West Pommerania	14	83.7	95.0	120.7	3	97.9
Bremen	15	71.8	95.8	151.8	1	98.9
Berlin	16	70.1	95.0	114.2	8	94.5
National average		100.0	100.0	107.1		

transfers according to Article 107 II GG have been widely used after unification, but were almost insignificant before. They also were decisive in establishing consensus among the various jurisdictions to compensate the formerly socialist eastern states. Unlike horizontal equalization, states that receive such grants are not considered "financially weak," but "weak in the provision of services" so as to be legally "entitled to federal support." In particular, "gap-filling grants" (*Fehlbetragsergänzungszuweisungen*) have been introduced that guarantee at least 99.5 percent of the average fiscal ability for all states. Moreover, nine states out of sixteen receive federal grants to relieve the costs of "political management" (*politische Führung*), and the new Eastern states as well as some Western states receive federal grants in compensation of "special burdens."

The highly controversial "gap-filling grants" of the federal government were 5.8 billion DM in 1998; and the special grants for the new *Länder* were 14.0 billion DM. They supplement state resources by 7.1 percent on average. The high volume of the federal grants has been criticized not only by economists, because of inefficiencies of "softening" budget constraints, but also by politicians and lawyers – and specifically the Constitutional Court – who stress the excessive redistribution. The constitution had reserved such forms of asymmetrical federal intervention for exceptional circumstances only (such as unification, for instance); there was certainly no intention to use regular instruments for "filling gaps" in the budgets of a majority of states.

The importance by amount of each of the three steps of horizontal equalization is shown in Table 6.2 for 1998.

Table 6.2 Amount of redistributed resources (1998 in billion DM)

VAT (only supplementary payments)	Finanzausgleich	*Federal grants*
17.6	13.5	25.7

The Court's ruling

As mentioned, a recent ruling of the Constitutional Court on the *Finanzausgleich* punctured the German equalization law.[29] It is obvious that a Court, cannot transgress the framework set by the constitution. However, its verdict has given some support to an in-depth revision of the general philosophy of the *Grundgesetz*, and it has spurred farther-reaching discussions of intergovernmental fiscal relations in Germany.

The Court's arguments underline "the preservation of the historic individuality"[30] of the states and "a degree of competition among the individual states as secured by the federal principle" (sec. 213) as well as the "innovation-fostering function of political competition among the states, and *vis-à-vis* the federation" (sec. 214). The verdict requests the legislators not only to revise the existing law on equalization, but also insists on a "law on general standards" (*Maßstäbegesetz*) which is to specify the constitutional principles to specify the equalization process (sec. 277). This law would attain almost constitutional rank (sec. 282).

The Court has even expressed its unwillingness to tolerate legislation, which, in practice, views equalization as the sole responsibility of the *Bundesrat* (sec. 284). A simple parliamentary majority would not justify equalization at the expense of a minority of states – even though their governments may have actively and positively been involved. It conveys a responsible, balancing, and neutrally appraising role to the federal government, a duty confined by elementary, general, and overarching legal principles.[31] On a more technical level, the Court called for the abolition of certain guarantee clauses and ordered lawmakers to use a broad definition of "financial ability" when assessing states' and municipalities' resources, that is, their tax income.[32]

It should be mentioned that the verdict only accelerates a process of discussion that would have been started anyway as certain rules of the 1992 compromise between the federation and the states will expire in 2004.

The finance ministry's position

In reaction to the Court's ruling, the finance ministry issued an "*Eckpunkte-Papier*"[33] in September 2000, clarifying the federal government's position for the negotiations with the states. As expected, the government did not promote a grand reform of Germany's fiscal system, but proposed minor revisions of the law to bring the current system in line with the Court's demands while keeping it generally intact. Accordingly the government calls for a consensus solution (sic!) in the spirit of cooperative federalism.

Vertical distribution of VAT

The federal government proposed to base the distribution of VAT on the budget and financial planning exercise, in which the states are involved on a regular basis, so that the volume of spending would be based on medium-term financial planning (see above). Thus, the finance ministry's view is that the "law on general standards" requested by the Court is not needed, because techniques used to establish medium-term financial planning would include standardized measures for determining "necessary expenditure" and "current income."

The shares of VAT distributed between the states and the federation would generate similar coverage between "current income" and "necessary expenditure" at each level. This procedure would ensure fair compensation in the splitting of VAT proceeds. The ministry also suggested that a more automatic rebalancing mechanism than the hitherto be used (see Article 106 IV GG above).

Horizontal distribution of VAT

The ministry is convinced that the distribution of VAT among the states should remain based on the number of inhabitants. States whose financial endowment is below average should receive supplementary shares of the states' share in VAT. However negative incentives of the distribution mechanism should be reduced.

Horizontal equalization

The government considered a correction of the primary distribution of tax income necessary as long as it is inadequate for solidarity. The differences in the financial ability of states would be equalized without weakening the paying states, or achieving full state-level financial equality. The rules governing the calculation of the amounts to be transferred among states need to be designed in a transparent way. As the present guarantee clauses contain contradictions, they would be abolished.[34]

The Court ruled that financial capacity should be understood in a comprehensive sense; therefore concession levies[35] must be taken into account for equalization, as well as all incomes generated by municipalities.[36] As to the weighting of inhabitants, the governments' position is that it is essential to take the particularities of city–states into account – but that more reliable and objective criteria be used.

Federal grants

The Court's ruling particularly censured federal grants.[37] It clearly states that federal grants are extraordinary and transitory measures to mitigate financial stress in particular states. They must not affect the horizontal equalization or the vertical splitting of VAT on a permanent basis. The federal government will, therefore, have to reduce the number of its grants as well as their magnitude.

In the future, grants for special burdens are to be the exception to the rule and their duration is limited. As a consequence the Ministry has announced that grants for the relief of additional costs of political management[38] will no longer be provided. States in budgetary distress will still receive grants for only a limited amount of time and on a regressive scale. States receiving such grants will have to present binding plans for financial reorganization. The federal government and the states will share the burden of such grants in relation to their spending.[39]

Evaluation of the Ministry's position

As pointed out above, a "grand reform" of the Germany's equalization system is highly unlikely, as the matter is politically intricate and pressures to reach a consensus are ever present. However, the Ministry's proposal falls short of the Court's requirements.

Vertical aspects of VAT sharing

The demand to design the vertical sharing of joint taxes on the basis of positive statistical criteria for "necessary expenditure" and "current income" of each layer of government is virtually impossible to comply with. The vertical splitting of competencies is always a political decision. Peffekoven has expressed skepticism about prospects for a quasi-automatic adjustment of vertical VAT sharing.[40] This skepticism is based on the experience of an expert commission that was set up to in the beginning of the 1980s in order to define "necessary expenditure" and "current income," and other loosely defined concepts of Germany's fiscal Constitution. At that time the experts could not reach a complete agreement.[41] However, there was agreement that the constitution should not penalize public entities that are successful in consolidating their budget, which is what happens under the current system.[42]

The ministry believes that a specific "law on general standards" as requested by the Court is not necessary. This view is based on Article 106 GG where medium-term financial planning is referred to as a guiding rule for VAT sharing between the federation and the states. This position of the federal government is highly dubious because the quantitative framework of medium-term financial planning is "shaky" and mainly reflects political priorities.[43] Moreover, the *Finanzplanungsrat* (Financial Planning Council) – responsible for medium-term planning – is likely to shift the emphasis of its work to monitor the Maastricht criteria for budget performance in the future. Its projections must, therefore, strike a balance between policy ambitions and actual performance, in line with the budget criteria if Germany is to maintain its AAA rating in the bond markets.[44] Thus, the outlay figures produced by the Financial Planning Council are unlikely to represent "necessary expenditure" in an economic sense.

Horizontal equalization

Article 107 II GG obliges the legislature to equalize differences in financial capacity (*Finanzkraft*) suitably. The latter refers to actual financial resources, not to a relationship between revenue and specific expenditure needs.[45] The Court has reemphasized the number of inhabitants to form an "abstract needs criterion" (equal per capita financial resource) as a yardstick for horizontal equalization. And it criticizes the "weighing" of population figures (*Veredelung*) as a means to express specific burdens (for instance of the city states). Indeed, the economic profession is split over the question on whether the costs of providing local public goods do in fact rise with population density.[46] By 1992, the Court had asked for more accurate data and a scientifically founded backing of the weighing procedure for inhabitants, but so far neither the federal government nor the states have seen any necessity to act. The Court also questions the wisdom of "specific burdens" that have crept into the equalization system such as for harbors.

The federal government seems to be decided to retain the weights in favor of city–states. More importantly, it has practically promised a continuation of the scheme in an effort to win Bremen's support for a tax reform package.[47]

As to horizontal equalization among states, the government appears willing to abolish specific "needs related" elements, such as the provision for harbors. It has long been questioned for instance whether Hamburg's harbor constitutes a fiscal "burden" or whether the state might actually be worse off without it. Agglomeration effects are difficult to analyze – but generally one would suspect Hamburg benefits from its historic position as a logistic hub of the nation.

Moreover, the federal government seems to accept the Court's request to conceive financial ability of states in a comprehensive sense, that is, including all financial resources of municipalities. This will reduce the current system's complications noticeably as changes in the assessment bases – as were common – will no longer exist. However, the reaction of the paying states remains to be seen, as they would probably lose resources. This is due to the fact that municipalities in paying states have a greater financial ability, on average, than municipalities in states receiving transfers.[48]

Federal grants

An overall reduction in federal grants is indeed necessary because an instrument originally designed for emergency cases has degenerated into a source of general revenue for some states. As these grants constitute a heavy burden on the federation's budget, the federal government is most likely to follow the Court's order in this case. The proposed reform should indeed focus on the supplementary grants for special burdens. They should only be granted for a certain (preferably short) periods of time. Otherwise it is to be expected that the recipient states will get used to the additional resources and have every incentive to prolong the measure.[49]

In a first step, the grants for specific burdens of political management would be abolished. We support this for two reasons:

From a systematic point of view, the weighing by the number of inhabitants (used to compensate for higher costs of population density) and grants for specific costs of political management (used to support small-scale jurisdictions) are hard to defend if used concurrently within the same equalization framework. This would only make sense if the costs of providing local public goods were V-shaped, which is unlikely to be the case. On the contrary, one might argue that the provision of local public goods have constant returns to scale after reaching a certain number of inhabitants, as congestion phenomena counteract possible economies of scale.

More importantly, the states have the right to reorganize themselves.[50] If states are not willing to reduce the costs of financing political management by merging into larger jurisdictions, their citizens/voters should be ready to pay for it. The costs of preferring small political unities and hence higher management costs should be borne by those who opt for it, not by the federal government and the nation as a whole.

The future of Germany's fiscal federalism

As outlined above a general case can be made for more competitive forms of federalism in Germany while maintaining interjurisdictional solidarity. This is absolutely necessary to make room for more decentralized solutions at all levels of government – given economic and political developments after reunification.[51] We focus on two newer strands of theory – contract federalism and laboratory federalism – to discuss the German situation, and the possibility of an increase in the quality of service delivery within a model of contract federalism.

Spillovers, fiscal equivalence, and contract federalism

There are numerous spillover problems within the German federal structure. While the relevance – in some cases even the existence – of these spillovers is debated, the phenomenon clearly points to a more general problem: the size of jurisdictions and the structure of the German federation. Certain states are extremely small compared to the others; there are major differences in the number of inhabitants and tax potentials. Nine out of sixteen states are currently receiving supplementary grants for compensating costs endured in political management, that is, they are considered incapable of financing governance, or their own statehood.[52] Using Breton's or Olson's phraseology respectively, there are indications that Germany does not posses an economically optimal constitution or that fiscal equivalence is not reached within all German jurisdictions.[53] However, one must accept that the actual setup of states is a direct consequence of historic developments, that is, it is path-dependent. It must, therefore, be considered an exogenous variable even though economists might be able to identify superior structures.[54] If one accepts the political reality, there is need for techniques to help jurisdictions in coping with regional spillovers (or non-equivalences) that affect the horizontal and vertical relationships among jurisdictions. In addition to existing externalities, states and municipalities are facing a continuum of new problems that might call for collective action. Three possibilities have to be considered, according to Olson.[55] Of these possibilities, the case where collective good/bad or their utilities/disutilities reach beyond a jurisdiction's border poses severe problems.[56]

Breton argued that a higher level of government is needed to bring about a Pareto-efficient allocation of resources in such instances. He mentioned the possibility of treaties, organizations and committees, but considered them only imperfect substitutes for interventions by higher levels of government. This is in contrast to Buchanan who explicitly assumes that individuals facing certain externalities or having similar preferences for certain collective goods will form clubs. Benefit taxation can then be used to finance the provision of collective good to the members of a club. Buchanan apparently emphasizes Coasian bargaining,[57] while Breton does not, though, one must ignore for the moment that Breton considered agreements between jurisdictions, while Buchanan was originally concerned with agreements between individuals that form jurisdictions to supply particular public goods.[58]

Nonetheless, negotiations and contractual agreements between states resulting from such bargaining should be used to internalize spillovers that are now compensated by grants. This is especially true for city–states that constitute agglomeration centers within their respective regions. At present, their fiscal burden is carried by *all* other states. Compared to bilateral or multilateral negotiations, this may lead to an oversupply of local public goods by the city, because the individuals whose preferences determine demand do not bear all resulting costs. This problem would not exist in bilateral or multilateral negotiations involving only those states which benefit directly from the provision of public services. Thus, if an agglomeration center plans a new infrastructure project, for instance, it must decide on its scale and scope.[59] It will use cost–benefit analysis to decide whether the project should be undertaken. Generally there are two possible outcomes:[60]

- The center or the center's voters/citizens are willing to undertake the project alone – that is, the combined utility of the center is larger than the projects costs.
- The center is not willing to undertake the project alone – that is, the costs of the project are higher than the combined willingness to pay.

In the first case, it is rational to complete the project even though the surrounding state may free-ride on its benefits. This is the classic Olson case where one "individual" has preferences that are strong enough to produce a public good on its own.[61] Still the center might try to bargain with the periphery but chances of success are slim as long as preference-revealing mechanisms cannot be used.[62]

The second case is the more interesting, as the center could negotiate with surrounding jurisdiction, which, again, may have two rational outcomes:

- The combined willingness to pay for the project is smaller than its costs and, therefore, the project is not executed.
- The center and its neighbors agree to realize the project conjointly because a distribution of costs is found leaving all participants better off than without the project. A club of two or more states is formed in line with Buchanan's original concept, which results in a Pareto-improvement.

The example could easily be transferred to a situation in which there are two or more smaller states, all of which have preferences for statehood and are facing a situation of scarce resources, for example, because special grants for costs endured in political management have indeed been abolished. These states will have every incentive to bargain on a number of issues and institutions that they might be able to use and finance in concert.[63,64]

These are strong reasons in favor of abolishing the supplementary grants for costs endured in political management and the weighting by inhabitants respectively. Stronger budgetary pressures would then encourage less expensive and problem-oriented solutions.[65] It should be clear that this point depends on how the future transfer schedule for horizontal equalization will be conceived. If states cannot retain at least as much of their bargaining rents as they would save by trying to socialize their problems, bargaining will either break down, or not start off at all.

We call such bargaining processes instigated within a deficient federal structure and their institutional forms of interjurisdictional cooperation and coordination "contract federalism." While the basic constitution remains untouched, new institutions are set up and function as the basis of single-purpose contracts among states, eventually only for a limited period. The political reality in Germany renders contract federalism, that is, bargaining among states (or municipalities) attractive in a second-best world.[66]

Frey goes even further by envisioning so-called functional, overlapping, competing jurisdictions (FOCJ) that do not only have the power to tax, but are run and ruled by their constituents. As in the Tiebout model, individuals constrain government behavior through their option to leave and to join jurisdictions at their discretion, whereby any individual can be a member of several jurisdictions and face several governments at the same time.[67] While it is improbable that FOCJ could function in the real world for several reasons (e.g. the high cost of voting required, time and resources spent by individuals in deciding which FOCJs to join, control cost, etc.), the concept is useful in guiding proposals to tackle the problem of interjurisdictional spillovers.

Service delivery

Even though this paper is concerned with a first-generation type of policy reform, contractual forms of federalism can significantly improve the quality of service delivery in the public sector – a second-generation type of reform.[68] This is because contractual forms of governance affect the relationship between the parties involved, that is, they create supplier–user relationships. Financial flows corresponding to service delivery would correspond more or less to *quid pro quo* transactions, and any partner dissatisfied with the quality of the service could exit under market conditions. Of course citizens can be considered "customers" of public services even under present conditions, but so far this relationship was problematical in two instances:

- Generally consumers' potential to organize themselves is weak.
- Consumers now typically face monopolies for providing public services, that is, there is no choice or exit option.

While contract federalism does not necessarily alter the relationship between a public administration and the citizen/consumer, the perception is different from the viewpoint of states or municipalities. If one assumes that bargaining would indeed take place and that certain jurisdictions might specialize in the production of specific public goods, the "producer" possesses a "make-or-buy" option.[69] If it decides to buy the public good, and the contract goes to another jurisdiction or a private business, the quantity of goods and the level of quality expected within the agreements' lifetime are at stake inevitably. It is important to recognize that while, at a first glance, contractual governance replaces one multilevel principal–agent relationship (voter–politician–public service) with another (voter–politician–service provider), this will effectively terminate supply-side monopolies.[70]

Public choice is enriched by options and choice and one can be optimistic about its economic virtues – even though it may be restricted to politicians because consumer-led FOCJs do not appear to be a realistic option:[71]

- Politicians who face such choices are likely to use contracting because it could improve the quality of service delivery or reduce its costs.[72] This would be popular with consumers/voters and politicians who ignore these options are vulnerable to critique by party peers and consumers alike.
- Theory predicts that consumer welfare will rise as more options become available.

The representation of interest groups criticized above might actually be an advantage of the German system in this context. While the Labor government in Britain, for instance, attempts to involve consumers in the regulatory process, such involvement is a matter of tradition in Germany. This constitutes a fertile ground on which to build new institutions that would support politicians in making "make-or-buy" decisions. This would compensate, at least in part, the loss of political influence, for example, of state parliaments, that would result from state governments bargaining with other jurisdictions.

Laboratory federalism[73]

Proponents of laboratory federalism have argued that – with imperfect information – learning by doing and testing different options may enhance the quality of policy. Such experimentation is perhaps a particularly attractive feature of a federal system.

The argument relates basically to von Hayek's critique of centralized economies. He argues that the ability to process information in a central planning commission is weak compared to the market system's facility to process that same information. Thus, the ability of a nation to process information may increase as more than one level of government (or different governments on the same horizontal level) can test different options.[74]

The concept of laboratory federalism forms an antithesis to the German perception of solidarity and uniformity of public services. Germany's present fiscal constitution rather includes incentives that encourage states to go for the wrong solution: innovation is almost pointless where the financial outcome from such innovations has to be shared with fellow states – instantly and almost completely. A degree of solidarity that brings *all* states to 99.5 percent of their average financial endowment per capita is simply excessive in economic terms.

An excessive degree of solidarity has even greater adverse effects if it is put in a dynamic and longer-term setting. In a globalizing world – where nations have to compete among each other – there are high risks for a country whose rate of innovation in the public sector is consistently lower than abroad. It could cause companies to exit, or to raise their voice – both activities that are costly for the companies themselves as well as for the country and its economy more generally.

Conclusions

Germany has a highly developed model of cooperative federalism, which requires consensus within government, among public institutions, and among different layers of government. Cooperation is typically institutionalized, and there are exemplary conflict-resolving bodies and procedures. Joint tasks represent just one example of responsibility sharing and joint financing in order to tackle the problem of interjurisdictional spillovers. The *Bundesrat* is another example for cooperation and coordination among layers of government.

A second feature of German federalism is its high degree of uniformity in public service delivery. This is mainly achieved through revenue sharing and interjurisdictional solidarity, with significant resource flows among governments and a high degree of interregional equalization. While such transfers have created a regionally balanced public infrastructure and evened out income differentials among states, they tend to obliterate the incentive of regional governments to develop their own resources – and hence the accountability to their citizens. Nonetheless, the German states have some, albeit limited, discretion on the expenditure side of their budgets, which they are indeed exploiting to differentiate their policy profiles.

At present, the German model of federalism is under revision in response to a ruling of the Constitutional Court on the system of horizontal equalization, the *Finanzausgleich*. Moreover, there is increasing competition within the public sector and among public institutions as well as among countries in a globalizing world. This has remarkably improved the quality of service delivery through corporatization, privatization, and the greater use of "make-or-buy" options. Negotiated solutions within existing cooperative arrangements and institutions tend to account for possible regional spillovers and constitute an appropriate response to coping with market inefficiencies. This has contributed to both interregional solidarity and efficiency.

Generally speaking, the German model of cooperative federalism has indeed functioned remarkably well in the past: the quality of public service delivery is high, and governments are responding to regionally differentiated voter preferences while maintaining a certain "uniformity of living conditions" throughout the nation. What is at stake now is to open up such institutionalized forms of interjurisdictional cooperation, which are now formal and subject to legal procedures, and thereby limited (for instance for the joint tasks). Conventional budget procedures have to be opened up by focusing democratic control on budget outcomes, rather than rigid allocations of funds and budgetary processes, and to be replaced by more open contractual forms of interjurisdictional cooperation. This would certainly improve the quality of public services and could lead to a greater variety of such services if laboratory conditions are created at a larger scale.[75] Open forms of contractual intergovernmental relations would also be reflected in interregional resource flows as counterparts to the costing of providing public services through greater interjurisdictional cooperation.

Interjurisdictional solidarity is firmly established and will prevail in Germany. And horizontal and asymmetrical forms of equalization will continue to be used to achieve it. However, the Constitutional Court has expressed the need to limit the degree of interstate financial redistribution.[76] This has to be welcomed from an economic point of view. What is critical, though, is the fact that the Court defines state financial resources comprehensively, which would not allow regional governments to protect some own revenue against interregional redistribution. This contradicts the economist's quest for more accountability. The Court also interprets interjurisdictional solidarity to comprise virtual bailouts of governments in financial distress. Again this verdict runs counter to the economist's aim of promoting more efficiency through the equivalence of the costs of service delivery and the willingness of citizens to pay. Even the usage of user charges (over taxes) does not constitute a way out of the dilemma if the Court continues to interpret fiscal revenue comprehensively.

It is hoped that the benefits of interjurisdictional contractual arrangements and the need to redesign intergovernmental resource flows are recognized by German politicians, and that the pending revision of the fiscal constitution will render the system of equalization more efficient. In particular, negative financial incentives could be eliminated by allowing the states to generate some own revenue (such as user charges, but also state taxes or, preferably, surcharges on national taxes) that are at the discretion and responsibility of regional authorities. Moreover, such extra revenue must be protected against interregional redistribution in order to preserve incentives. This must not necessarily jeopardize solidarity among governments.

The irony of the German system could be that its basic philosophies and actual fiscal arrangements could be interpreted to foster such developments, as cooperative federalism is in fact the nucleus and archetype of more open forms of contractual federalism. However, the need for consensus and a partisan-driven misinterpretation of regional solidarity may ultimately prevent this modernization of German federalism to come to pass.

Notes

1 See, Aufbau Ost (2000).
2 The Mezzogiorno is Italy's extreme southern region which received transfers since World War II, but still lags far behind the economic performance of the industrialized North.
3 For instance, Wissenschaftlicher Beirat beim Bundesministerium der Finanzen (1992); or Föttinger *et al*. (1994); and more recently Scherf (2000).
4 Plans for Germany after the war included deindustrialization and transformation into an agrarian based economy – the famous Morgenthau Plan. The Americans had been in favor of a more moderate and development orientated treatment of Germany for quite some time then, for example, the speech Foreign Secretary J. F. Byrnes on 6 September 1946.
5 Benz (1994), Die Gründung der Bundesrepublik. Von der Bizone zum souveränen Staat., S. 153 ff. The Allies also wanted the Germans to elect a national assembly to design the constitution. This was refused by the Germans who insisted on a body in which the states were represented. The Germans were trying hard not to give the Soviets reasons to push for a terminal division of Germany. The statute of occupation officially ended as part of the 2 + 4 agreements in 1990, which also ended the division of Germany.
6 For Americans, the term "federalism" is used to describe the necessity of a central government for a union of states; Europeans (and especially Germans) tend to emphasize the relationship between layers of government and the relationship among the states. In particular, the German variant of "cooperative federalism" describes the fact that authority and financing is shared by the federal government and the states in many policy areas.
7 *F. A. von Hayek* held a different position concerning monetary policy for example – as he would have taken monetary authority away from national institutions altogether. This was finally achieved in the process of European integration and the creation of an independent European Central Bank in 1999.
8 Joint Tasks explicitly allow for cofinancing in the following areas: extension and construction of institutions of higher education, including university clinics; improvement of regional economic structures; improvement of the agrarian structure and of coast preservation.
9 All in all the draft version of the Federal budget for 2000 lists 40 billion DM of cofinancing between the federation and states. This represents roughly 8 percent of the federal budget (see Bundesfinanzministerium, 2000).
10 In Germany, cofinancing has been criticized extensively by scholars of fiscal federalism. At a theoretical level, matching grants could eventually be criticized on the basis of the so-called "flypaper effect" (see Fosset (1990), and Oates (1999)).
11 Each State has at least three votes; states with more than two million inhabitants have four, States with more than six million inhabitants five, and States with more than seven million inhabitants six votes.
12 In fact, voters tend to contemplate the federal government's policy even in local and state elections. The Schröder government (Social Democratic Party) lost its control of the Senate in 1999 after having won the general elections in 1998, as the opposition was able to recapture votes. This was largely due to the new government's troubling performance during the first months of its administration.
13 Article 53a I GG: Two-thirds of the members of the Joint Committee are deputies of the House of Representatives and one-third are members of the State House. The House of Representatives delegates its deputies in proportion to the relative strength of its parliamentary groups; deputies may not be members of the Government. Each State is represented by a State House member of its choice; these members are not bound by instructions. The establishment of the Joint Committee and its procedures are regulated by rules of procedure to be adopted by the House of Representatives and requiring the consent of the State House.
14 This rule is qualified by the fact that a party has to gain either 5 percent of the vote or 3 direct seats to be represented in the Lower House.
15 For example, Poterba (1994); or Alberto *et al*. (1993)

16 Italy and Belgium are good examples for the underlying problem. While Italy is ruled by multiparty coalition governments, Belgium's problems are caused by tensions between linguistic groups.

17 Examples include universities, public broadcasting corporations, and the social security system. In all these institutions interest groups have decisive influence on decision making.

18 One of the most prominent examples is the "*Betriebsverfassungsgesetz*" (Law on worker's coparticipation). In larger firms, employees have the right to elect representatives who may sit on the supervisory board of the company that employs them.

19 Legally, a German citizen is not defined by language, however. The criterion is still "blood relationship," which was written into the law in 1912 when Germany was still a monarchy.

20 Centralizing such principles is the rule, but uniform principles can also be established through horizontal coordination among states, through the conferences of state ministries and conforming treaties among governments. One prominent example is the cooperation in education and culture through the *Kultusministerkonferenz*. This body has come under heavy criticism recently as it was accused of working too slowly. Indeed consensus requirements imply that the slowest state will determine the timetable.

21 Municipalities are, however, accorded some discretion to set tax rates within predetermined ranges.

22 The current law on equalization is part of a consolidation package passed in consensus by CDU, FDP, and SPD in 1992 to cope with the burden of reunification (Gesetz über ein Föderales Konsolidierungsprogramm).

23 The horizontal distribution of income taxes is not without problems, however. The regional distribution of the corporation tax requires a formula apportionment of income for firms with multiple regional activities (*Zerlegungsgesetz*), and the assignment of personal income taxes according to residence favors residential areas over production sites, which could be critical for municipalities and city states.

24 In 2000, the federation was entitled to an initial deduction of 5.63 percent of VAT in compensation for supplementary contributions to the national pension system. The municipalities also shared the VAT since 1998 (Article 106 sec. 5a GG), receiving 2.2 percent prior to the sharing of VAT among the federation and the states.

25 State taxes are defined in paragraph 7(1) *Finanzausgleichsgesetz*.

26 State taxes as in no. 25 – benchmark for compensation through supplementary VAT transfers – do not comprise VAT itself. This is why the share including VAT will remain below the yardstick of 92 percent mentioned before.

27 The equalization yardstick also accounts for tax revenues of the state's municipalities (at 50 percent). For local taxes, municipalities can vary the tax rate, and an average national tax rate is used to standardize revenue. The unsystematic element of the scheme is the compensation for some "special burdens" according to paragraph 7(3) FAG, which is taken care of by lump-sum corrections, for example, the provision for harbors mentioned above. The weighting procedure for the population is ruled in paragraph 9(2) FAG for the states, and in paragraph 9(3) for local governments. The latter uses a progressive scheme in line with the population of the jurisdiction. The differential weights for city–states and larger municipalities can be interpreted as accounting for some "agglomeration costs" of larger jurisdictions.

28 This is the case if the sum of payments needed for the deficient states exceeds the sum of payments for the contributing states as calculated according to the formula. In this case, the discrepancy is distributed evenly onto contributing states.

29 BverfG, 2 BvF 2/98 of 11 November 1999, sec. 1–347; http://www.bverfg.de/.

30 This and the following citations of the Court are own translations.

31 This is in sharp contrast to the *de facto* behavior of the federal government which used pork-barreling to buy votes in the *Bundesrat* in favor of a proposed tax reform recently. The concessions even included the guarantee of specific benefits to city states that had been censured by the Constitutional Court.

32 Compare BverfG sec. 318–27. Whether certain resources have to be taken into account or not is one of the most fought over issues in the history of the equalization law. States have every incentive to "hide" income which in turn reduces their "fiscal ability" and enhances the transfers they receive.
33 The "*Eckpunkte-Papier*" was available to the authors only as draft paper of the ministry. All citations and translations are made from this draft.
34 In the current system there are up to five different guarantee clauses which are designed to keep the sequence of the states' financial position intact after equalization. The consistency problem results from the fact that the criteria used are different from the ones used for equalization itself (e.g. the tax income of municipalities is treated differently).
35 Concession levies are collected by German municipalities as a compensation for granting infrastructure companies (e.g. telecommunications or electricity firms) rights of way.
36 As the ministry's position addressing municipalities directly is not presented as above, but is the newspapers' and our interpretation of a general sentence on income relevant for the states' financial ability. The ministry did in fact support this interpretation when asked about it over the telephone.
37 BVerfG sec. 296–300.
38 The costs of political management are now thought to be roughly fixed, that is, they increase on a per capita basis as the jurisdiction becomes smaller.
39 It is an important (and unfortunate) feature of German cooperative federalism that the Constitutional Court, in an earlier decision, has interpreted solidarity between jurisdictions to include the need to bail-out state budgets in distress. This constitutes an incentive to accumulate debt without considering consequential payments – as this debt is practically guaranteed. This behavior is reflected in the accumulation of debt by the eastern states (see Spahn (2000), pp. 14–15).
40 Peffekoven (1999), Das Urteil des Bundesverfassungsgerichts zum Länderfinanzausgleich, Wirtschaftsdienst 1999, Issue XII, p. 710.
41 Schriftenreihe des BMF, 1981.
42 See Peffekoven (op. cit.), p. 711.
43 For instance, during the last two decades the fiscal deficit was typically reduced to almost zero for the fifth year of the planning period. However, the planned reduction of the federal deficit was never achieved. The figures were simply arithmetically adjusted year by year. (See *Bundesfinanzbericht* or the reports of the *Sachverständigenrat*).
44 Under the Maastricht treaty, no member state of the European Monetary Union is supposed to run a nation-wide public deficit higher than 60 percent of GDP, and a consolidated public sector budget deficit exceeding 3 percent of GDP in any given year.
45 See BVerfGE 72, 330.
46 There are not only "agglomeration costs" of densely populated states; there may also be cost disadvantages of smaller communities and thinner-populated states. See for instance Carl (1994), S. 87.
47 Compare BverfG. (1999) sec. 319–21.
48 Whether this innovation will lead to losses heavily depends on the general design of the future transfer schedule.
49 The Eastern states' behavior of the past 24 months clearly reveals the underlying incentive. Time and again the East German prime ministers have argued – regardless of partisanship – that the level of transfers needed in the future should not fall below present levels.
50 In 1995 there was a serious political attempt to merge Brandenburg and Berlin. While it was possible to come to a political solution that was drafted into a treaty between both states and took both political as well as bureaucratic hurdles a majority of Brandenburg citizens was not in favor of the measure.
51 For example, the West German model of labor relations, whose core is the "freedom of coalition," was transferred to the East immediately after reunification. This meant that wages and

general working conditions were suddenly agreed upon through collective bargaining. Furthermore, labor unions were successful in negotiating fast increases of East German wages with the objective of attaining the Western wage level as soon as possible. The process of determining wages was generally independent from the development of labor productivity (value added per capita), let alone of the situation of single enterprises. In effect, this policy is probably the main reason why the unemployment is still much higher in the East than in the West. Under these auspices, many enterprises left the employer's association and went back to decentralized bargaining, a survival tactic that, even though economically necessary, is considered illegal by some.

52 One should not overlook that a state does not only consist of government. In addition to its executive, it has legislative and judicative branches with corresponding bureaucracies to render them effective. In the case of some German states one must add the public broadcasting systems, state central banks (subdivisions of the Deutsche Bundesbank), school systems etc., that were established almost regardless of efficiency considerations.

53 Compare Breton (1965), and Olson (1969).

54 Compare Oates (1999), pp. 1130–1 on similar thoughts concerning the US states. One might be skeptical about such computing as the result it produces will probably lose its validity quite fast in a changing environment, that is, the rise and decline of certain sectors alters the buoyancy of regional tax bases.

55 The collective benefits might either reach beyond the boundaries of a providing jurisdiction, it might be of the same size, or it might be smaller.

56 As an example of relevance for Germany, consider infrastructure projects like major airports. As the discussion on a new airport Berlin/Brandenburg or the discussion about an expansion of the Rhine-Main airport in Frankfurt demonstrate, the scope of a regional project often goes far beyond the borders of a single state.

57 More recent thinking on the Coase theorem and its information requirements has shown that it will deviate from the Pareto-optimum if not all participants are fully informed *ex ante*. This is likely to be the case when states bargain with each other. However, one may still be skeptical whether a higher jurisdiction is better suited to overcome this information asymmetry.

58 Nevertheless there is a certain realism to the idea of one club per public good as Olson (1969) reports 1,400 governments in the New York metropolitan area alone – counting school, sewerage, pollution control districts, and the like, as governments.

59 Even now – without bargaining – it is hard to imagine Hamburg, for example, to build a new museum or theatre without considering how many potential users of such an enterprise might be living outside Hamburg's geographical region.

60 Compare Homburg (1994), pp. 319–21 for a similar argument.

61 See Olson (1965).

62 If preference-revealing mechanisms, such as Groves–Clarke's, could be used this would produce another problem: resulting user charges are most likely to be insufficient.

63 There are already some examples of German states making use of joint institutions, for example, Baden-Wurttemberg and Rhineland-Palatine merged their public broadcasting systems, which is a considerable success insofar as the two separate systems (running against states' borders) had existed since the Allies had created them in the late forties. Equally, regional central banks were not automatically tolerated for the new Eastern states, which was an incentive to create supraregional institutions.

64 There are notable examples for contacts among states on a number of issues, although only at an informational base. For instance, Bremen and Lower Saxony have set up a body that coordinates regional planning in the Northwest of Lower Saxony. However, incentives to reach bilateral solutions are inexistent as it is always possible for Bremen or any other city/small states to socialize the costs and let all fellow states carry their share of the burden.

65 There is one qualification to this conclusion: the Constitutional Court's judgment on the handling of budgetary distress of certain states that allows them to socialize their debts too.

66 The usage of "second best" in this context may be questionable theoretically, but highlights the fact that contract federalism is a superior solution under given political and institutional constraints.
67 See Frey (1997). As an example for FOCJ, Frey refers to Swiss municipalities that are generally ruled by their citizens in direct democracy.
68 Second generation reforms like improvements in the provision of services in the public sector are receiving more attention lately as it becomes clear that policy reforms alone will not generate desirable and durable effects. See Tanzi (2000).
69 Two additional points might be in order here: Jurisdictions with traditionally large public sectors might specialize in providing services to others with the aim of using their capital and labor more efficiently. Jurisdictions facing a "make-or-buy" option are basically redefining the borders of their "firm." Here, as in many other cases, theory that was originally designed for a private business environment, for example, Coase and Williamson on transaction costs, contracts and principal–agent relationships may yield powerful insights for the public sector.
70 Of course the supply-side-monopoly would eventually be replaced by a bilateral monopoly, which has its own drawbacks. However it would still represent an improvement of the situation compared to present arrangements.
71 It should be noted in passing that new technologies such as the internet enhance the possibilities of participatory governance such as participatory budgeting (a model initiated by the city of Porto Alegre in Brazil) or e-government which allows quality controls through consumer feedbacks.
72 Again Wicksellian tax prices could render consumers accountable for the consequences of the politician's actions more directly.
73 Compare Oates (1999), pp. 1131–4 for a survey of the literature concerned with laboratory federalism.
74 Historians have argued, for instance, that the European economies and nations of the Renaissance period constituted nothing else but laboratories, and that competition among those states spurred innovations and propelled them into leading positions in the world. See North (1981), chapter 11.
75 Laboratory federalism now begins to bear fruits chiefly at the municipal level in Germany.
76 The Court seems to accept a level of equalization up to 95 percent of the national average.

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7 Asymmetric fiscal decentralization in Italy and Spain

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Introduction

Asymmetric decentralization reflects deeply political processes – often to recognize special circumstances, revenue sources, expenditure needs or specific capacities. The decision to pursue this route inevitably complicates economic management by the central authorities. Nevertheless, there are good reasons, both political and technical, for pursuing this approach in many countries – this has been the experience of Italy and Spain.

An asymmetric approach to fiscal decentralization involves devolving differing fiscal powers to administrations at the same level of government. Asymmetries may occur on the expenditure or the revenue side, or both. On the expenditure side they may involve a differing devolution of responsibilities by sector (for instance, health or education), or by more discrete economic classifications of expenditure, for instance local capital investments or non-salary recurrent expenditure. On the revenue side, powers can differ over the extent to which local governments can alter the rate or base of a given tax or whether they collect and administer the tax themselves. Special revenue sharing arrangements may be specified for natural resources.

Many large federal nations contain regions with differing levels of economic resources and development. Regions where mineral resources or revenue bases are located may demand a larger slice, accompanied by explicit or implicit threats of secession. Specific regions may have a particularly strong historical, cultural or linguistic identity that differentiates them from the rest of the populace. These, and other, innate differences often create overwhelming demands for asymmetric treatment that are acceded to in order to hold the country together.

There are also technical reasons for taking an asymmetric approach to fiscal decentralization. These are primarily linked to issues of differing capacity at local levels. There are two main, interconnected, reasons for an asymmetric approach.

Existing local administrations do not necessarily have comparable abilities to manage greater fiscal powers. In large federal countries, subnational governments can exhibit marked differences in the quality of their management systems, qualifications of staff and sophistication of infrastructure. It is often possible to move quickly to decentralize services in urban metropolises or advanced regions than in less developed rural areas. However, if decentralization of powers moves at a pace determined by the most advanced of the local governments the risk of failure in the less advanced governments is increased, leading to a deterioration in the quality of public services or in the creation of unsustainable fiscal positions at local level leading to consequent macroeconomic problems at the national level. This may, in the extreme, lead to a loss of credibility for the entire decentralization process, irrespective of any successes in the more advanced areas. If decentralization proceeds at a rate determined by the least advanced government, the process may be unacceptable to the governments more able and willing to take on greater fiscal responsibilities. An asymmetric approach can ameliorate the potential risks of unduly hasty decentralization while allowing opportunities to be grasped.

Decentralizing expenditure responsibilities to regions with management capacity can create incentives to improve public service delivery. A careful sequencing of the decentralization of fiscal powers can enable a government to build and demonstrate capacity by achieving certain benchmarks in budget management that enable them to take on further powers. With advanced administrative and political institutions an advanced region may be able to effectively manage a range of public services, using, for instance performance-based budgeting, to better achieve a correspondence between service delivery and the demand for such services.

This paper reviews the experiences with asymmetric fiscal decentralization in Italy and Spain. Both countries framed their intergovernmental fiscal system while emerging from a totalitarian system into a new democratic environment. In both, the new environment had to accommodate significant internal differences – economic, cultural and geographic – and their associated secessionist tendencies.[1]

Spain

Background

There are three features of the broader regional decentralization process in Spain that need to be understood in order to analyze the asymmetrical development of the decentralized fiscal system.

The rationale for regional decentralization in Spain was political and its roots, historical. Economic considerations were not relevant, in spite of possible efficiency gains from some kind of decentralization, given the traditionally strong centralization of the state in Spain. Spain is not, and never has been, a homogeneous country. There are important cultural, linguistic and historical differences across regions that provide strong decentralizing pressures. Following the death of Franco, a peaceful transition to democracy could have been jeopardized, unless the demands for autonomy of Catalonia and the Basque Country were addressed.

The devolution of powers to the regions was marked by an urgency to implement self-government. The need for self-government was felt most strongly in the regions with distinct cultural and linguistic differences, and much less or not at all in the rest of the country. It was argued that these different needs might be satisfied by granting political autonomy to the three historical nationalities, and only administrative autonomy to the rest of the country. However, the return to democracy and the creation of local governments gave rise to the emergence of regional politicians willing to take over the emerging powers and potential economic privileges from decentralization.

The decentralization process was general, voluntary, gradual, and flexible. Self-government was constitutionally open to all the provinces fulfilling certain requirements. However, it was offered as a voluntary right, not a duty. A region could choose the way to accede to self-government, within a range of options provided by the Constitution, which contained a list of functions on which they could assume power as they saw fit. Given the different degrees of difficulty involved, most regions achieved self-government gradually.

Asymmetrical decentralization

The framing of the new decentralized system during the period 1979–83, resulted in seventeen autonomous communities (henceforth, regions) with very different sizes, populations, and economic capacities. The open-constitutional design took account of several priorities. First, the historical nationalities should achieve self-government as soon as possible, as they did not need popular approval for autonomy. Second, for the remaining regions, access to self-government involved fulfilling a set of requirements that showed clearly that their local governments, provinces, and municipalities approved the new status. Third, these regions might need to build their institutional capacity for effective management; therefore, the powers they were to assume, during a transition period of five years, needed to be fewer than for the historical nationalities. Fourth, to prevent some of these regions from feeling discriminated against relative to the historical nationalities, it was necessary to leave a door open for them to achieve self-government without waiting the period of five years, if they could fulfill very stringent requirements. Fifth, it was necessary to ensure that restricting a province from acceding to self-government would not prevent the efficient provision of regional public services. But it was necessary again to leave a door open for special cases, such as Madrid and Navarre, which has historically had an exceptional status similar to that of the Basque Country. The final step for a region to become autonomous was the approval of the state parliament of the corresponding statute of autonomy, the basic law of the region.

This led to a system marked in particular by two asymmetries.

The existence of regional governments with very different taxation powers. The Constitution recognized the historical rights of the Basque Country and Navarre (the Fuero autonomous communities) to have their own traditional fiscal institutions. These regions have the power to collect the main tax sources of revenues and regulate them within limits, and to pay an amount (the *cupo*) to the central government to contribute to the financing of functions, which are exclusive to the central government. However, the remaining regions, called "autonomous communities of common regime," were financed until 1996 mainly with grants and a few minor taxes, on which they had little control.

Differences in the extent of devolution of expenditure powers and the timing of their assumption. This originated in the constitutional design of two different ways to accede to self-government.[2] One, which might be called a Fast Broad Track (FBT), addressed the historical nationalities (Catalonia, Galicia, and the Basque Country); the special case Navarre, and three other regions that did not have to wait the five-year period to achieve self-government. Andalucia, satisfied the stringent requirements. Two others, the Canary Islands and Valencia, did not have to wait 5 years because they were upgraded under a constitutional provision authorizing the delegation of powers of the central government to the regions by organic law. This permitted the immediate assumption of a broader share of powers for education and health care. An alternative Slow Narrow Track (SNT), addressed other regions, which would have to wait a five-year period to achieve self-government over a smaller range of expenditure functions.

These asymmetries – summarized in Chart 7.1 – caused a complex decentralization process and have sometimes caused inefficiencies. The common regime regions are now trying to standardize fiscal powers.

Financing regime	Expenditure powers	
	Fast broad track (FBT)	Slow narrow track (SNT)
Fuero regions	Wide ranging taxation powers coupled with broad expenditure responsibilities.	
Common regime regions	Very limited taxation powers coupled with broad expenditure responsibilities.	Limited taxation and expenditure powers and protracted process for assumption.

Chart 7.1 Classification of regional governments.

Fiscal aspects of asymmetrical decentralization

Expenditure assignments

The key distinction in expenditure assignment is the difference in treatment between the FBT and SNT regions. The main differences, therefore, relate to the timing of transfers – SNT regions had to wait at least five years to begin assuming functions – and to their extent when they occurred – the responsibility for health and education was only transferred to the FBT regions.

The basis for assigning expenditure responsibilities was the Constitution and the statutes of autonomy. The Constitution uses a double list system with a residual clause. Article 148 lists those matters for which regional governments may adopt power in their statutes, but it does not say which functions, legislative, and/or executive, they can assume. Article 149 contains the functions of the listed matters that are within the exclusive purview of the central government. The residual clause allows the regions to assume functions on matters not included in any list; however, if the regional governments do not assume these functions, they are retained by the central government. For a period of 5 years, the SNT regions could adopt power only for matters listed in article 148. From the outset, the FBT regions could assume such powers in their statutes, as well as the functions not retained by the central government on the matters enumerated in article 149, and the residual matters, from the very beginning.

Both the Constitution and the statutes were purposely drafted in an ambiguous way because of the need to achieve a consensus. The abuse of the expression “exclusive competence” in these documents, for what were in many cases shared or concurrent powers, and the vagueness of certain expressions such as “bases,” “basic legislation,” "general regime," used by article 149 to designate the functions reserved to the central government, gave rise to confusion until the constitutional court judged that all of them have the same meaning.

In order to operationalize the financing system it was realized that it was critical to estimate the regional cost of the public services affected by decentralization. The actual process, however, revealed several problems. First, public services were not uniformly provided in each region, and there were neither indicators of need nor time to find them. Second, there was no cost accounting of services by regions in the central government and the traditional budgetary accounting did not provide information on depreciation costs. Third, the provision of certain public services involves the granting of public aid or the making of investments, and the corresponding funds in the budget had to be allocated to regions. The pragmatic solution was to define a new concept of what used to be called the "effective" cost. The new concept of cost had three components: direct cost of the service, the regionalized expenditures on personnel and purchases of goods and services; indirect cost, the imputed share of the same expenditures in the central administration; and investment cost, formed by a share of the investments included in the budget to maintain the stock of real assets in working condition. Public aid remained in the central government budget to be distributed annually among the regional governments according to criteria to be agreed upon in multilateral negotiations. Resources for new investments were provided initially through an Interterritorial Compensation Fund (ICF).

Despite some of the short cuts to technical solutions that had to be made for political reasons, expenditure decentralization has had some positive effects, many of which are related to the flexible approach taken to asymmetric decentralization adopted. First, it has fulfilled the desire of the historical nationalities for differentiation, thus solving a persistent political problem. Second, it has turned a centralist state into a decentralized one in a short period of time. Third, it has democratized all levels of government, making them more responsive and accountable to the citizens. Fourth, the quality of public services did not deteriorate. In fact, the general perception is that their quality has improved, although it is difficult to specify the extent to which improvement was brought about by the use of more efficient procedures and/or by increased public expenditure and borrowing.

Asymmetry has contributed to the negative side as well. First, for quite some time, the confusion in the division of powers made it difficult to ascertain which level of government was responsible for what. This confusion caused many interjurisdictional conflicts of power, testing the capacity of the newly created constitutional court, whose decisions have proved to be decisive in the clarification of the process. In recent years, the number of conflicts has fallen. Second, heterogeneity in the assignment of powers across regions also caused problems in public service management and eventually led to a convergence between the FBT and SNT regions. In fact, after the transfer of education to the rest of the regions in 2000 and with the transfer of health care in 2002, the assignment of powers will be very similar across regions. Finally, with a large number of concurrent powers, more effort should have been made to strengthen coordination. The numerous sectoral conferences to coordinate have had limited effectiveness. A serious gap is the lack of institutional mechanisms to produce and exchange comparably formatted information on the activities of the different levels of government. This is particularly complicated by the multiplicity of financing arrangements. Lack of this information obscures a broad picture of the public sector, prevents regional accountability, and weakens subnational budget constraints.

Financing

Financing decisions for the regions were taken on the basis of provisions in the Constitution supplemented with an Organic Law on the Financing of Autonomous Communities (LOFCA). The LOFCA contained guidelines to address tax assignments and equalization, but these guidelines were not sufficiently clear and left much to future negotiations.[3]

For a small set of regions – the upper left-hand quadrant of Chart 7.1 – significant expenditure responsibilities came with substantial financing autonomy. These regions are mainly financed by concerted taxes – the central government taxes, which the Fuero autonomous communities administer and to a large extent regulate in agreement with the central government. These taxes form roughly 80 percent of their financing so they are largely unaffected by the complexities of the financing system facing the common regime regions. As such they are insulated from some of the short cuts that had to be taken in order to cost the system prior to decentralizing expenditure functions. However, regional inequalities may have increased (see below).

For the common regime regions, the financing system consists of both unconditional and conditional financing. While expenditure decentralization has proceeded at a relatively brisk pace, tax decentralization for the common regime regions has lagged, creating a substantial vertical imbalance for these regions. Cession of certain taxes specified in law[4] had to wait until each region assumed powers whose effective cost were higher than the revenues collected in its jurisdiction, in order to avoid problems brought about by the devolution of revenues in advance of expenditure responsibilities. The regions could also levy surcharges on the Individual Income Tax (IIT) and the above-ceded taxes, however this did not occur and two of the ceded taxes were retained due to tax reforms related to EU harmonization. Ceded taxes and user fees represented about 15 percent of the regional revenues during 1987–96.

Effective control over the ceded taxes, however, remained with the central government. The regions could only manage, inspect, and collect them. In addition, they could regulate the user fees and charges linked to the public services they provided. Surcharges, except for gambling, have not been used by the regions, partly because of the lack of legislation developing their role in the regional financing system, and partly because of the reluctance of the regions to assume the political costs of an increased tax burden.[5] This meant that the only autonomy available to the regions would be the additional revenues they could obtain through a better administration of the ceded taxes. This is in direct contrast to the Fuero regions that had certain direct control over rates, bases, and administration – thus giving them far broader leverage, and accountability.

As taxes were ceded slowly and partially, the General Revenue Sharing (GRS) system became the primary unconditional instrument used to finance the regions. For a transition period lasting until 1986, the central government guaranteed the financing of public services with a volume of transfers to cover the difference between the effective cost and the revenues actually obtained from the ceded taxes. The gap filling nature had clear disincentive effects for effective regional revenue administration, which remained until the transition period ended in 1986 and a formula based on spending need and fiscal capacity was negotiated.

The GRS system has contributed significantly to the decentralization of expenditure powers without any deterioration in the quality of services provided by the regions. However, the effects of some of its features on incentives at subnational level have affected the stability of the whole system.

The inadequate decentralization of tax sources and the consequent reliance on unconditional grants removed any incentive to manage expenditures efficiently leading to vertical imbalances. Regional politicians received the political benefits of providing public services without paying the political cost of levying taxes. Instead of linking benefits to willingness to pay, local governments confronted the central government every five years to get a bigger share of general revenues. The responsibility for public services was easily shifted to the central government. This, in turn, led to increased grants every five years. The result was lack of efficiency in resource allocation and a soft budget constraint.[6] The rapid rise in regional borrowing that took place in the late 1980s and early 1990s was to a large extent caused by the inability of regional governments to use own tax revenues at the margin. The rise in borrowing in the Fuero regions – and in particular in the Basque country was smaller than that observed in other FBT regions reflecting their greater ability to use own-revenues.

This state of affairs lasted until 1996, when a new financing system was agreed upon, increasing the tax autonomy of the regional governments through the partial ceding of IIT to the regions with power to legislate on ceded taxes and the IIT – subject to provisions for national harmonization. However, following the 1996 GRS agreement for the period 1997–2001 the less developed regions suspected that horizontal imbalances might worsen. Three of them (Andalucia, Extremadura, and Castile La Mancha) refused to accept the reform and retained the financing system agreed upon in 1991.

Health care was left out of the general financing system. The national-health service was under the umbrella of social security, financed with social security contributions and grants from the central government. Eventually, tax revenues would exclusively finance health care. In the interim, health services – in the FBT regions, which had assumed this power – would be financed through conditional grants from the social security budget. These grants would be allocated to the regions in proportion to the population legally resident in each jurisdiction. Given that the social security budget for health was actually allocated using different criteria, it was agreed that, in order not to disrupt the health service, the regional governments would receive the amount actually spent in their jurisdiction the previous year. During a ten-year period the health care transfer would gradually converge with the figure resulting from the criterion defined by the law.

The transfer of health services caused serious financial problems for the regions. Traditionally, health care was under-budgeted, and supplementary budgets had to be approved during the year to avoid excessive arrears. This did not change with decentralization. The regional governments received funds according to the initial budget, and had to wait almost a year to get the supplementary funds. The result was that they had to assume the financial burden of the arrears, financed by borrowing.

Equalization in the decentralized system

The Spanish approach to asymmetric decentralization needs to be assessed against its constitutional background. The asymmetries that were designed to accommodate differing preferences and capacities amongst the constituent regions were not intended to lead to unacceptable inequalities in access to basic services. They were rather intended to provide options regarding the mode of delivery and level of financing at the margin. This is explicitly recognized by the Constitution and its regulating the LOFCA. One article of this law stipulates that the central government must guarantee a minimum level of fundamental public services by the regions, whenever the regions are unable to supply the minimum level with resources obtained through the regional ceded taxes and GRS. This wording is not clear. First, it is necessary to specify what the fundamental public services are. Second, the minimum level of provision needs to be defined. Third, one has to prove that the resources provided by the general financing system are insufficient.

These problems are difficult to agree upon when the negotiating parties have conflicting interests. The advanced regions are of the opinion that the present financing system is already very redistributive. Advanced regions also believe that it should converge to a more equal financing per head, because this standard of equity already embodies an important redistribution. Less advanced regions consider that the present redistribution is inadequate, and demand the implementation of special purpose transfers in addition to the redistribution implicit in the general financing system.

Very likely, these conflicting opinions have been influenced by the predominance of the GRS fund in the system until recently, and its double function of providing gap filling financial resources to the regions *and* redistributing them regionally. It is not easy to ascertain whether the present financing system provides sufficient resources or not, because that depends on what services are being supplied at what level. Neither is it easy to ascertain whether the services are over-redistributed or under-redistributed, since that requires defining a standard of equity. No definition of this sort has been offered in Spain.

Tables 7.1 and 7.2 present per capita resources supplied by the system in the form of unconditional and conditional financing to common regime regions. The first shows that there are important differences, in the case of the SNT regions due to remaining

Table 7.1 Unconditional financing per capita 1997 (pesetas)

	Ceded taxes	*Individual income tax*	*General revenue sharing*	*IIT revenue sharing*	*Total*
FBT					
Andalucia	19,557		88,374		107,932
Canarias	24,950	17,183	68,923	17,183	128,235
Cataluna	38,255	30,345	19,590	29,064	117,256
Galicia	17,788	16,821	74,857	15,410	124,839
Valencia	30,053	19,235	32,840	18,045	100,173
SNT					
Aragon	31,671	24,771	5,152	7,853	69,448
Asturias	23,217	22,199	1,037	6,901	53,355
Baleares	37,071	23,410	5,240		65,722
Cantabria	27,067	21,008	13,340	19,783	81,198
Castilla La Mancha	15,950		43,559		59,509
Castilla Leon	23,777	20,073	13,444	17,945	75,240
Extremadura	12,561		54,253		66,814
La Rioja	30,617	23,183	5,765	1,452	74,083
Madrid	33,080	37,758	−7,928		64,005
Murcia	20,023	14,299	2,121	9,182	45,625

Source: Informe sobre la Financiación de la Comunidades Autonomas, Ministerio de Economia y Hacienda, 1997.

Table 7.2 Conditional financing per capita 1997 (pesetas)

	Health	*Subsidies*	*Interterritorial compensating funds*	*EU structural funds*	*Other*	*Total*
FBT						
Andalucia	86,410	4,196	7,303	9,505	4,391	111,805
Canarias	84,680	10,626	3,758	15,654	5,855	120,571
Cataluna	94,549	6,909		3,147	4,970	109,574
Galicia	91,322	8,705	8,865	13,866	2,652	125,411
Valencia	88,646	7,158	1,962	5,287	1,697	104,750
SNT						
Aragon		6,629		11,297	3,236	21,161
Asturias		5,595	4,014	9,008	1,900	20,169
Baleares		6,075		2,305	1,204	9,545
Cantabria		7,722	2,379	15,829	1,699	27,628
Castilla La Mancha		7,389	5,628	11,379	1,778	25,173
Castilla Leon		7,591	4,782	7,585	2,441	22,399
Extremadura		8,544	9,519	8,388	4,788	31,240
La Rioja		4,888		7,925	3,857	16,671
Madrid		4,310		1,320	7,440	13,075
Murcia		6,428	3,867	7,190	1,557	19,043

Source: Informe sobre la Financiación de la Comunidades Autonomas, Ministerio de Economía y Hacienda, 1997.

differences in the powers they have assumed. It is more difficult to justify differences for the FBT regions, because they have practically the same level of powers. The differences between Catalonia and Valencia, on the one hand, and Galicia and the Canary Islands, on the other, may be explained by the redistributive factor implicit in the GRS system, and their unequal economic capacity. The differences between Andalucia and the last two remain unexplained.

As regards the Fuero regions, the complex nature of their financing relationship with the central government makes it difficult to make direct comparisons with the common regime regions. However, their debt service as a proportion of current revenues is at the low end of the national scale and amongst FBT regions.

Within the common regime regions, the higher tax autonomy achieved in 1996 should surely increase their differences in fiscal capacity. If these differences are to be equalized, a redefinition of the role of GRS in the regional financing system will probably be necessary. If ceded taxes are to be the main revenue to finance the regions in the near future, then the GRS fund, which has decreased in size, should become mainly an equalization fund.[7]

Impact of the EU stability and growth pact

Control of subnational borrowing altered following the adoption of the EU Stability and Growth Pact (SGP) as part of the Treaty of Maastricht in 1992. It provides an interesting example of the role supranational agreements can play in the control of subnational finances.

The LOFCA stipulated, first, that regional governments could borrow in the short term for cash management purposes. Second, they could borrow for a long term just to finance investments (the "golden rule"). Third, their debt service should not exceed 25 percent of current revenues. Finally, domestic bond issues and foreign financing should be authorized by the Ministry of Finance.

However, the LOFCA rules have never been specific enough to make them implementable and enforceable. Rules, to be effective, require a precise definition of the variables and of the entities affected by them, a body to monitor their implementation, a system to produce and exchange timely and accurate information, and, finally, realistic and proportionate penalties in the case of noncompliance.[8] Even when these requirements are reasonably well established additional problems remain: the extent to which a given rule makes sense and the possibility that it may be circumvented.

None of these conditions existed in Spain in the 1980s. The ineffectiveness of the rules and the deficiencies of the financing system meant that fiscal consolidation by the central government was accompanied by increasing deficits and overall debt at the regional level. Restrictive use of the direct controls by the central government – the only tool they had available – meant that the majority of debt was in the form of bank loans and much of this was short term.

By the beginning of the 1990s regional debt posed a substantial macroeconomic risk that the central government was unable to control. The deficit and debt requirements imposed by the 1992 Treaty of Maastricht membership in the European Monetary Union changed this situation. As part of the new regional financing system negotiated for 1992–96, the central government agreed fiscal consolidation paths with the regions. These scenarios, made public, replaced the ineffective LOFCA provisions and became the main tool for coordinating the budgetary and debt policies of the central government with those of the subnational governments. A second round of scenarios for 1997–2001 consolidated the trend towards subnational fiscal sustainability with regional budget deficits being virtually eliminated.

Though the results in fiscal consolidation are noteworthy, the present institutional framework to coordinate macro fiscal policy still needs to be improved and formalized. One means of ensuring ongoing compliance with the requirements of the EU SGP that has been proposed is a Domestic Stability Pact (DSP) that mimics the provisions of the SGP.[9] At present, the central government is solely responsible to the European institutions for fulfilling the provisions of the SGP but does not have the tools to assure such fulfillment. A DSP would go a long way to changing this situation.

Italy

Background

The Italian system established by the 1948 Constitution is typical of a unitary state. Hierarchical relationships between lower levels of government do not exist or are very weak. The central government operates through direct relationships with all levels of subnational government which deal primarily with the center rather than intermediate levels of administration. The role of regional government, therefore, was premised on the transfer of previously central functions rather than managing the activities of lower levels of government.

Two distinct types of regional government were created. Five regions – the large islands (Sicily and Sardinia) and areas close to national borders with sizeable non-Italian speaking populations – were designated in the constitution as Special Statute Regions (SSRs) in order to reduce the threat of separatist movements and ethnic tensions. Their statutes have the rank of constitutional law. In the range of their competencies, SSRs can issue laws regulating their own territories and decide which functions to implement. Four of these SSRs were established in 1949 (and one in 1964).

In contrast, the Ordinary Statute Regions (OSRs) although also specified in the 1948 constitution, became operational only in the 1970s. They have very different functions and financing sources than SSRs, and issue laws only in the framework established by national laws.

OSRs and SSRs: characteristics and issues

The differing processes of assigning revenue and expenditure responsibilities to special and ordinary regions highlight two important policy issues for the design of intergovernmental fiscal systems. The rush to assign revenue to the special regions without clear competences has led to inefficiencies and inequity. The process of finally assigning expenditure responsibilities to OSRs illustrates the dangers of inadequate costing of assignments and the importance of a common Public Expenditure Management (PEM) system to produce adequate and relevant information.

Special Statute Regions

While SSRs are not identical, they have broader expenditure assignments than OSRs. Their revenues are based on a system of tax sharing, which varies from region to region (as a result of bilateral negotiations following their establishment) but generally assigns high shares (up to 100 percent) of the main locally collected taxes (such as income and consumption taxes) on a derivation basis. SSRs do not have any powers to vary either tax rates or bases.

The rationale for this revenue sharing was because of the extensive range of SSR expenditure assignments. However, the sharing percentages attributed to the SSRs were based on political considerations rather than a close evaluation of the regional cost of the functions to be decentralized. Their rapid establishment was deemed politically necessary and militated against any detailed analytical basis for their determination.

The outcome of this hurried political compromise is a textbook illustration of the outcome of the effects of transferring resources before functions: recipients will overspend on their current functions without performing their newly devolved functions. Evidence of this can be found by comparing differences between actual per capita 1992 expenditures in the sectors assigned to OSRs and SSRs (see Table 7.3).[10]

These data show a strong bias in overall per capita expenditure within SSRs. This is particularly so on aggregate capital expenditure where per capita expenditure in SSRs is six times that in OSRs. Inexplicable differences also exist in aggregate (with SSR 166 percent of OSR) and disaggregated current spending. This is best observed in spending sectors common to both Ordinary and Special Regions where SSRs spend on average many times more than OSRs, for example, six times more for social welfare. In Health Care, which is subject to strong national standardization through the national health fund system, spending on health care in SSRs is only very slightly higher than in OSRs.

Table 7.3 Per capita expenditures of Special and Ordinary Statute Regions (1992, 000 lire)

Expenditure sectors	*Ordinary Statute Regions*		*Special Statute Regions*	
	Current	*Capital*	*Current*	*Capital*
General administration	91.83	10.86	402.83	18.84
Job creation	1.55	1.45	53.30	30.80
Police, fire protection	0.06	0.15	15.24	8.10
Education entitlement	11.06	3.51	95.37	31.00
Vocational training	31.57	1.16	102.59	5.66
Culture	3.84	11.53	66.05	27.04
Welfare	24.37	5.76	144.01	37.83
Health	1526.74	23.96	1592.41	67.60
Sport, leisure	0.41	0.79	9.20	23.21
Agriculture	15.47	63.79	61.79	272.71
Forestry	1.37	7.56	7.67	57.65
Mountain area development	0.84	2.83	15.18	6.04
Quarries, mineral water	0.01	0.08	7.99	15.60
Hunting and fishing	1.66	0.40	29.21	7.12
Public works	0.78	35.37	1.96	171.58
Aqueducts, sewage	5.94	39.65	26.01	113.87
Roads	0.22	7.14	5.63	64.04
Other public work	112.37	6.36	87.84	14.53
Railways transport	3.84	0.41	0.02	0.28
Sea transport	0.97	1.57	2.64	8.64
Air transport	0.06	0.06	0.12	5.31
Other transports	0.07	0.40	0.41	3.63
Crafts	1.53	11.04	10.33	58.73
Tourism	6.36	9.12	32.36	74.50
Commerce	0.39	0.92	6.04	40.50
Housing	2.39	24.57	0.91	178.57
Town planning	0.22	1.24	9.94	23.39
Industry, natural resources	1.21	8.40	8.04	160.26
Environment protection	1.64	5.58	8.59	21.44
Scientific research	0.98	0.58	2.48	2.39
Debt service	17.41	0.67	13.85	0.00
Not classified	11.24	13.75	70.90	191.90
General transfers to local governments	0.79	0.01	235.26	107.89
Social security	0.00	0.00	6.32	0.00
Total	1879.17	300.65	3132.47	1850.66

Source: Istat, Regional Budgets, 1995.

The decentralization of functions should also have implied less central government intervention in SSRs due to the greater transfer of functions. However, this is not apparent from the 1992 data, which shows a non-marginal central government presence in sectors of SSR competence, while spending on other functions is consistent with the assignment of competences (see Table 7.4). Nor does the comparison with some OSRs display the differences we may expect. Summing together the total endowment of public resources for areas of similar territorial and demographic characteristics show substantial benefits for SSRs in per capita terms even when taking into account estimation of the extra costs they incur.[11]

Table 7.4 Central government payments for different functions in Italian regions. Per capita values of own regional taxes and central grants to regions, thousands of lire (1992, actual payments and revenues)

Regions	*Population*	*(a)*	*(b)*	*(c)*	*(d)*	*a + b + c + d*
		Expend. F1	*Expend. F2*	*Regional own tax revenues*	*Transfers to regions*	*Consolidated expenditures*
Molise (Ord.)	331,494	42	2,281	42	1,872	4,237
Campania (Ord.)	5,668,895	851	2,429	61	1,786	5,127
Abruzzi (Ord.)	1,255,549	794	2,281	76	1,731	4,882
Umbria (Ord.)	814,796	683	2,496	98	1,874	5,152
Emilia Romagna (Ord.)	3,920,223	725	1,961	92	1,899	4,677
Lombardia (Ord.)	8,882,408	633	1,665	62	1,784	4,145
Valle d'Aosta (Spec.)	117,204	832	860	1,874	9,554	13,120
Bolzano (Spec.)	444,243	853	815	147	6,693	8,508
Trento (Spec.)	452,479	915	1,210	234	8,663	11,022
Friuli Venezia-Giulia (Spec.)	1,195,055	1,179	1,976	80	2,736	5,971
Sicilia (Spec.)	4,997,705	764	2,080	223	3,022	6,090
Sardegna (Spec.)	1,651,902	183	2,312	148	3,473	6,116

Source: Our calculations on data from Istat and Ministry of the Budget.

F1: include central expenditures on general administration, defense, justice, public safety, employment and pensions (net of transfers to Regions).
F2: include central expenditures (net of transfers to Regions) on education, housing, welfare, health (net of National Health Fund), transportation, agriculture, industry, trade, crafts, other economic interventions, civil protection, grants to local governments.
Ord.: Ordinary Statute Regions.
Spec.: Special Statute Regions.

Ordinary Statute Regions

The process of transfer of functions and financing to OSRs was considerably more protracted. They were formally established in 1970 and became fully operative only in 1978 with the establishment of the National Health System. Political wariness about the dangers of strong independent regions in the hands of opposition parties played a large part in the delay in decisions taken concerning the financing of these regions. However, as this threat faded the longer time scale allowed a sequenced approach to the transfer of functions to be undertaken.

The central government first quantified the cost of the functions specified in the constitution to be transferred and then determined the amount of funds to be allocated to finance them. The tax reform of the 1970s that accompanied the establishment of the OSRs was explicitly centralizing – assigning almost the entire "fiscal lever" to the central government both for macroeconomic and redistributive purposes. This centralizing tax reform in tandem with a decentralization in expenditure responsibilities created a massive vertical imbalance (up to 96 percent of OSR expenditure in 1992 was financed by central transfers), laying the basis for two decades of soft budget constraints and weak accountability in public finance in Italy.[12]

Originally, OSRs were supposed to receive their main revenues from two general funds – the Common Fund and the Regional Development Fund. The first would be unconditional and determined according to fixed percentages of excise taxes and the second discretionary. However, this became a system of conditional sectoral grants that accounted for around 90 percent of total regional expenditure in 1998, dominated by the National Health System which has been the major cause of confusion in the intergovernmental fiscal system.[13] The lack of clear financing rules and accountability for this sector, however, has meant that regions have used any increased fiscal autonomy to finance the deficits stemming from expenditures in other sectors. This is the effect of a double moral hazard problem, regions spend money in sectors other than health, as the perceived budget constraint is softest in the health sector (central government will cover it) and other sectors are more politically advantageous for the regions to spend on. The central government takes the blame for health and regional governments take the credit for other sectors.

The main problems with the overall system can be summarized as:

- Transfers were negotiated on an annual basis. This was a protracted and complex process and led to huge delays in the determination of their total amount, inefficient budgeting process in a context of great uncertainty, regional overspending and growth of deficits.
- The allocation of funds was based on previous years' expenditures and therefore, rewarded overspending and inefficiency and increasing the incidence of federal bail out and a loss of macroeconomic control.
- The inadequacies of the PEM system, in particular with regard to the information available for monitoring, meant that the central government was unable to set clear standards in the various sectors and to monitor and control the use of funds. This led to a lack of accountability in the use of public funds and created additional instability.
- There was also a lack of accountability to the local citizens. Local populaces could not perceive what small local taxation decisions actually implied. The lack of substantial political and fiscal autonomy of regional governments meant that all problems could be passed off to the central government.

Reform efforts in the 1990*s*

The motivation for reform

Decentralization trends in Italy strengthened in the 1990s. A primary factor was the fiscal and monetary crisis associated with EMS membership in 1992, accompanied by an abrupt change in the political environment with a new political party (the Lega Nord) from the more affluent North, that campaigned on issues such as "taxes back to the regions where they are paid" and plain words such as "secession."

Since 1990, a Parliamentary Commission charged with the task of proposing constitutional reforms has generated widespread debate covering the whole range of political and economic decentralization issues. After initial deadlock, work on constitutional reform resumed in earnest in 1996 again with limited success. Overall, the debate has shown that the reasons and the process by which political bodies unite into a country cannot easily be adapted to the reverse process of decentralizing of central functions and powers. A flavor of the reverse process follows.

Reform in the Special Statute Regions

Reform of the SSR system has been a slow and difficult process. Many proposals have been made to more closely align SSR functions and financing with that of OSRs. However, as the SSRs are defined in their individual statutes – which have the rank of constitutional law – changes are particularly difficult, especially when the regions themselves are not in favor of the changes.

In the 1990s two important reforms in SSR financing were implemented, in order to address the inequities in financing between the SSRs and other regions.

- cutting specific purpose transfers to SSRs on the assumption that they already had sufficient resources for functions such as health; and
- transferring spending competences (e.g. for state road management) without any corresponding transfer of resources.

These reforms have reduced horizontal inequalities, and challenges in the constitutional court have not been upheld. However, recently agreed deficits in some of the richer regions threaten Italy's adherence to Maastricht deficit guidelines.

Reform in the Ordinary Statute Regions

During the 1990s a system emerged for OSRs with potential for greater fiscal autonomy together with a hardening of their budget constraint. In order to counter the problems of weakened accountability and effectiveness associated with the sectoral fund method of financing OSRs, a new system was introduced in 2001. Specific purpose transfers have been abolished, and substituted with sharing of VAT, gasoline tax, and personal income tax. These will initially be transferred to exactly replicate the total transferred under the previous systems and will gradually be replaced by a new formula-based equalization mechanism reflecting both expenditure needs and fiscal capacity. Greater fiscal autonomy will also be granted.

In tandem with electoral reforms to assist in greater accountability, regional governments will receive greater legislative and administrative power, and minimum standards will be applied to the health system (see Bordingnon, 2000).[14]

These reforms have made substantial inroads into the troubled Italian system, but they have not as yet succeeded in establishing a system that provides the correct incentives to local governments and eliminating soft budget constraints.

Coordination

The particular setup of the Italian system has engendered a growing awareness that effective political decentralization requires adequate institutional mechanisms. Mechanisms for intergovernmental cooperation and negotiation have been created to allow the state to enforce macroeconomic discipline and to give the regions a voice in important national decisions. Recent years have seen a progressive increase in the role and power of regions and local governments to influence the making of central government policies. This influence is higher – and sometimes with binding effects – when proposals for new legislation affect issues under the statutory powers of the regions or affect their financing.

The State–Regions Conference has been established to vet legislative projects affecting regions and on the central administrative decisions influencing regional interests. The conference has an advisory function and also helps coordinate issues such as health and environmental protection. Recently the Conference has also received autonomous power to steer and implement given laws. All legislative projects bearing regional consequences have to go through the Conference, if only for purpose of information. Any reform of intergovernmental fiscal relations in Italy is unlikely now to be adopted before an agreement is reached within the State–Regions Conference.[15]

Conclusions

The experiences of Spain and Italy have differing characteristics and their experiences are not directly transferable outside their specific economic, political, and cultural contexts. However, there are some broad lessons that can be derived from the two experiences.

Asymmetrical processes can work and are often required to retain the benefits of national integration. Both Italy and Spain have managed to address potential secessionist tendencies by ceding fiscal powers at different rates. There have been problems inherent in both experiences some which were due to the natural tensions that such a process creates and some due to problems with the design of the system adopted. Nevertheless, adopting an asymmetric approach has contributed to the continuation of the unified states.

Over time the asymmetry can contribute to confusion and inequity and lead to pressures for comparable treatment. In both Italy and Spain there is some evidence that the regions granted greater fiscal powers to head off secessionist tendencies have been significantly advantaged in the transfer system. In both nations pressures have increased for more comparable treatment of other regions. In Spain the system appears to be converging on common treatment of expenditure responsibilities for all regions.

The need for political compromise can lead to systems designed in haste with built in ambiguity and instability that hamper effective fiscal management. The political imperative to reach a swift deal is important and cannot be ignored. When reaching this conclusion, however, care needs to be taken to ameliorate the costs by establishing transition arrangements and/or principles for renegotiation. The system that was initially established in both Italy and Spain proved very durable; agreements for reform in both countries had stipulations that there should be no losers and/or that transfers could only increase. Renegotiations of agreements, therefore, result in a ratcheting up of transfers that is not necessarily related to expenditure responsibilities and which can endanger macroeconomic stability.

Fiscal arrangements need to be able to adapt in the medium term to the changing political and economic environment; enshrining them in laws of constitutional rank can hamper this process. Provisions that are made for political reasons are hard to roll back to solve a fiscal issue. Fiscal policy, however, needs to be able to adapt to changing circumstances. Enshrining financing agreements in laws that are almost impossible to change can severely constrain the central government's ability to appropriately manage fiscal policy; it is, therefore, preferable to leave scope for periodic renegotiation of intergovernmental fiscal arrangements when establishing the legislative basis for the broad intergovernmental system.

Clearly specified coordination and dispute resolution mechanisms are required to enforce the political and economic principles underlying the system. Concepts such as equalization and solidarity inevitably have different meanings to different subnational governments according to their economic position. A strong political national government needs to mediate the process – bureaucrats can delay and distort the process. Constitutional courts and/or other coordination mechanisms are needed to solve the ambiguity that is often the price of political compromises.

Adequate information systems are required for the design of a full system. Even when appropriate sequencing of reforms was undertaken – the identification of expenditure responsibilities, costing of them and then identifying financing – in both Italy and Spain this process was undermined by the information provided by the PEM system being inadequate to establish and monitor the costs of delivering decentralized services. This is likely to be the reality in many countries undertaking decentralization reform. Care needs to be taken to build in transition mechanisms to allow early decentralization while leaving time for adequate costings to be derived and financing schemes revised. If transition mechanisms are adopted they should be time bound and measures to improve information systems should be an integral part.

If national standardization is required the responsibility should remain at the national level. In both Italy and Spain the health sector has been the cause of much of the confusion and fiscal instability in the intergovernmental system. This has primarily been the result of decentralizing the national responsibility while seeking standardization of services across the nation. The *ad hoc* financing arrangements this promoted and the ability of the regional governments to divert finance elsewhere in the confidence that the center would cover the cost reduces accountability and increases fiscal instability. If expenditure responsibility for such functions is to be decentralized it needs to be in the context of a well defined system for financing and setting and enforcing appropriate minimum standards. The accountability framework also needs to be clear so that the theoretical benefits of decentralization (tailoring to local preferences) can be realized.

Supranational economic agreements can strengthen the macroeconomic control of central government. Problems in the fiscal decentralization processes in Italy and Spain led to increased macroeconomic instability caused by unsustainable debt policies at the subnational level. The fiscal rules inherent in the EU SGP required the reduced general government deficits and debt. These external influences enhanced the leverage of the central government. The effectiveness of such supranational agreements, however, is contingent on the commitment of the central authorities to the principles of the rules embodied in the agreements. If this does not exist the supranational agreements are unlikely to prove an effective constraint on irresponsible fiscal policy at the subnational level.

Notes

1 The paper considers only regional governments. In both countries a level of government below the regions exists but is treated in a generally symmetrical fashion.
2 See Spain Constitution article VIII.
3 Probably the best analysis of these problems in the case of Spain is in Monasterio *et al.* (1995).
4 Individual net wealth, gifts and inheritances, property transactions, gambling, and the retail stages of the luxury tax, the general sales tax, and certain consumption taxes.
5 An attempt by the regional government of Madrid to levy a 3 percent surcharge on the individual income tax faced popular and political opposition and had to be withdrawn, making a valid instrument to finance the regional governments unusable.
6 See Walsh (1991) and Eichengreen and von Hagen (1995).
7 In July 2001, a new regional financing system was agreed upon between the central government and the regional government by which 33 percent of the individual income tax and 100

percent of taxes on vehicles and electricity are ceded to the regions with a limited normative capacity. In addition, 35 percent and 40 percent of the revenues collected by the VAT and certain excises in each region, respectively, will also be ceded without normative capacity. A so-called budgetary stability bill is under discussion in the parliament by which, as a rule, all levels of government will have to approve balanced budgets or remain in surplus. Exceptional deficits will have to be corrected over an agreed period of time.

8 See Kopits and Symansky (1998) and Kopits (2001).

9 For the SGP, see Eichengreen and Wyplosz (1998) and Buti *et al.* (1998).

10 More detailed analysis can be found in Piperno (2000).

11 Maggi and Piperno (1992). See also Cerea *et al.* (1989) for estimation of these costs for further calculations.

12 See Bordignon (2000) for an account of the mechanisms through which this led to macroeconomic instability.

13 See Reviglio (2000) for an extended discussion of the issues in the Italian health care system. Bordignon (2000) also provides useful analysis.

14 The distribution of competencies is still in flux but regions *have already received* many new competencies. In 1997 the Government launched a third phase of regional decentralization (after the two phases of 1972 and 1977) aimed to rebalance powers between the center and the regional governments. In particular, under the "Bassanini laws" the s.c. "administrative federalism" was implemented: the regions were attributed all administrative powers not attributed elsewhere. In March 2001, the Parliament approved an important constitutional reform moving further toward a federal constitutional structure and this bill was confirmed by a popular referendum last October. It involves a huge transfer of legislative powers to Regions, based on the subsidiarity principle, that supposedly will be implemented in the next few years (even if there is still conflict among the different political forces about how to implement). According to that principle, only the functions explicitly stated in the constitutional law are excluded from the power transfer. In particular, the central government will retain legislative jurisdiction over some strategic areas, such as foreign affairs, relations with the EU, justice, defense, monetary and fiscal policies, universities and other sectors (some critics say too many) that have to be dealt with nationwide. *Moreover the reform is very important because it accepts the principle of asymmetric decentralization* (for both OSRs and SSRs) in some of the fields assigned to the state (judiciary, education and environmental, and cultural policies), based on specific agreements between central government and regions to be incorporated in ordinary state laws.

15 Intergovernmental bodies are not confined to the State–Regions Conference (in which both OSRs and SSRs take part) since after long debate, the State–Cities and Local Autonomies Conference was set up in 1996 and for given duties the two Conferences can join together in the so-called Unified Conference. The latter has played a crucial role in solving conflicts for the assignment of competences and resources to enact the administrative federalism and it is likely to play an even major role to implement the constitutional reform cited above.

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Part III

Transition economies

8 The effectiveness of decentralization in Hungary and Slovakia

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Introduction

This paper contrasts decentralization in Hungary, one of the most decentralized countries of Central and Eastern Europe, and in Slovakia, one of the least decentralized, during the decade of transition from socialism to market. It also draws lessons based on this experience. Has decentralization been effective? Has decentralization improved the delivery of essential services? Has it promoted efficiency, ensured accountability and encouraged democratic practices? We make the point that the effectiveness of decentralization depends on three crucial factors. First, appropriate expenditure and tax assignments. Second, governance mechanisms to strengthen accountability and fiduciary responsibility. Third, incentive mechanisms to ensure that agents deliver services of an acceptable quality at least cost. For constitutionally guaranteed entitlements, the latter condition is not easy to achieve because many principal–agent problems arise in the context of shared governance. We use as an example, education, a type of public good for which governance is typically shared between central and local levels of government.

The Hungarian and Slovak experiences show that, even when expenditure assignments and accountability rules in intergovernmental affairs are specified by legislation, in practice, major expenditure management and public accountability issues still arise. We examine both fiscal and institutional aspects of decentralization – venturing into issues of accountability mechanisms and incentive schemes that are used to ensure balance between revenue and spending and minimum quality standards in the delivery of public goods.

The role of incentives in determining how local organizations like schools operate is crucial. The fiscal literature suggests that it is not possible to ensure incentive compatibility simultaneously with optimal allocation of resources and a balanced budget in the provision of public goods. In the absence of incentive constraints, an optimal fiscal system would equalize the marginal utility of taxation with the marginal utility of consumption of local and national public goods. But in the presence of incentive constraints, public expenditure management is costly. The free rider problem has to be recognized as a second best problem, imposing the requirement of incentive compatibility. The problem then becomes one of supply of public good and optimal taxation in the presence of information constraints. In addition, the literature on governance stresses the constraints imposed by the political system – that is, by the governance system which regulates the exercise of power. Thus, the provision of the public good has to be recognized as both a political process and a budget process (Laffont, 1988).

There are two options to reduce information asymmetries and induce compliance in the relationship between central and local governments. First, it is possible to make cheating and information hiding costly through various reporting requirements, monitoring and controlling arrangements. However, this is costly for the principal (the central government) and it is only efficient in informing the principal to the extent that there are sufficient capacities to process and use the information – which is not always the case in Hungary and Slovakia where local skills are scarce. Second, principal–agent type problems can be solved through incentive arrangements where the agent's utility maximizing behavior and the behavior expected by the principal can be approximated to each other (Papp, 2000). We review both types of arrangements in this paper.

A priori, decentralization is expected to increase public expenditure, first because tax revenue is managed by smaller entities (diseconomies of scale) and, second, because of duplication of administrative structures. If greater democracy and participation are also objectives, cost savings are even less likely. Thus, decentralization by itself is more likely to increase public expenditure. Vito Tanzi (1995; 2000) has cautioned against excessive enthusiasm for decentralization – grounded in empirics, not ideology – for fiscal and macroeconomic, but also for institutional reasons. A broader issue, raised by Oates (1999), is whether Tanzi's "politically incorrect" view can be framed in terms of trade-off between economic efficiency and political participation?

Decentralization in Hungary

In 1990, Hungary enacted a fundamental law establishing local governments, patterned after the Council of Europe's European Charter. The 1,523 local councils functioning as agents for the central governmental through a system of nineteen county councils were abolished. The Law on Local Self Government dramatically scaled back the responsibilities of the nineteen regional bodies (*megye*, counties). To replace the local councils, citizens were granted the right to create autonomous self governments (*önkormany*). This political imperative to get rid of the old system led to excessive fragmentation, resulting in 3,200 local governments roughly half with less than 1,000 inhabitants.

The Law on Local Self Government was the first of eight laws that now frame the Hungarian intergovernmental system and lay out the terms of autonomy for local governments (Ebel *et al.*, 1998). Local governments are no longer agents of the center: they are autonomous public service entities with assigned tasks and taxing powers. The Law adopts the general principle of subsidiarity – that public services should be supplied by the smallest unit of government that is administratively and economically capable – embodied in the European Charter. Local governments are obliged to provide primary education, basic health and social welfare provisions, waste disposal, safe drinking water, public lighting, and to maintain local public roads and cemeteries. They must respect rights of national and ethnic minorities. Other tasks – not all mandatory – include providing local mass transport, settlement development, snow removal, fire protection, and public security and the explicitly voluntary provision of cultural and sports facilities, housing and public safety.

Local expenditures in Hungary have accounted for roughly 20 percent of public sector expenditures and 35 percent of public sector investment (see Table 8.1). Locally raised tax revenues over which localities have control have amounted to only 20 percent of total revenues, or roughly 3 percent of GDP. Local governments also receive a share of the personal income tax, based on the amount collected within their jurisdiction, and 50 percent of the motor vehicle tax; but these two revenue sources yield only 11 percent of total local revenues. As a result, local governments depend heavily on transfers to finance their

Table 8.1 Hungary – local government accounts, 1993–99 (percent of GDP)

	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*
Total revenues	16.1	15.9	13.6	13.0	12.8	12.0	12.3
Own current revenues	3.0	2.8	2.6	3.0	3.3	2.9	3.5
Revenue sharing w/central govt.	1.4	1.5	1.7	1.6	1.7	1.9	1.8
Transfers from central govt.	7.7	7.3	5.7	5.0	4.3	4.2	3.9
Of which education norms (%)	33	22	23	20	19	18	19
Transf. from other public sector	2.8	2.9	2.4	2.4	2.4	2.3	2.2
Capital revenues	0.7	0.9	0.8	0.6	0.6	0.5	0.5
Other revenues	0.5	0.5	0.4	0.4	0.5	0.4	0.3
Total expenditures	17.2	17.4	13.9	13.0	13.1	12.7	12.5
Current expenditures	13.5	13.7	11.5	10.9	10.5	10.2	10.2
Of which education (%)	44	37	38	36	35	34	32
Capital expenditures	3.1	3.3	2.4	2.1	2.6	2.4	2.3
Of which education (%)	6	5	4	3	3	2	2
Other expenditures	0.6	0.4	0.0	0.0	0.0	0.0	0.0
Balance	−1.1	−1.5	−0.3	0.0	−0.3	−0.7	−0.2
Net financing	0.5	1.0	0.2	0.3	0.3	0.4	0.1
Privatization revenues	0.2	0.3	0.5	0.7	1.0	0.5	0.2
Net borrowing	0.3	0.7	−0.2	−0.4	−0.7	−0.1	−0.00
Balance	−0.6	−0.5	−0.1	0.3	0.0	−0.3	
Borrowing or borrowing cap (%)	117.0	167.0	81.0	27.0	19.0	30.0	n/a

Source: Ministry of Finance of Hungary. Draft Final Account for 1999.

Note: (n/a = not available).

expenditures, including untied (normative) and earmarked transfers to cover current expenditures, as well as a system of specific grants to finance investment.

Before 1996, transfers and own revenues, including borrowing, were insufficient to cover total expenditures. This resulted in residual deficits (Table 8.1) which were ultimately covered by the central government. During this period, some local governments also started to default on their debt and to call for additional resources from the central government. This situation stemmed, in part, from an imbalance between expenditure responsibilities and revenue assignments, but also from the lack of transparency in the use of public moneys, and from the fact that the central government is ultimately responsible for many local government obligations.

In 1995, faced with a major macroeconomic crisis, Hungary implemented a stabilization program (the "Bokros package").[1] The stabilization program included three elements that introduced greater discipline in the management of local government finances. First, "high powered incentive schemes" were used to force municipalities to reduce spending. Transfers declined by around 3 percent of GDP, and efforts were made to improve and simplify the system of normative transfers. However, it is not clear whether this led to the desired results (see Section on High Powered Incentives).

Second, annual borrowings by local governments were subjected to a cap (equal to 70 percent of own revenues minus debt servicing costs). Third, the Parliament enacted a local bankruptcy law that prevents bail-outs by the central government, forbids the use of core local government assets as collateral, forces local governments to negotiate with their creditors, and allows the central government to appoint a commissioner to control local finances during bankruptcy proceedings. As shown in Table 9.1, these measures have resulted in a substantial reduction in current and capital expenditures and reduced local government deficits. New borrowing has remained well below the borrowing cap, and local governments have also made use of their privatization revenues to retire part of their debts.

Although local governments have been able to meet fiscal targets in recent years, there are indications of inefficiencies in the delivery of public services and of strains in local finances (World Bank, 1999). First, there is still a systemic imbalance in the intergovernmental finance structure. Expenditure and revenue assignments are not well matched. The system of transfers creates inappropriate incentives, which lead many local governments to claim gap-filling or deficit grants. Although the amount of deficit grants has remained about HUF 7 billion in 1996 and 1997 (around 0.1 percent of GDP), the number of local governments applying for such grants increased to almost 25 percent of all municipalities.

Second, fragmentation in the provision of services implies that economies of scale are not exploited, leading to high costs and poor quality services in many areas. There have been efforts to promote cost-effective service delivery through the creation of functional associations and regional development units. Such associations are, however, constrained by their limited legal status, and by their inability to either collect own revenues or to receive grants from the state as a single entity. Roles and responsibilities of the different levels of regional development are still unclear. This creates problems of coordination and undermines efficiency in service delivery.

Third, although local expenditures have declined as a share of GDP in response to the decline in transfers and the tighter borrowing constraints, expenditures cannot be maintained at their current level, as the amortization of local assets has not been properly incorporated in local spending decisions. The renewal of assets has been repeatedly postponed, and there are substantial additional investment needs. In the health sector, a majority of hospitals are owned by local governments and the stock of buildings needing renovation or replacement was an estimated HUF 140 billion (or 1.7 percent of GDP) at the end of 1997 (World Bank, 1999).

Decentralization in Slovakia

Slovakia is one of the least decentralized countries in Central Europe. Following the democratic elections in Czechoslovakia in June 1990, autonomous local governments were created by law and the first municipal elections took place in November 1990. Local governments are self-governing, but have much more limited powers than in Hungary. Similar to Hungary, there has been a process of fragmentation and there are now 2,881 local governments. Their spending represents only about 7 percent of general government expenditure, one of the lowest levels in Europe.

By law (Act No. 369 of 1990), local governments are obliged to provide basic services such as waste disposal, safe drinking water, public lighting, maintenance of public roads, etc. Currently, municipal governments have four major sources of revenues. Shared taxes represent the biggest amount (SK10.6bn or 37 percent of total revenue in 1997).[2] Non-tax revenues, such as revenues from business activities, administrative fees and capital revenues make up the second major source (SK10.3bn or 36 percent). Central government transfers amount to SK5.4bn (or 19 percent) and borrowing to SK2.4bn (or 8 percent).

Local government expenditures are dwarfed by that of the center which maintains eight regional and seventy-nine district offices.[3] The regional offices are responsible for essential public services including primary and secondary education, social assistance, fire protection and culture. These public administration entities are arms of the central government and maintain close contacts with the Ministry of Interior. Each regional office has a separate budgetary chapter in the state budget and authority to prepare and submit their own budget. The total budget of the eight regions in 1999 accounted for 14 percent of total general government expenditure. Regional offices are responsible for distributing budgetary funds to the seventy-nine district offices or to regional budgetary institutions. The allocation takes place on the basis of norms based, in theory, on the cost of public goods or services. In actuality, the norms are subject to budgetary bargaining so that the relationship with actual costs is weak. For example, there are no norms based on the number of pupils for education. Unpaid public utility bills and postponement of maintenance expenditures also indicate that the link between costs and normatives is weak.

In April 2000, the coalition government of Prime Minister Dzurinda approved a framework for decentralization.[4] The essence of the reform, as stated by the Ministry of Finance, is "how much power and resources are to be delegated to lower levels of government, to what levels and what finance system is to be chosen for the decentralized sphere." In September and October 2001, the Parliament adopted a set of six fundamental laws creating higher territorial units (*Vyššie Uzemne Celky*, that is, regions, known as "VUCs"), amending the Act on Municipalities, defining the new competencies and transferring state property (such as schools and public buildings) to these local and regional bodies, and amending the Act on Budgetary Rules.

The parliamentary debate has reflected profound differences in political philosophy within the country and even between coalition partners. A political agreement was finally reached that there would be eight "VUCs" with self-governing bodies. One of the most contentious issue has been the boundary of the region where the ethnic Hungarian minority is concentrated.

The reform represents a major change in the intergovernmental fiscal system. Central government competencies will be transferred in the course of 2002 to local and regional governments. Resources will also be transferred with the notional aim of sharing public expenditure in a ratio of the order of 55 percent for the central government and 45 percent for local and regional governments. The main expenditure areas to be transferred to both subnational levels include schools and social assistance, maintenance of local roads and some health care facilities, fire protection, and culture. Table 8.2 contains an estimate of the importance of those expenditure areas in the 1999 and 2000 budgets. Local government expenditure is expected to increase from 7 to 20 percent of total spending, including salaries and social welfare payments. It is not yet clear whether responsibility for teachers salaries (representing around 80 percent of current expenditure on schools) will be devolved.

The intended objective of the reform is to improve public services by reducing excessive centralism, increasing local participation and increasing the accountability of elected officials and administrators. There is, however, a risk that the reform could greatly increase public expenditures; introduce new inefficiencies in the system; threaten macroeconomic stability and increase the risks of mismanagement and corruption at

Table 8.2 Expenditures to be transferred to regional and local governments in 2002 (1999 and Budget 2000 data, in SK thousand)

Sector	*1999*	*2000*
Health care	34,904	32,160
Social assistance	14,318,437	14,410,830
Fire protection	600,492	627,002
Civil protection	51,835	53,902
Local road maintenance	1,000,000	1,200,000
Education – Total	25,773,725	25,055,517
Of which:		
Preschool education	3,145,331	2,959,661
Elementary schools	9,731,006	10,053,182
High schools	1,230,256	1,148,173
Vocational high schools	2,214,535	1,986,882
Apprentice high schools	3,745,627	3,482,104
Church schools and facilities	629,127	663,943
Private schools and facilities	102,482	104,355
Other schools	3,623,746	3,406,543
Culture – Total	934,180	921,311
Total (SK thousands)	42,713,573	42,300,722

Source: Ministry of Finance.

Note: Average exchange rate for 2001: 1 US$ = 48 SK.

local level. With the 2001 fiscal deficit projected to reach 5 percent of GDP, the MOF was concerned that the reform would increase public spending. Local government representatives fear an erosion of state support because their level of funding is vulnerable to discretionary changes in budget laws.

Fiscal capacity and efficient service delivery

The experience of the Hungarian and Slovak local governments in mobilizing own-source revenues has been a failure, given that the autonomy of the municipalities is limited to minor sources of revenues, and they lack incentives to seek own revenue as expenditures are largely financed through tax sharing or transfers. Local taxation in Hungary is discussed by Ebel *et al.* (1998) and Kopanyi *et al.* (2000), and in Slovakia by Berčik (2000) and Davey *et al.* (2000). The latter report suggests two possible additional revenue sources for own revenues at the municipal level: a real estate tax and a business payroll tax. However, the latter could have an adverse effect on employment in the present context of very high unemployment (national average of 18 percent). There is some scope in the long run to increase municipal real estate tax yields in urban municipalities, but this is predicated on the development of an active real estate market (which itself presupposes improvements in the cadastre, etc). Deregulation will progressively increase the responsibility of municipalities for sensitive utility pricing and this will also enhance their accountability. For the own revenues of the new regions, the Davey report recommends against a regional surcharge on the income tax on enterprises and is in favor of a “piggyback” surcharge on individual income tax, as in several EU countries. This could be introduced in such a way as to have a neutral impact on both the state budget and individual tax burdens initially; and it would have a considerable impact on the accountability of regional governments to their voters.

To transfer funds to local governments on the scale envisaged in the proposed Slovak reforms requires a system of revenue sharing. To do this entirely through tax sharing would favor rich local governments with large tax bases (Davey *et al.*, 2000). Tax sharing as a (unconditional) grant mechanism entails important efficiency costs: fiscal gap estimates are based on historical data, on supply of public services, not on an assessment of demand, and therefore tend to favor rich regions or regions where tax collection is mediocre. Welfare costs can also be high since targeting is poor. Tax sharing also has costs in terms of accountability: it lacks transparency because there is vigorous political bargaining (Wetzel and Dunn, 2000).

Ideally, municipalities should finance their own spending at the margin subject to additional own-revenues, or matching grants in case of spillover effects between jurisdictions (Oates, 1999). To avoid major disparities between communities, equalization transfers are necessary. The aim of such transfers is to ensure basic levels of social provision, particularly in local government areas with large low income populations. Such transfers are based on indicators such as numbers of population, numbers of children of school age, incidence of poverty, numbers of the elderly, etc. Hungary extensively makes use of formula-based normative grants. About 25 percent of subnational funding comes from such grants while another 10 percent comes from categorical grants and targeted matching grants for investments (Wetzel and Dunn, 2000).

The formula-based, unconditional and transparent character of the normative grant is its main advantage. Its main drawback is that such grants are a disincentive for local revenue mobilization because of their "fiscal gap" nature, and also contribute to perpetuating municipal fragmentation.

The policy choice is between a system under which grants are largely distributed according to capacity use (e.g. number of care-days for elderly, beds in institutions) against one based on indicators of expenditure need, such as the number of inhabitants in a jurisdiction, or tax capacity (potential to generate revenues given some average national tax rate).

The capacity-use norm is appropriate to the extent minimum service levels are mandated by the center. Some argue that it is not fundamentally different from the pre-reform system that provided incentives to institutions to inflate expenditure needs. For example, they over-report the number of pupils in a school to qualify for larger grants. A further aspect of the capacity-use approach is that the grant is perceived as an entitlement by local officials. Moreover, because the norms direct minimum grants to small jurisdictions, it may perpetuate localities which, on efficiency grounds, should be consolidated with neighboring jurisdictions.

Ebel *et al.* (1998) propose a compromise – to move from a formula based on use to one in which funds are allocated on some measure of *fiscal capacity*, defined as the potential ability of a local government to raise revenues from its own sources relative to its expenditure needs. Thus, it has both expenditure and tax dimensions. They concede that such an approach is complex, and runs the danger of becoming non-transparent. Accordingly, Ebel *et al.* (1998) propose to maintain the norm-based system, with improvements: a reasonable reconsideration of duties and competencies, in which the norms are less differentiated and their number is reduced; looking at the fundamental issues of government size and structure; and addressing equalization by providing incentives for municipal associations in taxation and services delivery. This is – hesitantly and slowly – the road taken by Hungary (Kopanyi *et al.*, 2000).

The fiscal issues faced by Slovakia are similar to those in Hungary: to design a transfer system to cover the gap between devolved expenditures and revenues. To finance education, the Slovak government intends to revise currently used education norms, and base these on the number of children enrolled and the number of schools, and population density. Davey *et al.* (2000) favor such a Hungarian or Polish-style system. Coupled with parental choice, this could promote budget rationalization by "simulating the market." Similar formula-based normative grants are envisaged for social assistance.

With the normative grants for education and social assistance, is there a need for a horizontal equalization grant system? In Poland, equalization brings the per capita revenues of individual *gmina* nearer (but not up) to the national average, but aims to bring all *wojewodztwo* and *powiat* revenues up to the per capita level of the highest (Davey *et al.*, 2000). The question arises mostly at the regional level. Slovak VUCs (regions) are also likely to have fairly similar needs as their budgets are likely to be dominated by the costs of educational, social and health care institutions whose services are constitutionally guaranteed. With variation in regional government taxing sources, horizontal equalization would be necessary and justifiable.

Subnational governance: accountability and fiduciary responsibility

A good framework for decentralization involves designing proper incentive mechanisms and rules of governance for economic management. Since self-governing entities expend public funds (tax revenues from their residents and transfers of state funds), they should be publicly accountable for these funds. Full accountability requires transparency given proper standards and established principles. Budgets and annual financial statements should be public documents. Local government entities should be subject to independent audit by relevant professionals. Self-governing bodies should have their own accountability arrangements. But, in addition, they should report to the upper tier of government since they have a fiduciary responsibility toward the state (for central transfers). Cheating and hiding information should be made costly through various reporting, monitoring and controlling arrangements such as audits and inspections to ensure the funds are used properly for their intended purpose (Dean, 2000).

Financial control and accountability are not simply a question of legislation, but of democratic practice. There are complex conditions for their success or failure, particularly in former socialist countries where historically, control had an entirely different connotation from the practice in democratic market economies. Moving from a system of central directives to one based on public accountability and a wider devolution of power can only happen as fast as the participants are prepared to go. In this respect, Hungary seems to be more advanced than Slovakia.

In theory, decentralization increases transparency and efficiency, and reduces corruption. In practice, however, decentralization merely changes the location of corruption, the amounts involved and the identity of the perpetrators and the beneficiaries. To have an impact on the level of corruption, decentralization would also have to affect the causes of corruption, such as weak controls, lack of transparency, incentives to cheat, lack of public interest in honest administration and low likelihood of being penalized. We would not expect decentralization by itself to reduce these causes of corruption, unless it changes behavior through accountability and various democratic practices.

There is scant evidence from Slovakia that behavior has changed fundamentally. Survey data[5] indicate that corruption is endemic in the public sector. Responses from public officials confirm the findings from household and enterprise surveys that the use of bribes is common. More than two out of five officials said they had been offered a "gift" and one in ten had been offered money or an expensive present, in the two years before the survey. Of those who frequently interact with the public, roughly half had been offered small gifts, and 10–15 percent had been offered money or expensive presents. Public officials also clearly indicated that the offers of bribes by clients were sometimes accepted at their institutions (USAID/World Bank, 2000). Interestingly, the perception of corruption is higher for the central and regional governments than for the local governments. However, local governments are perceived to be *less* corrupt than the central government and its regional offices. Nearly a quarter of the central government officials reported that corruption was widespread at their institution, and nearly half of the officials at the regional and district bodies of state administration report the same (see Figure 8.1). A smaller percentage of officials from local self-governments reported corruption to be widespread. These results are correlated with the type of public good provided by each level of government. Central and regional governments manage education and health care, for instance, while local governments are essentially in charge of municipal services.

Most public officials believe that incentives to generate quality service delivery do not exist in their institutions. From the perspective of the public official, high quality service in associated with low levels of corruption. Similarly, slowness of service delivery fosters corruption – from the perspective of an enterprise waiting for a permit, or a household waiting for their day in court, a bribe may be a small price to pay speed things along. The findings of the public officials' survey suggests that corruption is generated by slow service delivery, which in turn is frequently generated by bureaucratic rules.

Halasz (1998) provides some evidence on accountability in the education sector in Hungary. Accountability refers to both legality of use (i.e. absence of corruption) and reasonableness of use (fiduciary responsibility). In the case of municipalities, reasonableness of resource management is not subject to external auditing. Funds for development are audited given county-level planning, but there is no external control of current expenditures. As far as the legality of the use of funds is concerned, external audit is limited. Examinations by the State Audit Office of Hungary are very rare and

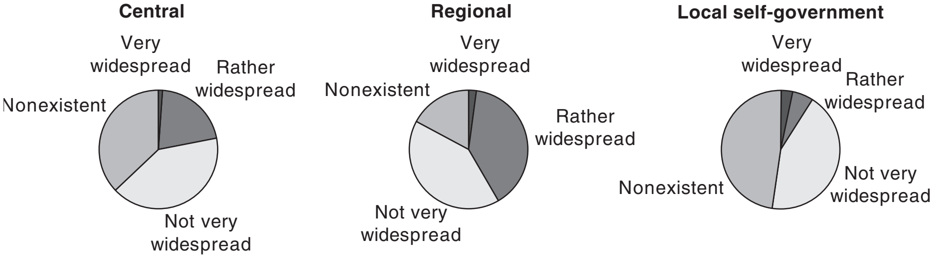

Figure 8.1 Public officials' assessments of the levels of corruption in their institutions.
Source: USAID/World Bank 2000.

do not cover all municipalities. Complaints regarding the legality of educational resource management are few, and those that are filed go to the Ministry of Interior offices operating at the county level, which can then enforce the law through the courts. In the case of private school owners, legality is controlled by local governments. Though accountability is weak at the level of local governments that have political autonomy, it is very strong at the level of schools: local governments can exercise almost full control, and do it in most cases. They can control cash management in their own schools, both in terms of reasonableness and legality. However, the control of "reasonableness" is very restricted and – though it is a legal obligation of municipalities – rarely covers the evaluation of teaching efficiency. Elected school councils can also exercise some control over schools.

There are three main challenges in fighting corruption and improving accountability (Dean, 2000). First, managing finances responsibly requires specific legislation defining the financial powers and responsibilities of local self-governing entities, in particular covering tax administration (raising revenue), budgeting, accounting, reporting and auditing, and controls that are consistent with the spirit of decentralization. Second, meaningful local participation implies the need for openness and transparency in financial dealings (for instance local budgets and annual financial statements to be made public, as they are in Hungary and Slovakia); local self-governing units to be audited by independent auditors (which occurs in both countries) and involvement of citizens either individually or collectively (e.g. parent associations) in local affairs. Third, local governments cannot be completely independent from the center. They use public money, including transfers; have a duty to report on the use of public funds and must be subject to independent audits. The audits must be comprehensive (applicable to all public funds and not just to central transfers). Decentralization implies a danger that resources transferred to local units will be misused (control and accountability being weaker at local levels). The natural reaction is a search for strict central controls. But this negates the fundamental objectives of decentralization. The trick is therefore to create a system of "remote control": one in which local self-governing units are both responsible and accountable and in which central government has a predominantly monitoring role (Dean, 2000).

Decentralization aims to achieve greater local participation in decisions about local use of funds. The decline in state influence on local matters is only a consequence of this. Therefore, wherever possible, policy should be directed at achieving proper public accountability without placing state bodies in supervisory control. In practice, this means that local governments must be governed by sound financial management principles set centrally; be publicly accountable (as discussed above); must keep their own accounting records and process their own transactions; and must be audited by independent auditors (professional auditors from either the private or the public sector).

The central government should establish the financial management and accounting framework under which local governments are to operate; to ensure that the purposes intended for special purpose transfers were in fact achieved; to set limits to the borrowing powers of local bodies and establish a reporting framework to ensure compliance; to monitor compliance with public accountability requirements (public budgets and financial statements and independent audits) via receipt of the relevant documents; and, finally, to impose sanctions on a local body seriously failing to meet its public accountability obligations (taking the local body into temporary state receivership in extreme cases) as the 1996 Hungarian law on municipal bankrupcy envisages.

Table 8.3 Slovakia – General government debt (SK billion at market prices)

	1994	*1995*	*1996*	*1997*	*1998*	*1999*
Consolidated debt	116.4	124.5	166.2	203.8	228	255.8
Of which;						
Local governments	2.0	4.4	5.5	6.9	9.2	11.2

Source: Ministry of Finance.

Note: Figures include domestic and foreign debt. Local governments did not report any foreign debt.

Both Hungary and Slovakia have laws defining accounting norms for local authorities, the latter must prepare their own budgets, can maintain bank accounts with commercial banks, prepare their own accounts, borrow money, carry forward unused resources beyond the end of the budget year and invest any surplus they may have. But there are differences between the two countries. The main difference is that Hungary has set a "hard constraint" on borrowing in 1996: there is a yearly cap for borrowings by local governments, equal to 70 percent of own revenues minus debt servicing costs. Moreover, a stringent local bankruptcy law was passed in 1996. Slovakia had no legislation restricting the borrowing powers of local governments and no law for municipal bankrupcy until October 2001. This has led some municipalities like Kosice to become over-indebted, to fund nonviable construction projects and fall into financial crisis (Table 8.3).

While legislation on financial control and accountability is in place, several problems have been reported with the accountability framework in Slovakia (Dean, 2000; SIGMA, 1999). First, the flow of funds from the center to local governments is unpredictable, making financial management difficult. Second, internal audit is carried out by a controller voted into office by the elected council and paid from the budget of the self-governing unit. The controller is appointed for life and has a status independent of the mayor. The controller reports directly to the elected council on the budget (which is made public in draft form 14 days before it is debated) and on the annual final accounts. Each local government is also theoretically subject to annual audit by an independent auditor. Controllers appointed for life are certainly independent, but may reflect other disadvantages as part of a modern accountability system. The legislation passed in October 2001 has created a system of external audit of municipalities with reports prepared by independent auditors for the Ministry of Finance.

Shared governance in the education sector in Hungary

Public service delivery is directly affected by the mode of governance, including decentralization. The agency funding the public good and that responsible for actually delivering the service are often different. This is generally the case for constitutionally guaranteed entitlements such as basic education and health care. In Hungary and Slovakia, schools or hospitals are managed by agencies that are not responsible for their funding. Governance is shared between the center and subnational levels. For services like education and health, there is a good case for shared governance or complementarity between decision-making at the local and central levels. In education, for instance, some parts of the system (such as setting the curriculum, organizing examinations at secondary school level, monitoring the quality of instruction, etc.) are best provided centrally. For other activities the center should not get involved; while for yet other issues, it is best to share responsibility. Teacher absenteeism is such a case. Local communities have more information and a greater stake in monitoring teachers. At the same time, the local education management structure can be effective only if it responds to parental complaints. Shared governance could ensure minimum standards of service and accountability toward taxpayers when the central government transfers large sums to municipalities. However, the central government needs incentive mechanisms to implement and monitor that local spending meets norms. Education provides an example of how incentives determine the behavior of stakeholders (central government, municipal authorities, teachers' unions and parents).

Hungary's public education was decentralized in almost all functions, from establishing schools to employing teachers to defining the curriculum. This process began in the 1970s, well before the democratization process of 1989 and is, therefore, not only the product of the "transition" but of more gradual structural changes. The transition, however, accelerated the changes.

Municipalities automatically receive a predetermined amount from the central budget when normative criteria are met. On average, municipalities allot about 30 percent of their incomes to education, and education is the largest local expenditure. Local authorities spend more on education than they receive from the center (e.g. the ratio of normative grant to local education expenditures decreased from 66 to 56 percent from 1991 to 1996). Normative education grants (related to the number of students) are the largest transfer to municipalities, and are set in each year's budget law. Until 1996 there were few normative grant categories; their number has since grown to include, for example, students enrolled in ethnic or national minority programs, or transferring from other municipalities. The normative grant is available to every school with an operating license. Non-state schools can receive subsidies from central or local budgets. The Constitutional Court ruled in April 1997 that the state is obliged to provide similar subsidies to church and local government schools. In addition to normative grants, the state supports local public education activity through subsidies for specific goals, usually keyed to priority development tasks. These expenditures have increased since the new 1996 law: the 1997 budget includes for such tasks more than 8 percent of planned normative public education expenditures.

Municipal financing of education is largely governed by bargaining. The laws requiring local governments to finance education are defined only in very general terms. These include legislation on the remuneration and legal status of public servants, and rules contained in the Public Education Act 1996. The amount of time put in by qualified teachers is the basis for calculating wage costs and for demand for equipment and material expenditures. As these regulations do not set precise determinants for wages and other costs, bargaining between schools and their owners takes place. The rules only allow municipalities to calculate the minimum teaching load mandated by law, for which they have to secure financing for teacher remuneration. Schools where teachers have higher qualifications – or average ages – than prescribed by law have higher wage costs than the norm that might be financed. However, municipalities can also extend school hours, provide extra services, or agree to pay higher than obligatory wages.

Hungary has a large number of municipal schools. There are more than 1,000 localities, more than 55 percent of all municipalities, with schools having eight grades. Almost one-quarter of eight-grade classes are in localities with less than 2,500 inhabitants.

Since all municipal schools have the right to bargain for their budgets, the process is onerous and outcomes can be very different.

The school budget emerges annually after several rounds of bargaining. This bargaining process differs in villages with only one school and larger cities with complex school systems. In a typical budget scenario, local authorities request a budget plan for the following year from the school principal, given information about the available resources (e.g. wages may be increased in a determined proportion, material expenditures frozen, etc). The school principal and staff then produce a budget and submit it to local government staff. The latter then compare school budgets with each other and prepare the municipal budget for approval by the assembly of elected representatives.

Until 1995, most schools simply adjusted the budget of the previous year for inflation, and it was approved without changes by municipal authorities. In addition to normative grants, the state budget provided (until 1996) transfers to cover wage increases adopted in (tripartite) collective bargaining agreements. Apart from agreed wage increases, deviations from the previous year's budgets were relatively rare and happened only in some large urban municipalities.

Following the measures adopted as part of the 1995 stabilization program ("Bokros package"), many local governments began to pay more attention to the school budgets, especially the wage "grids" used by the schools. This process was first done on the basis of local regulations or locally agreed practices (for example, regarding teaching loads) then, after 1996, under the provisions of the amended Education Act (Halasz *et al.*, 1998).

High powered incentives: are they effective?

Under the Public Education Act, transfers by the center had to cover teachers' salaries. It was not clear whether the transfers should be based on national average teachers' salaries or should finance every teacher who was already employed. Whether the central or the local government should bear the responsibility for paying teacher salaries – and whether this should cover all employed teachers – has been a hotly debated issue in Hungary since 1990.

The issue became particularly sensitive due to the decline in student numbers since the beginning of the 1990s. In primary schools (6 to 13 year olds), the student/teacher ratio fell from 14 to 11 over 1988–94, a very low ratio by international standards; the number of students per classroom fell from 25 to 20 over this period. This created a large surplus of teachers, and the existing financing system for public education could not handle this problem. After the stabilization program of 1995 it was decided not to move to direct central wage financing though this solution had the preference of the Ministry of Finance. Trade unions supported direct financing of teacher salaries, to guarantee security of employment and better pay levels. By contrast, the Ministry of Culture and Education wished to continue decentralized financing, because it felt that this was the most appropriate system to guarantee both efficient employment and security of wages in a decentralized context.

Finally it was agreed that efficiency issues would be addressed by indirect government action – under decentralized patterns – by influencing the behavior of local decision makers. The 1996 amendment to the Public Education Act set standards under which local governments calculate wage expenditures and the appropriate number of teachers. Thus the center can only affect the education system and local budgetary decisions by indirect means.[6] The central government postulated in 1995 that if transfers declined, local governments would be faced essentially with two options only, given that their ability to borrow is limited: either to reduce expenditures or to increase own-revenues to compensate for declining transfers. The central government assumed that cost-reduction on the spending side, sufficient to accommodate revenue decline, was possible only if institutional adjustments, such as closing down schools or reductions in the number of teachers, took place to ensure a restructuring of primary education services. Alternatively, local governments could increase own-revenues to maintain expenditure levels. The central government was in favor of the first form of adjustment (Papp, 2000).

Reducing central government transfers while rewarding cost-saving efforts can be interpreted, in theory, as an efficient incentive scheme. Contracts in which the costs of operation are fully taken into account by the agent can provide efficient incentives for cost reduction (Laffont and Tirole, 1993). Primary education in Hungary is financed through normative transfers which cover a certain share of costs. The basic structure of the incentive contract is $t = a + (1 - b)C$, where t represents transfers from the principal to the agent. These transfers consists of two parts, a constant support a and a cost sharing part, $(1 - b)C$, in which the share of costs financed by the principal are represented by the term $(1 - b)$. The "power" of the incentive schemes is b, which is the link between the transfer and the cost performance of the local government. If $b = 1$, the total cost of the services is borne by the agent. This is the most powerful incentive scheme since the ratio of expenditures to be financed from own financial resources directly depends on the agent's cost-saving efforts. If $b = 0$, costs are totally reimbursed and this is the weakest cost-saving incentive. The "Bokros package" let coverage $(1 - b)$ of educational costs decline, so that local financing had to increase unless cost-reduction took place. In other words, "b" increased, while any cost-saving (i.e. decline in C) was given to the local governments.

There is another reason to argue that cutting transfers while rewarding cost-saving efforts is as an efficient incentive scheme. Local governments with information on the operation of public schools were entitled to decide to increase own revenues or reduce costs. If the latter, they could choose the actual form of cost cutbacks (such as school mergers or outsourcing). Allocating decision-making authority to the most informed level is a necessary requirement for organizational reforms. De Groot and van der Sluit (1987) examining the hospital system in the Netherlands argued that reorganization decisions should be allocated to the level of government with full information on the operation of the sector for better outcomes.

What actually happened in Hungary? Local governments reacted to declining government transfers by increasing own revenues, which grew continuously from 1995 onward. But expenditure adjustments have taken place as well, and local budgets as a whole declined by 4.7 percent of GDP during the 1990s. However, contrary to expectations declining transfers were not accompanied by large scale reorganization of services. The number of schools, teachers, pupil-to-student ratios remained unchanged (Bokros and Dethier, 1998). In other words, instead of cost-reducing institutional arrangements, such as having fewer but bigger schools, local governments cut several expenditure items, such as cash and in-kind social benefits available to the poor, or maintenance and renewal. Other more "tricky" methods were also applied, for example cutting social security expenditures through forcing teachers to change their employment status (Davey, 1998). This may lead to undesirable distributional outcomes or poorer service provision.

Preliminary analysis of the twenty-two largest Hungarian local governments (Papp 2000) shows that localities adjusted in non-personnel (material) expenditures as a response to declining general government transfers. Reduction in maintenance (measured by non-personnel expenditures) or postponement of maintenance often results in quality deterioration of services (Domberger *et al.*, 1995). The data partially support the view that quality deterioration took place in public primary education in Hungary as falling non-personnel expenditures proved to be directly associated with declining general government transfers. Therefore, despite the seemingly proper design, declining central government transfers to the local governments were inefficient as an incentive scheme. The modest observed cost-reducing behavior of local governments stands in sharp contrast to the large expected adjustment predicted by incentive theory.

Basic education in Slovakia

Slovakia inherited an integrated but strongly centralized and hierarchical education system from its socialist past. The Ministry of Education (MOE) directly controlled all levels of education through its regional and district level units, called Regional and District Educational Committees. Employment and financing decisions, for both current and capital expenditures, were made by the Regional Committees in consultation with the MOE. Allocation of funds did often not reflect the need of the schools and there was no flexibility in the financing system.

At the start of the transition, a new education structure was established (Act 542/1990) which consisted of the MOE, three independent regional school councils responsible for higher and secondary education, and thirty-nine district level school councils dealing with primary and pre-school education. In addition, a special school inspection body was established. This system lasted until 1996. Act 222/1996 reestablished regional and district offices of public administration, in which education issues are represented through departments of education within public administration units. Moreover, it increased the numbers of these units from three to eight at the regional level and from thirty-nine to seventy-nine at the district level (in line with the new territorial structure introduced by the Act) and public administration employment skyrocketed, including in education.

Under the current system, the MOE is responsible for higher education institutions, educational methodology, state pedagogical institutes, methodological centers, and leisure centers. The regional offices are responsible for secondary education, and the district offices for primary education and pre-K childcare. All financial resources are allocated to the district level by the regional level. In principle, this allocation of funds to districts takes place on the basis of guidelines prepared by the MOE. But, the chairpersons of the regional public administration offices often disregard educational issues and rarely consult with heads of education departments. Given the close links between the regional offices and the Ministry of Interior, it is not an exaggeration to say that, in Slovakia, education policy is strongly influenced by the Ministry of Interior!

A 1999 decree transferred the authority for the allocation of funds from the chairman of the (regional and district) public administration offices to the respective heads of educational departments. In practice, however, only three out of the eight regions and thirty-nine out of seventy-nine districts had complied with the new rule by the summer of 2000.

Education financing in Slovakia is based on institutional norms (per school as opposed to per student), to cover the operational costs of education institutes according to geographical location: for example, higher heating expenses due to colder climates are accommodated by the system. Since there are few incentives for the institutions to save on fuel and other expenditures and since the formula used for the transfers probably underestimates the true cost of running the schools, the regional offices have been in arrears since their creation in 1996 (see Table 8.4). Month after month, their spending exceeds their receipts and they accumulate arrears (generally, *vis-à-vis* the district heating company) which the Ministry of Finance ends up covering at year end.

During the budgeting process, the MOE only has a consultative role on secondary and lower level education expenditures. The eight regional public administration offices prepare their budget proposals and submit them directly to the Ministry of Finance.

Education policy in Slovakia is undergoing profound changes. First, a reorganization of the administration of the education system is planned – and the MOE wishes to establish its own education offices independent of the currently existing Regional and District Public Administration offices. Second, arrangements are being made to introduce decentralized management of individual schools with elected local governments becoming responsible for financing operational costs. Third, the design of education financing through a major revision of the current system of normatives is also under discussion. The MOE's focus on the first issue satisfies neither the supporters of more

Table 8.4 Slovakia – arrears of the regional offices (in SK million)

Regional offices		*1998*	*1999*	*2000**
Bratislava	Total	119.4	53.3	116.9
	Education	75.0	16.4	74.6
Trnava	Total	56.3	13.5	72.3
	Education	31.9	7.7	50.0
Trencin	Total	114.0	61.6	130.6
	Education	60.6	51.0	109.6
Nitra	Total	97.1	38.4	102.0
	Education	66.7	24.7	85.0
Zilina	Total	111.7	73.7	191.0
	Education	66.3	42.9	153.0
Banska Bystrica	Total	150.2	73.6	167.4
	Education	115.7	58.1	148.9
Presov	Total	252.8	169.2	217.3
	Education	165.2	86.9	176.3
Kosice	Total	283.3	131.7	309.7
	Education	196.3	64.8	239.2
Total regional offices	Total	1,185.2	615.1	1,307,237
	Education	778.0	352.8	1,036,722

Source: Ministry of Finance.

Note: 2000 is an estimate.

substantial decentralization, such as the Association of Municipalities ZMOS, nor the Ministry of Finance, which considers that it could lead to increased expenditure.[7]

The planned reform of education raises the issue of state control over education. Should the central government's role be limited to providing educational methodology and carrying out school inspection, or should the state also have other responsibilities? Who will be in charge of budgeting, employment policy and financing? Should these functions go to the new "VUCs" which will have elected bodies? If education is managed at the regional (VUC) level, what would be the role of local governments? One option, favored by the MOE, is that local governments be involved in the operation of district education offices. They would thus have a right to influence the education process as well. The MOE does not want mayors to manage schools because of the risk that they use schools to further their political agenda; misuse educational assets and/or misuse operational funds resulting in the breakdown of educational services in some localities. The MOE believes that wages should remain the responsibility of education offices (where a local government is not able to finance operational costs, the MOE would do so). If the latter idea were to be implemented, there would be no incentives to reduce operating costs at the local level, and would seriously soften the budget constraint for local governments right from the beginning.

In terms of financing, the MOE intends to revise currently used education norms, based on the number of children per class room/school. It is unclear whether the norms are simply budgeting tools (no longer used in advanced countries), or represent earmarked expenditures, leading to no flexibility in their use at the local level. If the latter holds true, the new system cannot be truly considered a decentralized one. Local governments would simply be "pass-through" paying agencies.

The MOE, in line with the Teachers' Unions believes that employment of teachers should be the responsibility of district education offices. The alternative is that all educational staff become employees of municipalities. The MOE believes that this arrangement would reduce the school's role to that of an "economic unit" within the budget of local governments. This proposal is thought to ensure that professional aspects would guide hiring and firing, as in case of schools with a legal entity, school directors would be entitled to decide on employment issues, while in case of schools with no legal entity, district education offices would do so.

Conclusions: decentralization and EU accession

For countries like Hungary and Slovakia in the process of joining the EU, one important issue is to find the optimal organization for the provision of local public goods such as education, health care or social assistance services.

Decentralized government creates several problems. First, a major constraint is the lack of qualified personnel in the public sector. Many communities cannot meet minimum standards of services simply because they do not have enough qualified personnel to do so. The authorities of communities with a population of less than 1,000 have nearly the same set of duties as large jurisdictions like Bratislava or Budapest.

Second, organizational and institutional issues are more complex in a decentralized context because they require more coordination. Many problems of expenditure management require appropriate organizational models and incentive structures. The example of education in Hungary indicates the complexity of the coordination problems involved. A clear definition of roles and responsibilities (and avoiding duplication) across tiers of government is required; together with good tax legislation providing incentives to improve services and finally, incentive structures that improve accountability and participation.

An option for organizational reform is to abolish and/or consolidate small units, as in the EU since 1960. In Sweden the number of localities has been decreased from 2,500 to 278. Denmark merged 1,388 into 275 localities, Germany moved from 24,512 to 8,500 by 1980 and Belgium from 2,663 to 589 between 1961 and 1980. Britain went even further, and has no local authorities in its villages, with the basic unit being the district with an average population of 120,000 (Ebel *et al.*, 1998). The consolidation option has economic merits, but in Central Europe, 10 years after the restoration of local autonomy, it may be too soon for such a political option.

Another option is to generally redefine the competencies among subnational governments, with an eye to assigning functions such as water supply, basic health and social services, and primary education to general-purpose regional governments. This may be the vision behind the Slovak reform. It could make sense in terms of principles of economies of scale, appropriate size benefit areas, and administrative feasibility for the local public sector. Its attractiveness for Central European EU accession countries, however, seems to be elsewhere: it conforms to the EU's use of regional governments to carry out various EU directives and spend structural funds. Achieving EU membership would give Hungary and Slovakia access to structural funds of about 2 percent of GDP every year. Although access to these funds would substantially increase the scope for rebuilding local infrastructure, local governments do not have yet the capacity to meet the cofinancing requirements of 20 percent, or an additional 0.5 percent of GDP to infrastructure projects in order to utilize the EU's structural funds. If local governments are able to develop their own revenue sources, the cofinancing requirements could be partially met from these sources. Any remaining cofinancing needs would have to be met from additional transfers from the central government, or from borrowing. Note that convincing empirical evidence indicates that there is no link whatsoever between amount of structural funds spent in EU countries over the past twenty years and regional development (Boldrin and Canova, 2001).

One last option is for the central government to provide incentives for intergovernmental cooperation and privatization in local service delivery. This is already happening on a large scale in Hungary through the design of matching grants to encourage cooperation, local government establishment of nonprofit organizations for purposes of delivering services, the granting of central transfers and non-municipal organizations and the municipalities' own decision to cooperate for common functions.

Whatever option is chosen, there will be a need to develop the capacity of local governments to generate and to manage a larger volume of resources (World Bank, 1999). Shared governance between the center, intermediate tiers (regions, counties and associations) and local governments will require clarification. Expenditure assignments will need to be specified more precisely and the legislation on health, education and other sectors will need to clarify who has decision-making power. It would be desirable that oversight over financial management remain centralized through "remote control" of lower levels. Regional development organizations could also perform the function of managing funds but their programming and implementation capacity will need major improvements. Local governments will also need to develop their attractiveness for business and their capacity to generate revenues from local sources. Introducing a value-based property tax and implementing a gradual upward revision of the vehicle tax rates could boost local revenues. Personal income tax (PIT) sharing currently allocated by origin might be replaced by a PIT surcharge system. There is also scope for raising more revenues from the business tax by having the tax implemented by a wider range of subnationals. The property tax, the PIT surcharge, and the business tax are expected to gradually become the major sources of local revenues (Ebel *et al.*, 1998; World Bank, 1999). This would increase the ratio of revenues subject to local discretion, and hence also increase local accountability. Transfers will continue to be the principal source of funds for current expenditures. The annual level of those transfers could be tied to macroeconomic benchmarks such as inflation and GDP growth (as in France) or determined as a fixed percentage of taxes (as in Japan). Moreover, the system for allocating current grants needs to be simplified and made administratively less burdensome. Equalization grants which are now allocated through numerous parallel channels should be consolidated into a single equalization fund designed to compensate imbalances across municipalities and regions.

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Notes

1 This program and its components is described in details in Bokros and Dethier (1998). Kiss and Szapáry (2000) also contains a good summary.

2 There are three kinds of shared taxes: personal income tax, business tax, and road tax. Out of the total SK8.2bn personal income tax revenues planned for 2000, approximately SK6.4bn (or 78 percent) is meant to be shared with local governments. These taxes are redistributed to local governments on a per capita basis. The business tax (tax on income of legal entities) is much smaller. Sixty percent of it is redistributed to localities on a per capita basis and 40 percent on the basis of origin. The road tax is expected to yield SK1bn in 2000 – 30 percent to be transferred to municipalities on a per capita basis and 70 percent to the Road Fund.

3 In 1996, under the Meciar government, the Parliament adopted Act 221/1996 creating eight regions and seventy-nine districts. These are not decentralized organs, but deconcentrated organs of the central government. The number of territorial units increased – with respect to the socialist period – from three to eight at the regional level and from thirty-nine to seventy-nine at the district level. As a consequence, public administration employment skyrocketed. In addition, the 2,881 local governments remained.

4 Resolution No. 230 of April 11, 2000 on the "Concept for Decentralization and Modernization of Public Administration," Government Office of the Slovak Republic.

5 The World Bank and USAID financed three surveys on corruption in Slovakia in 2000 (USAID/World Bank 2000). The surveys reveal that corruption is widespread and affects all key sectors of the economy. Individual citizens were most affected in the social sectors, with 60 percent indicating payment of pozornost (bribes, gratitude money) to obtain hospital services and between a quarter and a third for other medical services and higher education. Enterprises are most affected by licensing and regulatory bodies, courts and customs, with incidences of bribes reported by one-third for a number of these offices. Many firms reported that they

unofficially sponsor political parties. All three groups of respondents identified the judicial system as a major area of corruption.

6 In addition to regulating the performance of educational tasks and defining subsidy entitlements and scale and "output requirements," the state also has the responsibility to establish a system of evaluation and quality assurance (Halasz *et al.*, 1998).

7 The current fragmentation of educational services, where 47 percent of schools have only two classes (one for pupils aged 6–10, and another for 11–14) would be addressed through subordinating small schools to big schools (with a pupil number of 250–300) in the neighborhood. Small schools would not be closed down, but they would have their director jointly with bigger schools, and they would have a joint account for the funds they receive.

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9 Reforming fiscal federalist relations in Russia

Centralization of resources and decentralization of autonomy[1]

Aleksei Lavrov, John M. Litwack and Douglas Sutherland

A number of studies have identified the state of fiscal federalist relations as a major obstacle to successful economic transition in the Russian Federation.[2] The current system offers weak incentives to regional and local levels of government for responsible budgetary management and the adoption of policies conducive to entrepreneurship, fair competition, and the development of new private firms. This finds reflection in a poor climate for business and investment in Russia compared to a number of other transition economies, including excessive entry barriers, licenses, fees, taxes, and various types of extortion.[3] A major improvement of the climate for entrepreneurship and investment in Russia requires changes in the conditions under which regional and local Russian officials operate. Such is the motivation for a fundamental reform in fiscal federalist relations outlined in the new Economic Programme of the Russian government (Programma …, 2000).

A number of recent studies in economics and political economy have raised questions about previously accepted wisdom and practices in fiscal federalist relations, often focusing on developing or transition countries both in the process of building market institutions and struggling to achieve lasting stabilization and growth. It has been argued that properly designed decentralization can effectively serve as an engine for market reform and growth (Weingast, 1995; Monitola *et al.*, 1995). On the other hand, a number of other studies warn of the dangers of decentralization, again often focusing precisely on problems in developing or transition economies (Fukasaku and de Mello, Jr., 1998; Prud'homme, 1995). The relative advantages and disadvantages of decentralization also underlie current policy debates within Russia. Is the cure for poor economic policies and irresponsible behavior of regional and local administrations a crackdown by the central government or a more effective and rational decentralization?

The Russian system of interbudgetary relations indeed stands to profit greatly from an explicit decentralization in decision-making authority. But the particular characteristics of the Russian economy suggest accompanying this decentralization with a package of additional measures to ensure overall financial control, the achievement of basic social policy goals, and the proper alignment of incentives for state organs. This suggests a dual approach that decentralizes some autonomy and responsibility, while at the same time centralizing more resources to the federal level, particularly in the short and medium term. A longer-term strategy should gradually increase in the share of resources in subnational budgets, as institutions for subnational finance and responsibility become stronger, more durable macroeconomic stability is achieved, and social distress among the population subsides. The strategy outlined in this paper is consistent with, and builds on, recommendations in OECD (2000b) and the general directions set out in the Economic Programme of the Russian government (Programma …, 2000).

The following section briefly describes the state of fiscal federalist relations in Russia, drawing upon both OECD (2000b) and more recent information. The next section turns to the general question of decentralization for the case of Russia. Final sections outline a comprehensive direction of reform and discuss current strategies and programmes of the Russian government.

The state of fiscal federalist relations in Russia

In the Soviet system, all state revenue was first centralized and then allocated according to the national plan. Subnational administrations began to play an increasing role in resource allocation with the weakening of the product-line ministries in the 1980s. This process intensified during the transition to a market economy in the 1990s, leading to a significant devolution of effective power and authority to the regional (Subject of the Federation) level of government. By and large, this devolution of power did not follow a specific plan or central legislation, instead deriving from strong autonomous centrifugal forces that followed a weakening of the central government and its corresponding inability to meet a large part of former expenditure obligations. In a rather chaotic environment, regions lobbied for greater shares of revenue through bilateral agreements with the center, while the federal government pushed expenditure responsibilities downward.

Official legislation evolved along with this process, but generally opposed the chaotic decentralization through measures aimed at bringing regional and local finance under greater central control. One important accomplishment since the mid-1990s has been the creation of somewhat more uniform rules for revenue sharing and expenditure assignments for all Subjects of the Federation. These rules have, to a large degree, replaced the separate bilateral agreements of the past.[4] But legislation and actual practice in Russian fiscal federalist relations still remain far apart in many areas. Therefore, an understanding and assessment of the state of fiscal federalism in Russia requires distinguishing between the system as it exists on paper and how it actually works in practice. A much more detailed treatment of a number of the issues in this section can be found in OECD (2000b). On paper, the current system of fiscal federalist relations is distinguished by an extremely high degree of central control over subnational budgets. In practice, subnational administrations have ample means to circumvent this control. The nature of this game accounts for important distortions in the incentives of state officials at regional and local levels.

Russian administration now consists of three main levels: federal, eighty-nine (regional) Subjects of the Federation, including nine autonomous *okrugs* that are considered part of larger subjects, and several thousand local administrations. The precise nature of the actual hierarchy can vary in practice, however, ranging from 2 to 4, 5 tiers. Some federal legislation refers to "consolidated (regional and local) budgets of Subjects of the Federation" as one legal entity, suggesting a two-tier hierarchy. The actual administrative structure can vary significantly from region to region. Some Subjects of the Federation interact directly with a series of local (third-tier) municipalities, while in other regions only larger cities and districts have municipality status and interact with smaller subordinate administrations. A mixture of these two models is also common.[5] A typical Russian region will have one or two strong cities or districts that supply the vast majority of tax revenue, while most of the remaining districts, usually without any sort of real tax base, are financed primarily by the regional budget.[6]

By the share of subnational budgets in consolidated revenue and expenditures, and the degree to which subnational budgets consist of revenue raised on their territories as opposed to transfers, the Russian system appears significantly decentralized (Figures 10.1 and 10.2), at least at the regional (Subject of the Federation) level. In the 1990s, the share of consolidated subnational revenue (before transfers) in all state revenue gradually increased from 40 to 56 percent in 1998, before falling back to 49 percent in 1999. This share decreased again in 2000, due primarily to higher federal revenues from export taxes and changes in tax legislation, but remains well above 40 percent. As shown in Figure 9.1, this places Russia close to China and a number of developed federations, such as Germany and the United States, and above Brazil, India, and Mexico. The comparative share of subnational expenditures is lower, reflecting a relatively low average share of transfers in subnational revenue (Figure 9.2). The share of federal transfers in aggregate subnational (consolidated regional) revenue stood at roughly 15 percent in 1999. This can be contrasted with India, China, and Mexico, where transfers account for over 30 percent of sub-national revenue, as well as Brazil where they account for over 25 percent. But a rather high degree of variance exists across different Subjects of the Federation according to this measure. While transfers account for less than 10 percent of the revenues of many Subjects of the Federation, this measure

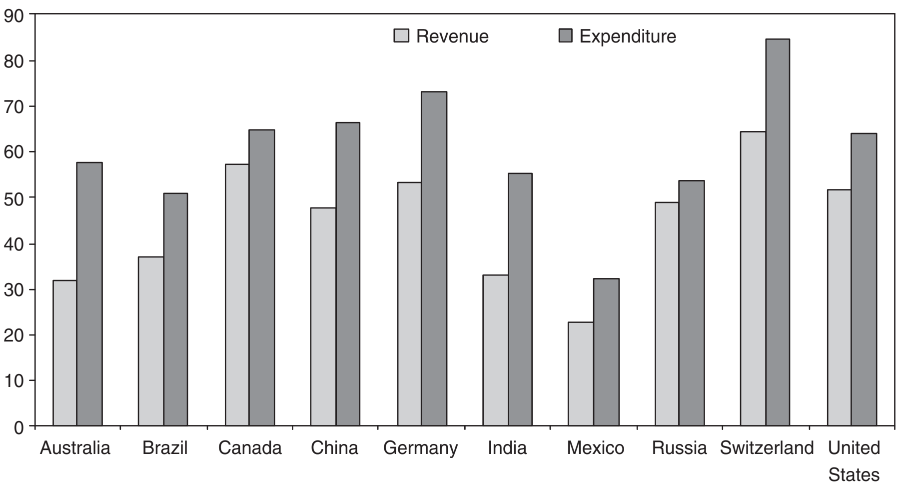

Figure 9.1 The share of subnational budgets in consolidated state revenue (before transfers) and expenditures in selected countries.

Sources: OECD and IMF.

Note: Revenue is total revenue before transfers, including tax sharing. Expenditures include transfers data for Russia are from 1999, for Australia and Germany 1998, for China, Switzerland, and the United States for 1997, India 1996, Canada 1995, and Brazil 1994.

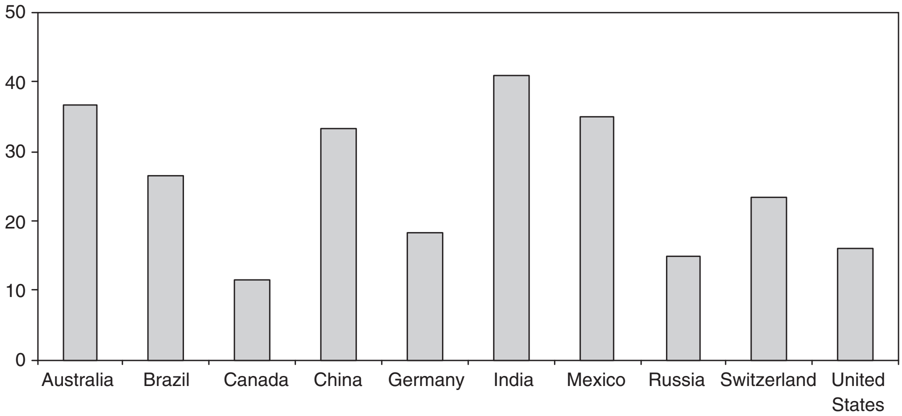

Figure 9.2 The share of transfers in consolidated regional state revenues in selected countries.

Sources: OECD and IMF.

Note: Country data are from the same years as Figure 10.1.

reaches 50–60 percent for over twenty of the least developed regions. The variance in local transfers is even greater, with a number of rural municipalities receiving transfers accounting for over 80 percent of revenue.

Formal measures of decentralization tell another story altogether. Here, the legacy of the over-centralized Soviet system survives, further bolstered by a number of measures in the second half of the 1990s that place additional limitations on the autonomy of subnational administrations. The vast majority of subnational revenue and expenditure obligations are determined by laws and regulations of a higher level of government, most notably the federal level. A single federal tax ministry collects all taxes, transferring the majority of this revenue to the federal treasury, which then allocates it to various budgets. The federal government sets the rates and sharing rules of the major taxes as part of the annual federal budget law. Only roughly 15 percent of regional and local (explicit) revenue derives from taxes over which the relevant administrations have any sort of real decision-making authority, and even these taxes are usually rigidly regulated from above or subject to federal ceilings (see Table 9.1). The new Tax Code of 1999 (Part I) and 2000 (Part II) reinforced the narrow limits on subnational autonomy, restricting subnational taxes to a short possible list. Other measures have targeted some of the few remaining local and regional taxes for elimination or greater central control.

This places subnational tax autonomy for Russia considerably lower than in most other federations, especially in developed federations such as Canada, Switzerland, and the United States, where subnational governments have almost complete autonomy in choosing tax bases, types, and rates.[7] By this measure, the Russian system is also far more centralized than that of China, India, and Brazil.[8] Among other federations, only Germany and Mexico have comparable low explicit subnational tax autonomy, but both are smaller and less diverse than Russia.[9]

The determination of subnational expenditures is also quite centralized. Formal expenditure responsibilities assigned to regions and localities include (regional) state

Table 9.1 The composition of regional and local budgetary revenue (in percent)

	1997		*1998*		*1999*		*2000 (Jan–Jun)*	
	Regional	*Local*	*Regional*	*Local*	*Regional*	*Local*	*Regional*	*Local*
Total revenues	100	100	100	100	100	100	100	100
Of which:								
Tax collection	69	67	64	64	75	71	76	68
Shared taxes	55	54	50	52	60	56	58	53
Regulated[a]	31	40	30	38	25	42	23	39
Of which:								
Profit tax	—	11	—	10	—	17	—	15
Fixed federal[b]	3	12	3	12	4	12	4	13
Subject to federal ceiling[c]	21	2	17	2	31	2	31	1
Of which:								
Profit tax	19	—	15	—	20	—	25	—
Other taxes[d]	13	8	14	12	15	15	18	15
Non-tax revenue	6	2	6	4	6	4	6	4
Transfers from higher-level budgets and extra-budgetary funds	24	31	30	32	19	25	18	28

Source: OECD calculations based on data and information of the Ministry of Finance.

Notes

a Rates and sharing rules are set annually by the superior level of government.

i For regional budgets: VAT, personal income tax, excises, and tax for natural resources (except payments for natural deposits and land tax).

ii For local budgets: VAT, personal income tax, profit tax, single imputed income taxes, and taxes for natural resources (except payments for natural deposits and land tax).

b Rates are set entirely by the superior level of government and sharing rules fixed by federal legislation.

i For regional budgets – payments for natural deposits.

ii For local budgets – payments for natural deposits, sales tax, and property tax (enterprises).

c Rates and sharing rules are set primarily by the superior level of government, but allowing some discretion to change tax rates (bases) within fixed federal ceilings (norms) and/or to introduce additional tax exceptions.

i For regional budgets – profit tax, single imputed income tax (legal entities), and road tax.

ii For local budgets – land tax.

d Rates, tax bases and exemptions are set subnationally, but within a federal legal framework.

i For regional budgets – sales tax, property tax (enterprises), licences and registration fees, and single imputed income tax (personal).

ii For local budgets – licenses and registration fees, property tax (persons), advertising tax, social infrastructure and other local taxes (are to be cancelled after the introduction of the sales tax).

administration, finance of regional organizations, housing subsidies, transportation, and roads of purely regional significance. In addition, regions share a certain ambiguous "joint responsibility" with the federal government for large expenditure categories such as education, health, social policy, and economic subsidies. Current Russian legislation assigns expenditure responsibilities to lower budgets without any guarantees of autonomy in the determination and execution of these expenditures. In this context, most expenditure categories in subnational budgets are subject to rigid federal regulations relating to the obligatory size and exact breakdown of budgetary outlays. In addition, regional and local budgets have been extraordinarily burdened by the accumulation of numerous unfunded federal expenditure mandates throughout the 1990s. The majority of these mandates dictate subsidies or exemptions in housing, communal services, transportation, etc. for various groups of the population. Although these mandates have a legal status as only "recommended" rather than obligatory since 1993, technical legal ambiguities have made at least a good number of them obligatory for all practical purposes, and recognized as such by the courts.[10] Only recently has the Russian government tried to take inventory of the stock of existing mandates and their burden on subnational budgets. A survey of 68 of 89 Subjects of the Federation in 1999 asked for an identification of current outstanding federal mandates. Although regions typically did not identify mandates that they did not recognize as binding, the combined burden of the twenty-five most important federal mandates (identified by at least 10 percent of all regions) was as much as 60 percent of all consolidated regional expenditure. The combined burden of all mandates recognized by at least one region in the survey amounted to 170 percent of all consolidated regional expenditure.[11] Subsequent measures in have finally reduced, but still not eliminated, the burden of these unfunded mandates. Thus, the fundamental problem of ambiguous and irrational expenditure assignments, which was stressed in the first comprehensive study of fiscal federalism in Russian (Wallich, 1994), remains unsolved.

As indicated above, while transfers account for only 15 percent of subnational revenues on average, they are of critical importance for a large number of regions and localities. Russian transfer policies have suffered in the past from both a lack of transparency and a "soft" adjustment to current budgetary needs, thereby weakening incentives and responsibility at lower levels of government. This is particularly true for transfers from regional to local levels of government (Zhuravskaia, 1998). Consequently, transfer policies have been a primary target for reform since the mid-1990s. The methodology and allocation of federal transfers has been improved notably in recent years. This includes the concentration of the vast majority of federal transfers into a single Fund for the Financial Support of Subjects of the Federation (FFSSF). Under a 3-year government programme for the reform of inter-budgetary relations for 1999–2001, the methodology for determining the size and the allocation of this fund has become more transparent and rigid, depending less on recent budgetary performance in a given region. The new methodology has also concentrated federal transfers more effectively in the poorest regions. But other types of less transparent federal transfers still exist outside of the FFSSF, including various loans, debt restructuring, and so-called "mutual settlements." At the regional level, a 1997 law on local self-government sought to make the rules determining transfers from regions to localities more rigid over time. For various reasons, however, this law appears to have been largely ineffective in practice (OECD, 2000b).

A virtual explosion in subnational debt issues followed a federal law of 1993 that granted regional and local administrations the right to issue debt with few restrictions. The existence of numerous and sometimes complicated subnational debt instruments complicates an assessment of the outstanding debt and creditworthiness of different administrations. These instruments include various bills of exchange, sometimes issued by "authorized" banks or other affiliates, direct loans, and subnational loan guarantees. While official statistics place outstanding subnational debt at an insignificant level (less than 2 percent of GDP), this methodology fails to account for numerous categories of debt. On the basis of partial survey information from fifty-three Subjects of the Federation, OECD (2000b) estimated the combined burden of subnational debt and loan guarantees (46 percent in arrears) to be roughly 8 percent of GDP, more than quadruple the official figure. Over 35 percent of this debt was estimated to have been in arrears in 1999, indicating regional defaults and insolvency on a massive scale in wake of the 1998 crisis. More recent estimates of the Ministry of Finance show a similar picture, with almost 40 percent of outstanding debts of subnational governments in arrears as of April 2000.[12]

Despite the highly centralized nature of the formal system, subnational administrations do, in fact, exercise a high degree of informal autonomy within their jurisdictions, particularly at the level of the Subject of the Federation.[13] Thus, the system in practice is significantly decentralized with respect to expenditures as well as resources. This nature of this informal autonomy, combined with formal central control, is the source of many of the distortions and incentive problems that plague intergovernmental budgetary relations in Russia today.

Subnational organs have a number of mechanisms for gaining leverage over economic organizations and financial institutions operating on their territories.[14] This includes direct participation in the capital, indirect participation through affiliated companies, control of utilities, control of various inspections empowered to administer penalties and fines, close ties with the courts and federal anti-trust or tax bodies, licensing, and the police. Federal organs operating in the regions typically have close relations with the regional administration, depending on the latter for a number of reasons, sometimes even for the provision of office space. Federal organs in the regions are also often staffed by local officials with a background in the regional administration. Until recently, the regional governor had informal veto power over the selection of some federal representatives, most notably the head of the branch of the tax ministry. Only in the context of recent administrative reforms has the influence of regional governors over federal structures perhaps begun to decline.

In this context, regional administrations almost always make direct use of enterprises and financial institutions on their territories for the provision of public goods and services. First, most large industrial enterprises inherited social infrastructures such as housing, schools, hospitals, etc. Many of these firms, particularly those that are profitable, continue to finance this infrastructure, even in the event that ownership has been formally transferred to the municipality. More fundamentally, profitable enterprises may be asked to provide subsidies to the region in many various forms, such as entire networks of retail consumer goods outlets (operated at a loss), housing, road work, monuments, sports stadiums, and the like. In return, these firms can receive various special privileges or protection from the administration, including explicit or implicit tax exemptions, debt restructuring, and protection from bankruptcy or competition. Complicated bilateral agreements of this sort between administrations and large "budget-generating (*biudzetoobrazuiushchie)*" enterprises are the general rule. Administrations themselves, or their affiliates, are often significant shareholders in these firms as well, and the activation of (tax) debt restructuring, debt/equity swaps and bankruptcies during 1998–2000 appears to have increased the extent of this shareholding. External management of financially distressed firms is often at least implicitly under the control of the regional administration. A primary advantage for administrations in relying on such bilateral bargaining and the direct provision of public goods is the avoidance of the ubiquitous tax sharing and rigid central regulations on expenditures in the formal system. The region effectively becomes a 100 percent marginal claimant on (implicit) taxes and exercises complete control over the allocation of expenditures. Lower profits due to the provision of regional public services offer the enterprise an advantage as well, lowering its tax obligations to the federal government. Many regions also have one or more "authorized" commercial banks that can hold various funds of the administration, offer deficit finance, and issue bills of exchange for use in fiscal policy. Analytically, it is quite difficult to distinguish the actual "budgets" of administrations from those of their affiliated firms and financial institutions.

Various extra-budgetary funds represent another informal tool of fiscal policy for subnational administrations. While these funds are technically illegal, numerous loopholes exist. For example, such funds can be set up as independent non-profit organizations with a murky shareholding structure that disguises administration ownership. "Volunteer" contributions can then be solicited from economic organizations. Small businesses have complained of extortion by state organs through pressure to make donations to such funds.[15] These funds again offer the dual advantage of avoiding revenue sharing and maintaining full control over expenditures. Subnational administrations also possess their own special accounts (*Sumy po porucheniiu*), which contain various fines, other off-budget payments, and some "excess" budgetary funds from economizing on certain expenditure categories. These accounts hold close to the equivalent of 5 percent of resources in the explicit budget on average. They share the advantages of extra-budgetary funds and the direct provision of public goods through economic organizations stressed above.

OECD (2000b) also placed particular emphasis on money surrogates, particularly debt offsets, as primary tools for the conduct of relatively independent informal fiscal policies at the subnational level. This includes direct control over resource allocations (through the arrangement of barter chains), various means of keeping a greater part of shared revenue in the region, an inherent lack of transparency in accounting that allows for "creative book-keeping," the difficulty of monitoring such arrangements by federal bodies, and the freedom for individualized tax treatments in the spirit of the bilateral relations described above. Although the Ministry of Finance has cracked down on the collection of taxes in money surrogates at regional and local levels in recent years (Figure 9.3), various schemes continue to exist. Such schemes can involve broker firms or "authorized" commercial banks that operate along side the regional administration, buying and selling bills of exchange that are redeemable in commodities, and organizing barter chains from taxpayers to budgetary recipients. After a firm sells such bills of

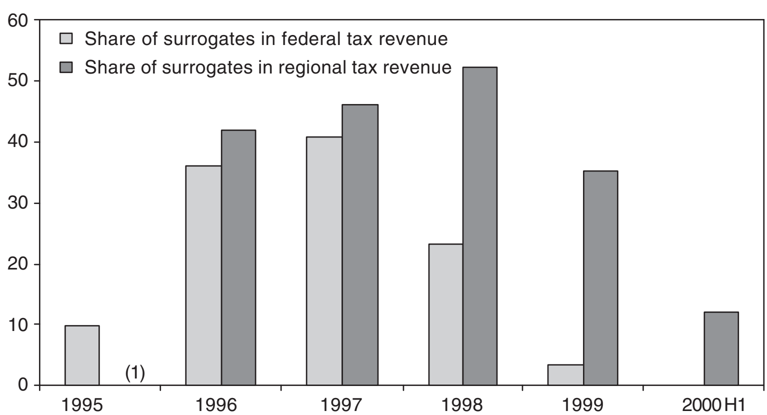

Figure 9.3 The share of money surrogates in consolidated regional tax revenue: 1995–2000.
1 Data are not available for 1995.

Sources: OECD and Ministry of Finance.

exchange to a financial affiliate of the administration, the cash receipts can be used to pay taxes formally in cash.

The typical infeasibility of fulfilling all federal norms and mandates for budgetary expenditures offers another important fiscal policy tool for subnational administrations: the selective sequestration of expenditure categories. For example, the twenty-five most important mandates identified by regions in the survey of 1999 were reportedly fulfilled on average by only 31 percent.[16] The choice itself of what extent to fulfill each category of expenditure obligations grants an obvious degree of discretion to subnational authorities. While the aggregate consolidated regional budget deficit on a cash basis was close to 1.0 percent of GDP between 1996 and 1998, OECD (2000b) estimates that the corresponding deficit on an accrual basis, which accounts for the under-fulfillment of twenty-five most important mandates, would be at least 5.5 percent.

Thus, subnational administrations in the Russian Federation continue to possess ample means and strong incentives for conducting their own implicit independent fiscal policies. A crackdown by the federal government appears to have shifted some of the emphasis away from money surrogates toward other sources, perhaps most notably the direct provision of public goods and services through enterprises. The recent wave of tax debt restructuring, debt/equity swaps, and bankruptcies appears to have solidified the leverage of administrations over enterprises in many cases.

What type of reform is needed?

The fundamental contradiction between the highly centralized formal system and substantial (informal) subnational autonomy is a major source of problems in Russian fiscal federalist relations. First, the highly centralized and often unfeasible nature of the formal system prevents the effective delegation of financial responsibility to lower levels of government. This not only concerns the establishment of appropriate disciplinary measures from above, but also political pressure from voters. Subnational officials can effectively pass the blame for fiscal problems to the federal government. Regular federal bailouts of subnational wage arrears in recent years bear witness to this problem (OECD, 2000b), as do the continuation of transfer policies that bypass the FFSSF. Second, the inherently underground nature of subnational policies encourages rent-seeking. By their very nature, these policies lack transparency and are not monitored by the usual federal organs, including the Anti-Monopoly Ministry and Fiscal Control Inspection. Second, the institution of informal bilateral bargaining with firms supports a political favouritism toward large enterprises that are capable of supplying public goods in the region, to the possible detriment to fair competition.

Some combination of recognized formal autonomy and measures aimed at reducing “informal” behavior is needed to resolve this contradition. The strategy of the Russian government in the second half of the 1990s focused on the reduction of both formal and informal subnational autonomy. In fact, on balance, these measures appear to have increased the severity of the contradiction. This includes the decision to revoke the rights of subnational governments to set their own taxes in 1996, the restriction of subnational taxes in the Tax Code to a small fixed list subject to heavy federal regulation, an increasing burden of federal expenditure mandates, crackdowns on the use of surrogates in budgetary operations, the elevation of the status of federal authorities in the region (such as granting ministerial status to the Anti-Monopoly body and “service” status to the federal insolvency body), severe restrictions on external borrowing, and some efforts to make federal transfers more conditional on the behavior of local officials. As indicated above, recent legislation has also created a new federal hierarchy along the lines of seven macro-regions for helping to enforce federal laws and regulations. Additional legislation has allowed for the removal of regional governors by the president in the event of repeated violations of the law. Proposals are currently being considered in the Russian government to eliminate the only significant truly subnational tax, the regional sales tax, and to require subnational administrations to use the federal treasury infrastructure for budget execution.

The strategy since the second half of the 1990s to increase federal control in the regions had understandable motivations. A common feeling within the central government was that too much had been decentralized too quickly in the chaotic early years of transition, thereby justifying a certain degree of federal retrenchment. The idea of greater central control also had an immediate intuitive appeal, given evidence of deficient economic policies, widespread corruption, and resistance to reform in many regions. As described above, confusion and difficulties surrounding the delegation of fiscal responsibility to lower levels of government allowed the latter to pass responsibility for "bailouts" to the federal government. In a sense, the federal government has responded to this implicit responsibility with attempts to assume greater control over financial flows as well. Finally, a perceived relatively anti-reformist political orientation in many regions was sometimes viewed, in itself, as a justification for a relatively pro-reformist federal government to take more coercive action.

Nevertheless, these attempts at only increasing federal control over the regions, thereby further reducing explicit regional autonomy, have had mixed effects at best, and have been counterproductive at worst. Most important, basic incentives for responsible budgetary management and reform-oriented policies do not seem to have been positively affected by these measures to any significant degree.[17] Regions compensated for restricted formal autonomy with a greater share of informal budgetary activities. The accumulated burden of federal expenditure mandates has only reinforced poor incentives for formal fiscal responsibility, and facilitated passing even more of the blame to the federal government.

In a country as large and diverse as Russia, particularly in the context of democratization, central control will always be imperfect and highly limited. Even if the federative structure would be entirely abandoned, similar problems would persist between federal, regional, and local branches of the "unitary" hierarchy. The fundamental improvement of incentives for subnational officials in the Russian Federation will depend greatly on economic measures, as opposed to only federal restrictions and administrative discipline. Regional and local administrations cannot be expected to feel sufficient responsibility for their own solvency and the consequences of fiscal policies unless they possess explicit autonomy within a clear and feasible budgetary framework. Some studies have argued that competition among regions operating under a high degree of fiscal autonomy has contributed fundamentally to successful development and rapid growth in a number of countries, including the Dutch Republic of the sixteenth and seventeenth centuries, eighteenth century England, the United States, and, more recently, China.[18]

On the other hand, other studies suggest that decentralization can lead to disappointing, and even disastrous results in the event that subnational incentives remain distorted. In fact, Russia might be considered at least a partial case in point. Shleifer and Treisman (1999) and Treisman (1999b) associate strong (at least implicit) regional power in the fiscal sphere with shortfalls in federal taxation and growing fiscal imbalances during

1995–98. An appropriately designed decentralization in Russia should therefore account for the potential pitfalls identified in the literature, as well as an understanding of why the high degree of informal autonomy in Russia has been so far insufficient for creating this type of engine for business and growth.

The majority of pitfalls to the decentralization of autonomy, as identified in the literature, concern the so-called "soft-budget constraint," or the degree to which subnational administrations can pressure the federal government for bailouts in the event of "unexpected" financial pressures or their own threatened insolvency.[19] If the federal government is unable, for political or other reasons, to make budget constraints hard, a decentralization of decision-making authority may not only fail to boost economic efficiency, but could also jeopardize macroeconomic stability. Given the expectation of a bailout, subnational administrations will typically have weak incentives for responsible budgetary management, perhaps even making such bailouts, together with an implied fiscal or monetary expansion, a self-fulfilling financial crisis. A number of authors have linked crises in Argentina in the 1980s and Brazil in the 1980s and early 1990s with such soft subnational budget constraints.[20] Restricting attention to developing and transition economies, Fukasaku and de Mello, Jr. (1998) find a significant negative relationship between fiscal balance and decentralization, where the latter is defined by the share of subnational budgets in all state expenditures and the share of transfers from the federal government in subnational revenue. Similarly, there may be a dependency of fiscal deficits on a high share of transfers in subnational budgets and fewer restrictions on subnational borrowing. Correcting for other factors, Treisman (1999a) finds a greater persistence of high inflation rates in countries with a federalist structure.

As described above, Russia does not exhibit a particularly high average share of transfers in subnational budgets at present, although problems persist in the "soft" adjustment of transfers to current budgetary performance. In fact, the highly centralized nature of the former system has actually hindered government efforts to make transfers more rigid. As long as explicit revenue or expenditure shortfalls (or windfalls) depend little on the behavior of subnational officials, it is difficult to implement, or even justify, a high degree of rigidity in transfer policies. A clearer delineation of responsibilities, together with genuine formal subnational regional autonomy and responsibility, offers a potential firm foundation for enforcing harder budget constraints through more rigid and transparent transfer policies. While some direct federal legislation may also help improve regional transfer policies to localities, the effectiveness of such legislation depends critically on the creation of sound incentives at the regional level.

Despite the basic conclusions in Shleifer and Treisman (1999) that the power and leverage of subnational governments contributed to the growing budgetary dilemmas of the federal government between 1995 and 1998, several points should be noted here. First, this process was not the result of any *explicit* decentralization of either resources or decision-making authority in the fiscal sphere. On the contrary, as emphasized above, legislative and other efforts by the federal government during this period aimed at bringing subnational finance under greater central control and monitoring. After a major shift in monetary policy in the mid-1990s, which quickly phased out soft directed credits from the Central Bank, subnational administrations came to rely more on their (largely informal) fiscal leverage as a means of ensuring themselves a continued flow of resources and a basis for independent policies. As indicated above, some of these activities had a negative impact on federal tax collection. Again, the appropriate solution to this problem is a formal system that would legitimize the access of regional administrations to at least a good share of these resources, but at the cost of their having to shoulder genuine political and economic responsibility.

Bird (1999) examines a problem that is highly relevant for the design of fiscal decentralization in Russia. He stresses that developing or emerging market economies with federative structures often fall into a trap, whereby the subnational tax base is inherently inadequate to meet substantial expenditure responsibilities. Under these conditions, decentralizations have commonly been accompanied by an alarming increase in federal transfers and more political difficulties in preventing soft adjustments in their allocation. The Russian case also displays excessive delegation of expenditure responsibilities, although explicit transfers have remained relatively modest in size due to the practice of tax sharing. Due to the inherent problems with tax sharing stressed above, however, a separation of taxes and tax revenues has considerable value for Russia. Thus, an adequate subnational tax base to support newly delegated autonomy and responsibilities would be a critical component to the success of such a reform.

Another central question is the mechanism for delegating greater responsibility to subnational officials, which must accompany greater autonomy. A feasible formal system with clearly delineated responsibilities is a necessary, but not necessarily sufficient condition for the enforcement of responsibility. Recently, Blanchard and Shleifer (2000) have given particular attention to this problem, suggesting that it is a key difference in the nature of intergovernmental budgetary relations in Russia and China. Russian democratic institutions are still rather weak for the enforcement of responsibility for elected officials in the regions, while, until recently, the federal government has had only very limited means of punishing regional governors and administrations for poor performance or violations of federal law. This became particularly true after the introduction of direct gubernatorial elections in 1996. By contrast, China has a highly centralized political hierarchy that allows for the removal of officials from above who might be particularly corrupt or oriented toward rent-seeking. Blanchard and Shleifer (2000) argue that this threat of possible removal can be a pivotal consideration for regional officials in choosing between reform-oriented policies or allowing themselves to be captured by large incumbent firms. They therefore argue that effective decentralization in Russia might need to be accompanied by greater political centralization. The recent legislation allowing the president to remove regional governors would appear to be a step in exactly this direction. Such an effective mechanism for enforcing financial responsibility in the regions, as well as basic federal laws, is indeed a key precondition for an effective decentralization in the Russian Federation. For this purpose, both OECD (2000) and the Russian government Programme (Programma …, 2000) propose the development of a clear legal concept of insolvency for a subnational administration, together with the possibility, or even necessity, or external management by a higher level of government.

There are three primary costs of central control over subnational budgets: (a) the inability of the center to delegate responsibility in an effective and rational manner, (b) the fact that informal policies created to evade this control are not monitored by federal organs, and (c) the necessity of building these informal policies through special bilateral relations with large incumbent firms. Given the nature of the imperfect measures aimed at increasing central control in Russian, there are additional costs as well. Litwack (2000) examines a case in which a central government cannot monitor directly the (informal) behavior of subnational officials, but exerts control over the formal budget, setting and collecting (official) taxes and mandating expenditures. It is argued that, even with a completely benign central government, such an arrangement will lead to a higher overall tax burden on business and investment than in a case of complete decentralization. Furthermore, the addition of central measures that increase the cost to subnational officials of conducting informal operations can even make the situation worse. The logic is as follows: the center has an interest in increasing (monitored) subnational expenditures as an imperfect means of diverting energy and resources away from rent-seeking activities. The burden of these additional expenditures, however, combined with continued (although lower) rent-seeking gives rise to an overall higher level of taxes and larger regional budget. Furthermore, imperfect measures that increase the cost of informal budgetary operations can be counterproductive, as part of these additional costs might be financed through higher (informal) taxation. The presence of corruption can also convert well-intentioned efforts to monitor directly and punish rent seeking into this type of destructive cost.

A general proposal for reform

Our proposal for reform incorporates much of the spirit of "market-preserving federalism," as proposed by Weingast (1995) and Monitola *et al.* (1995). These authors argue that the combination of five conditions has played a vital role in rapid economic growth and development in a number of countries: (1) a well-defined federalist system (a hierarchy of government with a clearly delineated scope of authority), (2) a high degree of regulatory authority of subnational governments in their jurisdictions, (3) the central government has a recognized authority to enforce a common market and the absence of barriers to trade and factor mobility, (4) revenue sharing and borrowing are characterized by hard budget constraints, and (5) the allocation of authority has an institutionalized degree of durability that cannot be altered unilaterally or through a coalition of governments.

An appropriate comprehensive strategy for the reform of fiscal federalist relations for Russia can exploit a number of the advantages of market-preserving federalism. Such a strategy involves simultaneous measures on six fronts: (1) the establishment of genuine regional and local autonomy within clearly defined bounds, supported by the separation of tax and expenditure functions, (2) a clarification of expenditure assignments, including legal guarantees of autonomy in subnational expenditures and the provision of an adequate subnational tax base to cover expenditure obligations, (3) a transfer to the federal government of some additional revenue and expenditure obligations that are currently a formal part of subnational budgets, with a gradual decentralization of resources in the medium and longer term, (4) the development of a clear legal concepts of insolvency and external management for subnational administrations, (5) reform of transfer policies to make them more transparent, simple, and rigid over time, (6) an enhanced effort by the federal government to enforce free trade and factor mobility between regions and basic economic laws, such as the Law on Competition, and (7) a civil service reform that significantly increases basic salaries for important figures in the administration.[21] The details of this proposal can be found in Lavrov *et al.* (2001).

The reform package may fall short of the precise conditions of market-preserving federalism, most notably due to the continued, and even enhanced, strong role of direct federal taxation and expenditures. However, formal subnational policies will become independent, regional administrations will become residual claimants of their own (explicit) tax policies, in control of their own (explicit) expenditures, and in a position to equate marginal costs and benefits in fiscal policy decisions. At the same time, competition between regions for business and investment under hard budget constraints will motivate administrations to pursue reform-oriented policies. A clear and feasible budgetary system will offer a foundation for the better enforcement of laws and financial responsibility, including a crackdown on remaining informal criminal activities. These measures should substantially decrease all but criminal motivations for maintaining informal budgets, thus facilitating an effective crackdown on such activities.

As stressed in the section "What type of reform is needed?," types of municipalities and other local administrations in Russia are numerous, ranging from relatively large cities with well-defined budgets and tax bases to small rural communities that are essentially a part of the regional budget. Local administrations can be municipalities themselves or parts of larger municipal units. The current condition in the law on local self government that allows any populated area declare itself a municipality has added to the confusion somewhat, as the wide variance in types of municipalities complicates efforts to apply any uniform conditions of autonomy and responsibility. In fact, the legal status of a municipality is not even that of a government organ, which alone creates technical difficulties in assigning local administrations any sort of government autonomy.

A potential solution is a new administrative division of regions into larger units of local state power. In essence, these larger units (large cities and former Soviet districts (*raiony*) already exist. Some have the status of municipalities themselves, while others are simply administrative subdivisions of the regional government that oversee the operation of smaller municipalities. Basic federal legislation could provide a framework for determining or formalizing this regional territorial division, accounting for public opinion and stating procedures for choosing and electing local state officials. In this case, federal legislation could guarantee certain basic taxes and budgetary autonomy to local governments in the manner described above. Existing conditions that allow any populated area to declare itself a municipality within a local government territory should remain, including provisions for revenue sources and financial obligations. But functions that technically require state autonomy (schools, health, etc.) could be handled at the local level by the newly empowered local bodies. Smaller municipalities would also contract and interact primarily with this lower level of state power.

Under current Russian conditions, the success of a reform for the creation of local government autonomy and responsibility will unavoidably depend strongly on the incentives of regional administrations. When Subjects of the Federation themselves are placed under conditions of explicit financial autonomy and responsibility, they will have a far greater incentive to create similar conditions within their regions for local administrations. Thus, measures to straighten out relations between the federal government and Subjects of the Federations should be understood as a crucial part of the realization of effective local self government.

The economic programme of the Russian government of 2000 and prospects for reform

The year 2000 may have been a decisive turning point for the reform of fiscal federalist relations in the Russian Federation. In its Economic Programme (Programma…, 2000), the Russian government approved a comprehensive reform for fiscal federalist relations that is very consistent with the outline above and OECD (2000b). The Programme states clearly that "subnational government organs should have authority, and a significant degree of autonomy, in the conduct of fiscal policy within their territories."[22] Amendments to the Budget Code are proposed for a clarification of expenditure assignments, a delegation of genuine expenditure autonomy, and an association of full financial responsibility for all mandates with the level of government from which they emanate. The Programme contains a declared goal of shifting from tax sharing to a principle of "one tax – one budget," together with possible future agreement on the creation of subnational treasuries and tax collection agencies.

The reform of transfer policies is to continue, including the elimination of so-called "mutual settlements" and the introduction of matching grants for health and education based on minimal federal standards for the quantity and quality of services provided. A concept of insolvency for subnational administrations is being discussed, along with a new possible law on external financial management and a corresponding necessary amendment to the Budget Code.

Other parts of the Programme emphasize measures to ensure a unified economic territory within Russia and eliminate remaining barriers to labor, capital, and other factor mobility. The Programme also hints at a possible reform of the structure of local government.

The realization of parts of this Programme has already begun. The VAT has become a 100 percent federal tax and almost all revenue from the income tax is being channelled to consolidated regional budgets. This can be seen as at least a step in the direction of the separation of taxes by budgets. A Compensation Fund has been created at the federal level out of the additional VAT revenue for covering the costs of some remaining large mandates. One mandate concerning privileges for military personnel and the police has been incorporated directly into the federal budget. The methodology for the allocation of the FFSSF is made virtually independent of recent budgetary performance beginning in 2001.

Nevertheless, the reform of fiscal federalist relations continues to be a source of some uncertainty and controversy in the Russian Federation. This controversy concerns parts of the planned reform in fiscal federalist relations outlined above, the consistency of this reform conception with other parts of the Government Programme, and problems in the particular sequencing of measures for implementation.

Some proposals within the Russian government on tax reform, including parts of the Economic Programme, appear inconsistent with the creation of subnational autonomy. This includes proposals promise to make virtually all major taxes federal, and thereby placing subnational budgets in even greater dependence on taxes and revenue sources directly determined by the federal government. Among these proposals are a planned elimination of the regional sales tax and the continued predominant finance of subnational budgets from revenue sharing of federal taxes. As indicated in the section "What type of reform is needed?" of this paper, a number of already implemented recent measures have actually further limited, rather than expanded, subnational autonomy in taxation. As we have argued, this autonomy is a critical element for the realization of the entire reform strategy for fiscal federalist relations in Russia. Without such autonomy, other measures aimed at improving subnational finance through increasing responsibility and cracking down on informal budgetary activities are bound to fail. As discussed above, maintaining a strong purely regional revenue source, such as a general sales tax, is also a key element for a successful decentralization of autonomy.

Parts of the Economic Programme on social policy suggest that autonomy and responsibility for most social expenditures might be delegated to the regional (Subject of the Federation) level. Under such an interpretation, these measures would be inconsistent with the proposal that the federal government takes a greater direct responsibility in this area. In the context of regional autonomy and competition among regions for business and investment, purely subnational social outlays would very likely decline below adequate levels in many regions. With serious problems of poverty in many regions, this would have strong social and political implications, with the federal government likely to end up with a good share of the responsibility in any event. In fact, the combination of a centralization in taxation, as described above, with the delegation of social policy to lower levels of government could be a particularly detrimental mix, compromising vital efforts to de-politicise transfer policies and make subnational budget constraints hard. The absence of hard budget constraints, on the other hand, would negate the benefits of budgetary autonomy. The creation of formal subnational autonomy, together with the improvement of incentives for responsible and effective subnational fiscal policies, makes imperative a central role for the federal government in the regulation and support of social policy.

This paper argues that the creation of explicit budgetary autonomy is central to the success of the overall reform programme, the improvement of the environment for business and investment, and the achievement of sustainable stability and growth. There exist no rational means for holding regional and local officials responsible for budgetary management if they have little of no decision-making authority. Under current arrangements, subnational administrations will continue to realize a high degree of autonomy through various informal means in a manner that encourages corruption and is harmful to the overall business environment and fair competition. Genuine responsibility can be delegated only together with an explicit recognition of autonomy. The proposed federalism for the case of Russia may not exactly satisfy the criteria of market-preserving, but is close enough in spirit to be market creating.

Notes

1 This paper is a shortened and slightly revised version of the OECD CCNM working paper: "Fiscal federalist relations in Russia: a case for subnational autonomy." The ideas contained in this paper are those of the authors, and do not necessarily coincide with official positions of the Russian government or the Organisation for Economic Co-operation and Development.
2 See, for example, OECD (2000b), and Shleifer and Treisman (1999).
3 See, for example, Radaev (1996), OECD (1997b), Frye and Shleifer (1997) and Johnson *et al.* (2000).
4 Tatarstan and Bashkortostan (as well as Sakha Yakutiia until the mid-90s) are exceptional cases where special bilateral agreements have been important in recent years, although the conditions of these agreements have also come to resemble more closely the (uniform) conditions imposed for other regions. A current political initiative of the central government is to discontinue such special agreements and, at least formally, subject these republics to the same uniform conditions as other Subjects of the Federation. But, this process is unlikely to be quick or easy. As in the past, the federal budget for 2001 prescribes special treatment for these republics in allowing them to keep a share of revenue from federal taxes on their territories for financing federal expenditures.
5 In fact, current legislation allows any populated area within a municipality to declare itself a separate independent municipality.
6 See Box 5 in OECD (2000b) for more details.
7 See OECD (1997a) and OECD (1999b).
8 See Baipaj and Sachs, (1999), Monitola *et al.* (1995), Ter-Minassian (1997), and Dillinger and Web (1999).
9 For Germany, see Sphan and Feottinger (1997), Wurzel (1999), and Rehm (1998). For Mexico, see Carenga and Weingast (2000), Carrera-Hernandez (1999), and OECD (2000a).

10 The courts have increasingly impounded the funds of local authorities pending the fulfilment of obligations according to federal mandates. An important legal ambiguity has concerned wording in the federal budget law to the effect that mandates are accounted for in the determination of transfers to the regions. This would exclude them from non-funded status. As indicated above, gross federal transfers amount for less than 15 percent of subnational expenditures. Even if it were true the majority of these transfers were intended to assist subnational administrations with the fulfillment of such obligations, they would not come close to accounting for all of these mandates.
11 OECD (2000b), p. 131.
12 Data of the Ministry of Finance of the Russian Federation.
13 The source for much of remaining discussion in this section is OECD missions to ten representative regions (Subjects of the Federation) during 1998, 1999, and 2000.
14 OECD (2000b) provided a more detailed analysis of some of the primary informal tools available to regional and local officials, with a stress on the period of 1997–99. The discussion here echoes OECD (2000), although accounts for changes in 2000.
15 See, for example, Radaev (1996).
16 The courts did impound the accounts of a number of local administrations for this reason, however.
17 One important positive effect on incentives appears to have come from the crash of Russian financial markets in mid-1998. As a result, external borrowing constraints have tightened considerably.
18 The literature on so-called “market-preserving federalism” and its possible contribution to development and growth continues to expand. See, for example, North and Weingast (1989), Weingast (1995), Monitola *et al.* (1995), McKinnon (1997), Roland and Qian (1998), Carenga and Weingast (2000), and Weingast (2000).
19 The “soft-budget” constraint was first coined by Kornai (1986), and later partially formalized by Dewatripont and Maskin (1995). See also McKinnon (1997).
20 See Dillinger and Webb (1999), Prud’homme (1995), Saiegh and Tammasi (1998), and Wildasin (1997).
21 A basic proposal along these lines was contained in OECD (2000b) and Lavrov *et al.* (2000). Later proposals in this spirit include Lavrov (2000), Khristenko (2000), and the reform of interbudgetary outlined in the economic Programme of the Russian government (Programma…, 2000), which was drafted in the spring of 2000 and approved by the government in July.
22 Programma… (2000), Section 2.3.1, par. 5.

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10 Recentralization in China?

Ehtisham Ahmad, Keping Li and Thomas Richardson

Introduction

China is a unitary state with five levels of administration. There are thirty-one provincial level units (twenty-two provinces, four large cities directly under the central government, and five autonomous regions), which average over 40 million in population. Below these provinces are 335 prefectures and cities at the prefectural level; 2,142 counties, autonomous counties and cities at the county level; and a large number of townships, towns and city districts.[1] Prior to the reforms of 1994, there was a single tax administration responsible for all taxes – and given the numbers of staff involved remained largely under the control of provincial governments.

The focus in this paper is on central–provincial relations, though similar issues exist at lower levels as well, and most Chinese provinces are larger in size or population than many independent countries around the world.

China's intergovernmental fiscal system has evolved over 20 years of economic restructuring, albeit with a major reform in 1994. A number of the steps taken by the authorities over the course of this period have been aimed at redressing one or another type of dysfunctional behavior. The effective fiscal decentralization of the 1980s and early 1990s was marked by rapid growth together with increasing regional inequalities and declining general government revenues, a phenomenon also associated with the restructuring of the previously centrally planned economy.

The radical 1994 tax reform, which clearly delineated central, local and shared taxes, together with central administration (for the major taxes), was an attempt to establish a uniform tax system. The central government's share of revenues (before transfers) increased from around 35 percent of general revenues to just under 60 percent. However, in order to satisfy the coastal provinces that generate much of the revenues, a lump-sum transfer to guarantee pre-1994 income levels was agreed. It was also expected that a new equalization transfer scheme would be introduced, to gradually replace the lump-sum transfers.

In the event, the equalization transfer mechanism has remained small – and additional revenue returns have been negotiated with the coastal provinces, thus virtually preserving the pre-1994 pattern of interregional local revenues.[2] The regional income imbalances remain, particularly *vis-à-vis* the western and interior provinces, relative to the coastal regions.

In order to address the regional imbalances, as well as expenditures relating to the reform of the State-Owned Enterprise (SOE) and financial sectors, and restructuring of the social protection system, will require additional central resources. This paper addresses the pressures for a new intergovernmental arrangement in China.

The structure of the present paper is as follows. A brief overview of the Chinese fiscal system is presented in the next section. This summary of the current state of affairs is followed by a discussion of the challenges of SOE and financial sector reforms. The final three sections are concerned with possible reforms to the revenue sharing, expenditure assignment and transfer systems, respectively.

Conflicting trends in China's fiscal decentralization

Pre-1994: fiscal decentralization

A fiscal revenue sharing system was established in 1980 with the objective of providing subnational governments with an incentive to collect revenue. Under that system, central–provincial sharing rules were established by the central government, provincial–municipal relations were governed by the province, and this principle extended to lower levels. For the most part, enterprises, which were subordinate to the central government, were supposed to pay taxes to the center; and those which were subordinate to lower level governments paid at that level. Indeed, in this early reform period, both local governments and SOEs had relatively similar roles as agents of the central government. Revenue, or income in excess of expenses, was to be transferred to the central government, and shortfalls were to be covered automatically. In practice, the incentives for the local government were to reduce the revenue transfer to the center, and heighten the need for transfers from the center. Local enterprises and local governments had reason to collude to hide revenue from the center. The revenue-sharing system during the period 1980–88 was associated with a significant reduction in revenue collections as a share of GDP.

Some analysts have argued that this system gave local governments an incentive to develop industries, which would earn a healthy profit.[3] But it also gave rise to protectionist barriers to interregional trade.

Note that, while the intergovernmental fiscal system in the early 1980s afforded local governments relatively little incentive to collect revenue, tax administration factors also contributed to the revenue decline. As the role of market forces in the economy grew, rapidly changing prices and quantities made it harder for tax collectors to monitor enterprise behavior. Further, the number of taxpayers increased dramatically. For example, the agricultural tax was at one point collected from 50,000 communes, but after the reforms the number of taxpayers rose to more than 200 million households and TVEs. As a result, the authorities introduced four different revenue sharing arrangements during the 1980s.[4]

Finally, in 1988 a "fiscal contracting" system was implemented under which provincial governments each negotiated a fixed tax quota with the center, with collections above that level being retained at the local level. (This approach, dubbed "eating in separate kitchens," was also introduced at lower levels of government.)

The new system also created a strong incentive for local governments to conceal information about local revenue from the center, else they would face a "ratchet effect," as this information would be valuable at the time the fiscal contracts were renegotiated. Furthermore, many of the new enterprises in the rapidly expanding township and village enterprise sector were joint ventures with local government ownership. With retained profits accruing to the benefit of "local shareholders," there was a continued incentive to shift deficits to the center and hide profits from taxation. Thus, the system heightened an asymmetry, in that excess revenues were absorbed by local governments, while deficits were covered by the center.[5]

In addition, on several occasions during the 1980s the central government "borrowed" revenue from local governments, and also introduced new taxes meant to absorb local revenue that the central government felt was excessive. As a result, although they did not formally control statutory tax rates, local governments did so effectively through selective use of tax incentives, while significant revenues were diverted off budget into myriad extrabudgetary funds that were financed by fees, charges and other levies[6] (see Chart 10.1).

Thus, at the same time as the growth of the non-state sector was causing problems for tax administration (overall state budget revenue as a share of GDP fell from 25.5 percent in 1985 to 13.7 percent in 1993), the sharing rules were causing a shift of resources from the center to the provinces (see Table 10.1). The central government's share of revenue fell from 38.5 percent in 1985 to 28 percent in 1992 (and to 22 percent in 1993).[7] As a consequence, during the early 1990s the authorities considered the central government's share of total revenues (just 2 percent of GDP during 1991–93) to be seriously inadequate, and a radical reform of the fiscal system was initiated.

1994 reform and after: re-centralization

The authorities had four main goals for the 1994 fiscal reform, though only some of these have been achieved in practice (see Wong, 2000). These were to:

- Simplify the tax system,
- Raise the revenue to GDP ratio,
- Raise the ratio of central government to total revenue, and
- Make the fiscal federal system more stable by shifting from ad hoc, negotiated transfers to a rule-based tax assignment.

Progress was most pronounced with respect to the first objective, while for the other three the results of the 1994 reform have proven to be somewhat disappointing. These four objectives are discussed more fully in the sections below.

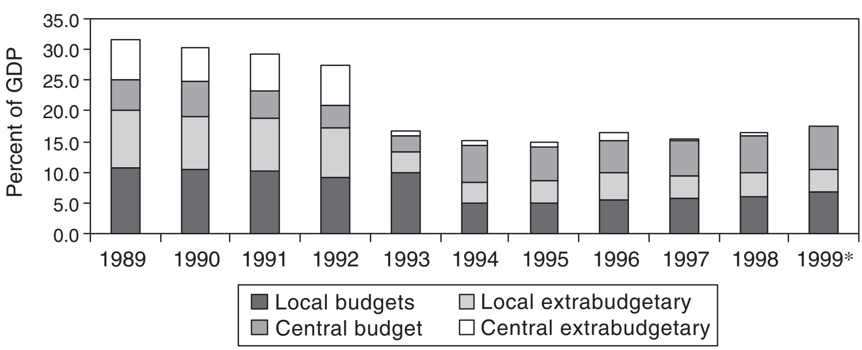

Chart 10.1 Revenue sharing on and off budget.

Notes: Extrabudgetary fund data estimated for 1999.

Table 10.1 China: state budget, central and local components (official definitions) (in percent of GDP)

19 Jun 00 11:39 PM	*1980[a] Actual*	*1985[a] Actual*	*1990 Actual*	*1991 Actual*	*1992 Actual*	*1993 Actual*	*1994 Actual*	*1995 Actual*	*1996 Actual*	*1997 Actual*	*1998 Actual*	*1999 Actual*	*2000 Budget*
Total revenue	25.7	22.4	15.8	14.6	13.1	12.6	11.2	10.6	10.7	11.6	12.4	13.9	13.9
Total expenditure	27.2	22.4	16.6	15.7	14.0	13.4	12.4	11.6	11.5	12.4	13.6	16.0	16.5
Balance	−1.5	0.0	−0.8	−1.1	−1.0	−0.8	−1.2	−1.1	−0.8	−0.7	−1.2	−2.1	−2.6
Central revenue	6.3	8.6	8.0	6.6	5.8	4.5	7.4	6.6	6.2	6.5	6.9	7.8	7.8
Own revenue	6.3	8.6	5.4	4.3	3.7	2.8	6.2	5.5	5.3	5.7	6.2	7.1	7.1
Transfers from local levels	—	—	2.6	2.3	2.1	1.7	1.2	1.0	0.9	0.8	0.8	0.7	0.7
Central expenditure	14.8	8.9	8.6	7.6	6.6	5.4	8.9	7.7	7.1	7.2	8.1	10.0	10.4
Own expenditure	14.8	8.9	5.4	5.0	4.4	3.8	3.8	3.5	3.1	3.4	4.0	5.0	5.4
Transfers to local levels	—	—	3.2	2.6	2.2	1.6	5.1	4.2	4.0	3.8	4.2	5.0	5.0
Central government balance	−8.5	−0.3	−0.6	−1.0	−0.9	−0.9	−1.4	−1.1	−0.9	−0.8	−1.2	−2.2	−2.6
Local revenue	19.4	13.8	13.6	12.8	11.6	11.4	10.1	9.3	9.4	9.8	10.4	11.8	11.8
Own revenue	19.4	13.8	10.5	10.2	9.4	9.8	4.9	5.0	5.4	5.9	6.3	6.8	6.8
Transfers from central government	—	—	3.2	2.6	2.2	1.6	5.1	4.2	4.0	3.8	4.2	5.0	5.0
Local expenditure	12.4	13.5	13.8	12.9	11.8	11.3	9.9	9.2	9.3	9.8	10.4	11.7	11.8
Own expenditure	12.4	13.5	11.2	10.6	9.7	9.6	8.6	8.2	8.4	9.0	9.6	11.0	11.1
Transfers to central government	—	—	2.6	2.3	2.1	1.7	1.2	1.0	0.9	0.8	0.8	0.7	0.7
Local government balance	6.9	0.3	−0.2	−0.1	−0.1	0.0	0.2	0.1	0.1	0.0	0.1	0.0	0.0
Memo items:													
GDP	451.8	896.4	1854.8	2161.8	2663.8	3463.4	4675.9	5847.8	6859.4	7446.3	7939.6	8205.4	8864.9
Ratio of central revenue to total revenue	24.5	38.4	33.8	29.8	28.1	22.0	55.7	52.4	49.5	48.8	49.7	51.0	51.1

Source: Ministry of Finance, *New China Fifty Years' Government Finance Statistics* (2000).

Note
a Data on intergovernmental transfers unavailable before 1990.

Revenue trends

Although the system continues to embody a number of serious distortions, under the 1994 reform, the tax structure was indeed simplified. A new VAT replaced the turnover based product tax; excise taxes (called consumption taxes) on tobacco, liquor and other luxuries were introduced; and the treatment of enterprises under the corporate income tax was largely unified, with the top rate reduced.[8] SOE profit and tax contracts, whereby firms negotiated annual transfers to the budget, were largely eliminated in favor of the uniform tax code.

The 1994 reform also involved a significant modification of revenue sharing rules, along with a substantial increase in the importance of fiscal transfers. Under the reformed fiscal system, tax revenue assigned to the central government included the following: 75 percent of the newly introduced VAT, excises, trade related taxes (customs duties, excises and the VAT levied on imports), the enterprise income tax collected from central SOEs, turnover taxes on the railroads and financial sector, and most of a securities stamp tax (see Table 10.2). At the same time, a national tax service was established to administer the new central and shared revenue system. This has involved an enormous and ongoing effort on the part of the center to administer the main revenue sources in China.

Local governments were assigned the following revenue sources: 1/4 of the VAT, the business tax (apart from that collected from banks, railroads and insurance companies), enterprise income taxes levied on local SOEs, the personal income tax, and a number of smaller taxes.

As seen in Table 10.3, the main goal of this reform was to increase the "two ratios" – revenue to GDP and central revenue as a share of the total. Given the context of a declining state budget revenue to GDP ratio, which fell by 4 percent of GDP between 1991 and 1995, local government revenues – including transfers – fell as well, from 11.5 to 9.25 percent of GDP. In 1996, it began to rise slowly, and has risen more rapidly since 1998–99 as a result of improved central tax administration, combined with more effective treasury controls.

After the one-off increase in the central government revenue ratio in 1994, local governments recouped some of their share, as local revenues grew more rapidly than that of the center during 1995–97. More recently, the antismuggling campaign in 1998–99 had some effect on the central government's share in total revenues, since all customs related taxes (duties, VAT and excises) accrue to the center.

At the same time, central government transfers to the provinces nearly tripled, rising from 1.5 percent of GDP in 1993 to over 4 percent in 1995. However, although one of the "two ratios" was rising, overall state budget revenues continued to deteriorate, falling by 4 percent of GDP between 1991 and 1995. Thus, local government revenues (including transfers) fell as well, from 11.5 to 9.25 percent of GDP, though these figures have rebounded in recent years.

Local governments continue to have very limited tax setting ability under the 1994 reform, at least in a formal sense. They can only modify the rates of a few minor taxes, and all other revenue decisions need to be taken by Beijing. This factor has given rise to continued incentives for local governments to raise revenue outside the budget system, in the form of fees and charges which accrue to locally managed extrabudgetary funds, over which the local officials have complete control and face virtually no oversight.

Table 10.2 Revenue sharing arrangements (1998)

Level	*Tax*	*Central share* (%)
Central taxes	Domestic excises	100
	Customs duties	100
	VAT and excises on imports	100
Local taxes	Personal income tax	0
	City and township land use tax	0
	Farmland occupation tax	0
	Fixed assets investment orientation tax	0
	Land appreciation tax	0
	House property tax	0
	Urban real estate tax	0
	Vehicle and vessel use tax	0
	Vehicle and vessel license plate tax	0
	Deed tax	0
	Slaughter tax	0
	Banquet tax	0
	Agricultural and animal husbandry taxes	0
Shared taxes	Domestic VAT	75
	Business tax – if paid by railroads, headquarters of banks or insurance companies, and 3 percent resource tax	100
	Business tax – otherwise	0
	Enterprise income tax – if paid by railroads, headquarters of financial institutions and insurance companies belonging to the central government	100
	Enterprise income tax – otherwise	0
	Income tax on foreign and foreign funded banks	100
	Income tax on foreign and foreign funded nonbanks	0
	Resource tax – if paid by offshore oil companies	100
	Resource tax – otherwise	0
	City maintenance and construction tax – if paid by railroads, headquarters of banks or insurance companies	100
	City maintenance and construction tax – otherwise	0
	Securities tax – if collected on stock transactions	88
	Securities tax – otherwise	0

Source: SAT, *Tax System of the People's Republic of China* (1998), p. 60.

Table 10.3 The "two revenue ratios" during the 1990s

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Revenue share in GDP[9]	19.1	17.0	14.7	13.7	11.9	11.1	11.2	12.1	12.9	14.2
Central share in revenue (MoF definition)	33.8	29.8	28.1	22.0	55.7	52.4	49.5	48.8	49.7	51.0
Central share in revenue (IMF definition)	—	—	—	—	—	50.8	48.3	47.9	48.8	50.2

Sources: Ministry of Finance and IMF staff calculations.

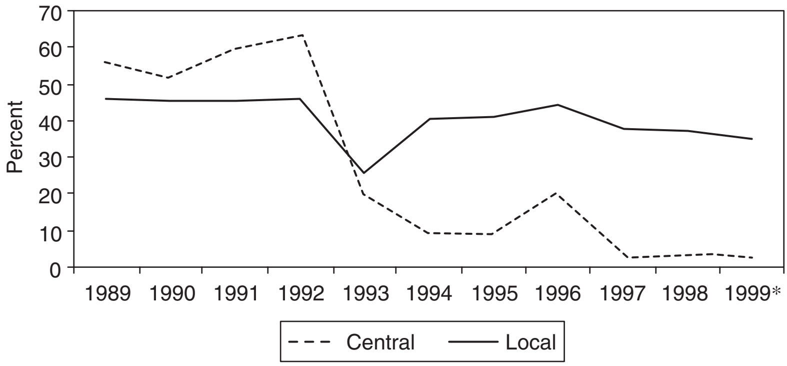

Chart 10.2 Extrabudgetary share of total revenue.

* Estimate.

These extrabudgetary funds continue to generate a significant portion of total revenue at the local level. After 1994, changes in budget recording make it difficult to assess the central government's use of this mechanism (see Chart 10.2). Although the recorded share of central government revenues collected off budget fell from an average of 50.4 percent during 1989–93 to 7.9 percent during 1994–99, this was in part due to the exclusion from the extrabudgetary accounts of SOE profits after 1993. Nevertheless, the ratio of local off-budget revenues to total local revenues remained in the neighborhood of 40 percent throughout (42.0 percent during the former period and 39.3 percent during the latter).

In addition to the use of extrabudgetary funds, local governments also have levers by which they can influence the behavior of State Administration of Taxation (SAT) officials based on their jurisdictions. These measures include the access to services such as water, power, housing and schools. Some local authorities have reportedly used such levers to ensure that local revenues are collected before revenues accruing to the center, leading in some cases to the under-collection of central government revenue.[10]

An issue of concern to the central government in the recent past has been the proliferation of fees and charges instituted by various local governments, causing considerable hardship and nuisance for the population in various localities. Such "unauthorized" use of revenue handles has the potential to cause social unrest and political difficulties for the center.

Attempts by the center to replace user fees and charges by a fuel tax were seen as an intrusion by the local governments, and the attempt to "re-centralize" was strongly resisted. However, as seen below, there can be an effective sharing of the base of the fuel tax between different levels of government, allowing each to set rates (within bounds) to meet their respective expenditure needs.

Further, the incentive to hide revenue by local authorities exacerbates pressures on the central government's finances in that it has at its disposal a relatively small share of overall fiscal resources to finance a variety of expenditures that are difficult to adjust (such national defense) and others such as social security and interest on government debt that are likely to increase over time.

Transfer mechanisms

In theory, the 1994 transfer mechanism was a major improvement over the older *ad hoc* system based on annual negotiations. In the event, the political bargain struck to secure the tax–sharing reforms has served to undermine the equalization objectives of the supporting transfer arrangements. The revised transfer mechanism was based on a 1993 compromise under which every province was to be guaranteed a transfer sufficiently large to ensure a revenue no lower than that of 1993.

Transfers ("fixed subsidies") under the old system were to be governed by the formula:[11]

$$\text{Transfer} \equiv \{1993 \text{ base revenue} - 25 \text{ percent share of VAT} \\ - (\text{most fixed local taxes and other})\}.$$

This commitment initially entailed a fixed transfer that would eventually become small in relative terms and the expectation was that this would be replaced by an equalization transfer.

However, a second transfer – known as "revenue returned" was also introduced that effectively preserved the 1993 relative inter-provincial distribution of resources.

Revenue returned was to provide each province with 30 percent of the increase in VAT and excise taxes over the 1993 base.[12]

The bases of each of these transfers were fixed in nominal terms, meaning that, with inflation, the revenue returned eventually swamped the transfers under the old system. Moreover, the revenue returned has been explicitly regressive, transferring more money to wealthier provinces. By 1998, revenue returned was almost 2/3 of total transfers, while the transfers under the old system were only about 3.5 percent of the total (see Chart 10.3).

The other types of fiscal transfers in the post-1994 system include the following:

- *Specific purpose grants* are a large, and in recent years, growing share of the transfer pie. In 1998 they comprised more than a quarter of total transfers. There are hundreds of different earmarked grants, all of which are allocated on an *ad hoc*, negotiated basis. Often they serve to provide SOE subsidies, as well as grants to enable local pension and unemployment systems to cover their shortfalls.[13]

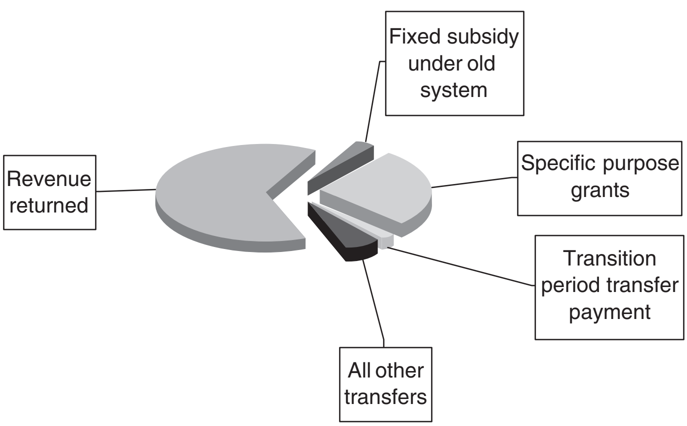

Chart 10.3 Transfers as percent of total, 1998.

- *Equalization transfers* are meant to provide resources for equalization across China's provinces. They are rules based, and rely on variables like provincial GDP, student–teacher ratios, number of civil servants, and population density. However, these transfers have been sharply under-funded since their inception, rising in 1998 to only just under a meagre level of 2 percent of total transfers.

Thus, in principle the available transfer mechanisms could provide a stable, rules-based framework for resource equalization across China's many provinces. In fact, however, owing to the reliance on the special purpose grants and the "revenue returned" window, the overall transfer system continues to be sharply regressive, rewarding wealthy regions with increased transfers (see Charts 10.4 and 10.5). The main element in the regressivity is the "revenue returned" (Chart 10.6), which is not offset by other transfers, including the relatively small equalization transfers (Chart 10.7).

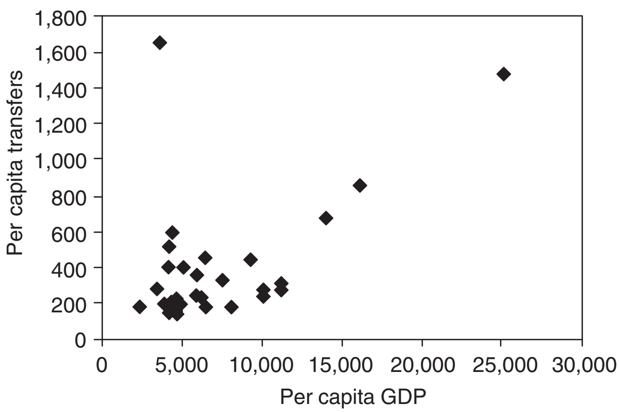

Chart 10.4 Total transfers per capita and GDP per capita in 1998.

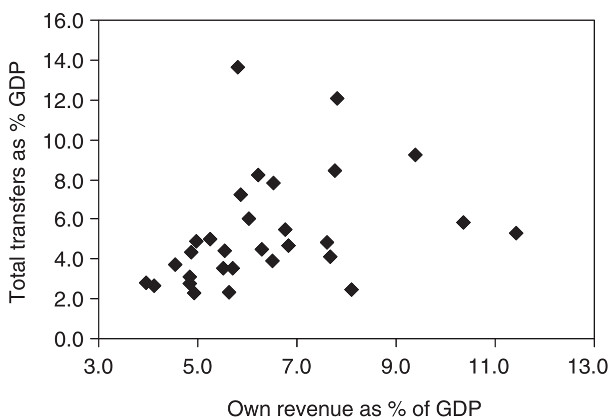

Chart 10.5 Total transfers and own revenue, as percent of GDP, in 1998 (excludes Tibet).

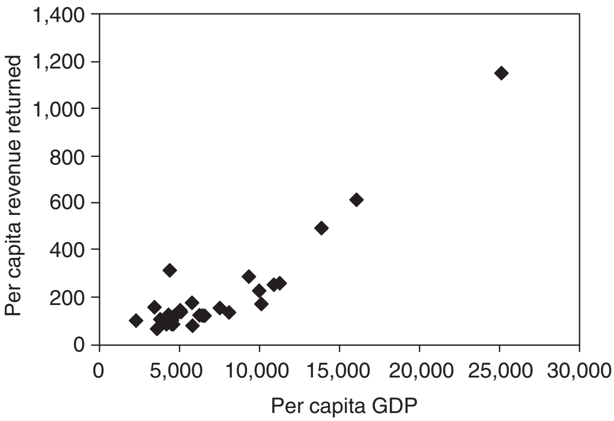

Chart 10.6 Per capita revenue returned and per capita GDP in 1998.

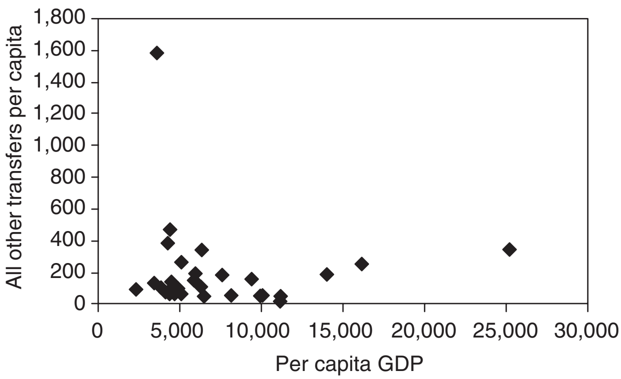

Chart 10.7 Per capita transfers other than revenue returned and per capita GDP in 1998.

Expenditure assignments

In very general terms, the Chinese system of expenditure assignments, as set out in the Constitution, is broadly consistent with international practice. The central government is responsible for national defense, external relations, capital construction of centrally owned enterprises, a number of central responsibilities in the areas of road and waterway construction, and servicing of public debt. Local governments are primarily responsible for local construction projects, most agriculture and water conservancy, education, health, culture, and most of the social safety net, including price subsidies.[14] Nevertheless, in a number of areas – particularly social protection – there is effective overlap in responsibilities which serves to complicate both the revenue assignments and the needed design of the transfer system.

A critical difficulty relates to the responsibility for the social safety net. In a strict sense, the local governments are responsible, and China has relied on local (recently at the provincial level) pools even for pensions, unemployment insurance and the local (township level) provision of social assistance. When there is inadequate provision of social protection – for example, delays in payments of pensions or unemployed workers without sources of support – the ultimate responsibility remains with the center, as do the downside risks of any social unrest.

The situation in China is complicated by the restructuring of the SOE sector. Most SOEs provided social services ranging from kindergartens and health clinics to housing and hospitals. These services are in many cases being divested on efficiency grounds – this passes additional responsibilities on to local governments without the corresponding resources, effectively adding to their need for transfers or rationalization of the intergovernmental fiscal system.

These issues are discussed in further detail below.

Macroeconomic management with multi-level administration in China – the recent past

In theory, local governments are thought to be more efficient in the provision of public goods by virtue of their proximity to, and thereby better information about, end-users. Similarly, because residents could move, and thus match their preferences to the provision of local public goods, inter-jurisdictional competition is thought to improve welfare outcomes.[15] Finally, some have emphasized the advantages of experimentation by subnational governments, a feature which has appealed to Chinese leaders, who have preferred to test reforms through extensive pilot projects.

Even in the Chinese context, the importance of informational asymmetries and incentives in institutional design cannot be ignored, such as the incentives facing bureaucrats at different levels of government (e.g. Qian and Roland, 1998). There may be an adverse incentive to assist in raising revenues that accrue to the center. Moreover, extensive reliance on transfers can affect local incentives to raise revenues from their own sources.[16] Following the Asian crisis, much attention has been paid to the design of fiscal and monetary institutions, which minimize vulnerability and which are resistant to shocks. This has translated principally into a required design of revenue assignments and revenue-sharing systems that protect aggregate revenues. Similarly, on the expenditure side, there is a greater need for central instruments as a means of ensuring that fiscal policy can be appropriately tightened (or loosened) in a timely manner.[17]

Subnational governments in many parts of the world (particularly in Latin America) have sought to leverage their debt to gain concessions from the center. Indeed, Brazil came close to a financial crisis in 1998,[18] and there are continuing difficulties with the local incentives to borrow against overall general government debt constraints in a range of developing countries.

Conflicting incentives and macroeconomic constraints would suggest that, in China, the potential rewards of fiscal decentralization for better service delivery need to be balanced against its risks.[19] On the one hand, lower level governments have better information about local needs, which should improve the efficiency of provision of local public goods. However, as noted by Ter-Minassian (1997) and others, income redistribution is less easily accomplished in a highly decentralized state, and short-term macroeconomic management is generally thought to be more complicated when substantial revenue instruments or expenditure items are controlled by subnational governments. In this view, fiscal discipline is best achieved when revenue and spending responsibilities are broadly balanced at each level of government.

Decentralization and growth

A number of researchers have argued that China's effectively decentralized fiscal system has had positive consequences for growth. Drawing on recent developments in the microeconomic theory of the firm, Qian and Weingast (1996; 1997) and Qian and Roland (1998) have argued that a form of "market-preserving federalism" has served to address incentive problems that otherwise might have undermined the commitment of central and local governments to market-style reform. In this view, the fact that local governments are equity holders in local SOEs has given them strong incentives to ensure that market conditions are conducive to the rapid growth of at least these firms, and to refrain from confiscatory taxation. At the same time, the political standing of local governments has been sufficiently strong to resist predatory taxation on the part of the central government. Moreover, the center has had relatively limited information on local government finances. The result has been an environment that was extremely conducive to rapid capital accumulation and growth, particularly of small and medium sized firms controlled by provincial and local authorities. However, the absence of information on local finances provides ample opportunities for rent seeking. Thus, the opportunities that facilitated growth in the earlier period, now also constitute a political liability if there is misuse of resources or rent-seeking behavior – particularly as the expectation of higher living standards are tempered through increasing inequalities.

In a cross-section study, Davoodi and Zou (1998) have found that fiscal decentralization was not associated with more rapid economic growth in developing countries, while in developed countries the relationship was unclear. Decentralization is thought to be potentially harmful for growth because of the complications for macroeconomic management to which it gives rise (Tanzi (1996), but see Shah (1998) for a view to the contrary). In any case for China, Zhang and Zou (1998) have found a negative relationship between growth and decentralization.

Decentralization and fiscal risk

Macroeconomic management in China is complicated by the intergovernmental implications of a number of policy issues facing the authorities, including financial sector and enterprise reform, and the implications of those reforms for the provision of social services.

Fiscal vulnerability

Perhaps the most worrying feature of the revenue sharing system in China is the degree to which fiscal resources are collected and managed, not by the central government, but by other levels of government. The most immediate fiscal vulnerability is thus the difficulty the central government could have in meeting its debt servicing obligations. Interest on government debt, which by law can only be issued by the central government, rose from 10.5 percent of central government own revenue in 1996 to 13.3 percent in 1997 and 15.1 percent in 1998. In 1999, owing to rapidly rising customs revenues and domestic debt for which the interest burden was postponed by means of balloon payments at maturity, this ratio fell back to 10.5 percent, but to stay at this level central government revenues will need to continue to rise.

The debt burden of the central government is slated to grow dramatically over the period ahead, moreover. Bonds placed for fiscal stimulus purposes in the aftermath of the Asian crisis will need to be serviced, as will at least a portion of AMC bonds. Ultimately, of course, the cost of restructuring the financial sector will fall on the central government. As a result, there is a need for a greater share of fiscal resources at the central level, effectively for precautionary reasons.

China's intergovernmental system has also given rise to dysfunctional behavior, such as indirect borrowing. Local governments, though forbidden to borrow openly, have attempted to do so through window corporations and banks, with the result that the central government is not in a position to monitor, much less manage, gross public debt.

SOE reform

The Chinese authorities have long signaled their intention to restructure the SOE sector, and this effort has taken on new importance with its entry into the WTO, since foreign competition will put the public enterprise sector under increased pressure. Although operating losses of the state enterprises have traditionally been covered by loans from the state banking system, the authorities' intention to streamline and modernize the financial sector are closing off this financing source. Hence, SOEs are being forced to adapt to market conditions, and this process is generating a variety of pressures that impinge upon the multilevel fiscal system.

Industrial location policy under central planning directed resources to inland provinces, particularly for the establishment of heavy industry, which now faces significant restructuring. Thus, regions with outdated industrial technology are likely to face high social costs given the unemployment consequences of restructuring. Yet pooling of unemployment contributions within provinces has been very limited, and virtually negligible across provinces. Since the unemployment system is largely funded by a uniform payroll tax, several local governments are flush with unemployment insurance funds that are not used effectively, whereas other localities do not have enough from the unemployment wage tax to cover minimum benefits, or adequate funds from other revenues to be able to meet the costs for the unemployed. This acts as a constraint on the scope for SOE restructuring.

Note that the existing horizontal imbalances also complicate attempts to use a macroeconomic stimulus to bolster the social safety net. In 1998 and 1999, the central government undertook significant fiscal expansions, and most of the spending took the form of capital investments. Some observers argued that social safety net spending might prove more effective in stimulating aggregate demand, and in facilitating SOE reform. However, the central authorities were reportedly wary of doing too much in this regard for fear of generating moral hazard problems with local governments (that might well have diverted their own spending on the social safety net to other uses, negating the social impact of the expansion).

Financial sector restructuring

Persistent losses in the SOE sector have been financed through continued lending by the state owned banks, and these losses will eventually need to be covered through fiscal transfers from the central budget. While the geographic distribution of "bad loans" is not well known, it is likely to be coincident with China's rust belt of presumably loss-making SOEs. Thus, any recapitalization of state banks may have an implicit element of intergovernmental transfer. Indeed, there have already been reports that bailing out state banks has proven difficult due to political disagreements over burden sharing (who should pay) and the allocation of benefits.[20]

Social security reform

China has a pension system based on pooling at the provincial level. Central pooling has been opposed on the grounds that this may involve transfers from poorer provinces with relatively young demographic profiles to those with a greater proportion of pensioners (especially along the coast) – but which also have much higher standards of living. However, because of limited pooling, a horizontal imbalance arises in regions with high concentrations of SOEs and a high dependency ratio of pensioners to pension fund contributors (e.g. in the coastal regions). As a result, to finance pension liabilities on a pay-as-you-go (PAYG) basis, payroll tax rates have risen to unsustainable levels in many localities, and pension arrears are becoming common.

In 1998 and 1999 the central authorities resorted to *ad hoc* fiscal transfers in order to settle outstanding pension obligations, and undertook a significant centralization in the form of mandatory provincial pooling for all industrial enterprises, regardless of ownership or industry. With the ratio of pensioners to working population in China rapidly approaching that in Europe and Japan, even with national pooling the PAYG system as a whole will need restructuring and possible central transfers in the near future. An additional concern arises concerning the management and oversight of the existing pension funds at the local level.

Similarly, with unemployment insurance, local pools do not provide sufficient pooling of risks – the localities that need the funds most (because of SOE restructuring) do not have sufficient resources to provide for the unemployed, whereas others have idle balances in funds that may not be effectively managed.

A wide-ranging reform of the social security system in China may involve a centralization of the pooling and financing mechanisms, perhaps with a centralized payroll tax or charge – this however need not imply reduced functions for local governments. Indeed by treating all the aged, and the unemployed, equally across China, the center would be able to relieve burdens on local governments (particularly along the coastal regions) that could facilitate a greater degree of progressivity in the tax-transfer system as a whole.

Information flows and public expenditure management issues

China remains a unitary state in which the ultimate responsibility for expenditures remains with the center. However, at this stage, the center lacks the instruments to track expenditures, including those made by subnational bodies on behalf of and with direct financing from the center. Even some payments made by the center for central government operations, such as some central wage liabilities, and financing for the construction of grain silos (a central government responsibility) are often routed through local government. A central difficulty is that center lacks the means to ensure that such payments are made in a timely fashion.

The difficulty is exacerbated when certain local expenditures are required by the center, with requisite financing provided through special purpose programs. Such programs may include basic education to a certain level. The center lacks the mechanisms to monitor compliance with the objectives of special purpose programs, which may be diverted to other priorities of the local governments. Attempts by the Ministry of Finance at the present time to create an effective treasury system and limit extra and off budget expenditures are beginning to assist in the transparency of central and subnational expenditures. However, these reforms are likely to become effective only in the medium-term, that is, within a four or five year time horizon. The recent revenue gains should continue to be consolidated.

Implications of changing intergovernmental dynamics

Revenue assignments – vertical and horizontal imbalances?

A number of issues arise out of the foregoing discussion. In part, the fiscal management system needs to be modernized in a way that allows accurate information to flow to policy makers at all levels. But it is also likely that the fiscal federal system itself will need to be revised to take into account the pressures to further reform the tax system.

The principal tax policy changes are dictated in part by China's prospective entry into the WTO, and also to rationalize the process initiated in 1994. The key policy measures include:

- *The reform of the VAT* – including from *production to consumption* basis will lead to changes in revenues generated in specific regions, thus affecting the returned revenue. Moreover, the *extension in coverage* of the VAT, supplanting business taxes which accrued to local authorities, will open up the question of appropriate county and city-level tax bases, and the design of transfers.
- *Elimination of nuisance fees and charges* levied by the county-level administrations, and their potential replacement by excises, for example, fuel taxes, has been opposed because of the potential centralization of a local tax base. In late 1999 the National Peoples Congress finally removed the last legal roadblock to introduction of a central fuel tax that is meant to replace half a dozen local fees assessed on essentially the same tax base, the authorities have been unable to implement the change as a result of local government opposition. However, there is scope to view such excises as a *shared tax base*, with more than one level of government levying such taxes (within bounds) – and there is clearly scope to "persuade" local governments.
- *The assignment of the personal income tax to local governments* may need to be reconsidered, given its potential revenue generation capability as the economy expands. Typically, in industrial countries, the largest share of the personal income taxes accrues to the central government, although lower levels in some countries also share the base and are permitted to levy up to a certain number of percentage points. Given the Chinese central government's revenue needs (e.g. for enterprise and bank restructuring, or for redistribution), it may be advisable to introduce such reforms before the revenue generated from this head becomes too large – else there will be a reluctance on part of the local governments to cede this base to the center.
- *For assigned local taxes*, a degree of control over rate structure is critical in ensuring local accountability. Otherwise the local government does not have at its disposal means of financing additional local expenditures by inflicting the burden on local

citizens. As seen in recent years, there is then a tendency to obtain additional revenues by circuitous means.

It may be useful to revise revenue assignments and sharing rules at this stage with an eye toward giving subnational governments bounded tax setting authority. In the absence of greater local revenue autonomy, it will continue to be difficult to convince local authorities to do away with the many fees and charges, which now serve to finance off-budget local expenditures. However, changes in these assignments will necessitate a review of resulting horizontal and vertical imbalances and need for transfers.

Specification of expenditure assignments

Unlike in the past, there is a need to specify expenditure assignments and responsibilities to ensure effective service delivery at the city and county level. This is important as SOEs shed responsibilities for enhanced efficiency.

The role of the social safety net also needs to be examined – including central pooling pursuant to the creation of a *social security tax*, should the authorities decide to move in that direction. While a centrally financed pension and unemployment insurance system may appear to be a "recentralization" move, in effect it would remove a major constraint on local governments enabling these to more effectively provide public services such as basic health and education.

There is a need to reassess the system of expenditure assignments in China's fiscal system. On paper, the system seems to match international practice, with national public goods like defense handled centrally, and others that vary with local characteristics, such as education, managed locally. However, in practice some activities are managed by several levels of government simultaneously, giving rise to inefficient delivery of services.[21] Beyond the budget, a great deal of progress remains to be made in deciding which activities should be done by the state at all, and which should be handed over to the private sector.

Moreover, there are some activities, which, by virtue of their magnitude, cannot be handled by local governments alone. For example, some environmental projects demand resources from the central government, and a number of transition-related expenditures in rust belt regions – because the rust belts were initially created at central government's behest – will need to be co-financed by the center.

Finally, the question of local government borrowing for legitimate capital purposes remains contentious in China, as elsewhere in the developing world. On the one hand, the outright prohibition of local borrowing can be inefficient – in that projects with high social rates of return might not be funded. A total prohibition can also be evaded, such as when local governments borrow through window corporations. In China both factors are evident. On the other hand, once local governments have a borrowing window to which they can turn, serious incentive problems are unavoidable in that local governments – and creditors – have reason to borrow excessively in the expectation of a central government bailout in case of difficulty. To date, the authorities have forbidden explicit local government borrowing, but local public enterprises regularly undertake debt issuance for projects, which appear to be public in nature.

In the absence of an efficient capital market and monitoring and reporting mechanisms, it may be premature to move quickly to a system that permits explicit borrowing by local governments, subject to borrowing limits. The individual limits for all local governments may be inconsistent with the overall limit for general government debt consistent with a sustainable macroeconomic stance. Thus, in the short term, it may be prudent to permit some local borrowing subject to approval by the center.

Design of transfers

In order to achieve greater horizontal equity across provinces, it will be important to reorient fiscal transfers away from "revenue returned" towards a system of rules-based equalization grants. This idea has been suggested for some time, but the size of the "equalization" transfer scheme remains tiny.

During 2000, the authorities have sought to address some of the regional inequalities through an explicit policy of developing the western and central provinces. To some extent, this program would be less urgent had an adequately funded system of equalization grants been in place. Indeed, as shown in Chart 10.8, fiscal revenue per capita wealthy coastal provinces like Zhejiang and Fujian, after taking account of all transfers and extrabudgetary revenues, is as much as twice that of poorer inland regions like Gansu and, to a lesser extent, Yunnan.[22]

In the absence of a sufficiently large effective vertical imbalance that permits the functioning of a significant equalization mechanism, the center has been tempted to resort to a better targeting of special purpose grants. The main difficulty with this reliance on special purpose grants is that the center lacks the monitoring mechanisms to ensure effective use. Also, the *ad hoc* decisions of the center may not fully take into account the overall directions that might lead to horizontal equity.

However, as described in Lou Jiwei (1997),[23] if there is an overall framework, it would make eminent sense to rely initially on a better targeting of special purpose grants while the full equalization system is being developed. While there is an increasing capability in China to design and implement an equalization grants system, the constraints remain essentially political and may need a coherent review of the revenue assignments together with the establishment of expenditure responsibilities and a consistent transfer design to act in support of an overall reform.

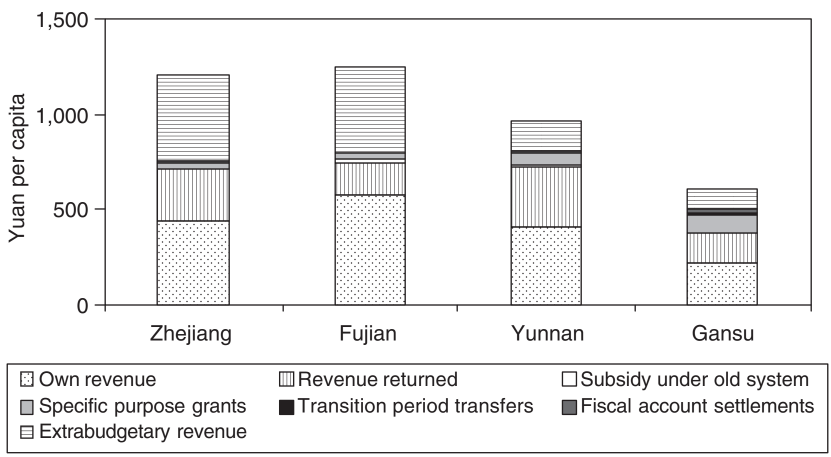

Chart 10.8 Composition of revenue in four provinces, 1998.

Conclusions

It was hoped that the 1994 fiscal system reform would contribute to an increase in the "two ratios": revenue to GDP and the central share in state budget revenue. Following some modest initial success with the latter, neither ratio rose appreciably during most of the period following the reform. Fiscal revenue remained low until central efforts to control tax evasion and introduce treasury discipline since 1999. While the revenue decline of the mid-1990s owes to a number of factors, including those common to many transition countries, adverse incentives in the fiscal federal system appear to have played an important role as well. Transfers have been inadequate and are not based on expenditure necessities. Provinces have extremely limited revenue-raising authority, which means they have strong incentives to keep resource flows outside the budget (indeed, often in the locally-owned public enterprise sector). Moreover, despite considerable evolution in the role of the state in the Chinese economy, expenditure assignments have not been fundamentally reassessed since 1994.

We have argued that a comprehensive reform of the intergovernmental fiscal system is needed in China. This effort should emphasize clear delineation of revenue bases and local authorities will need to be given greater freedom to set tax policy in accordance with local conditions. There has to be greater precision concerning the expenditure responsibilities, and there should also be an attempt to clarify the role of local contingent liabilities, which may have arisen outside the budget. The restructuring of the social security system, particularly for pensions and unemployment insurance will also have an impact on the local need for financing. The transfer system will need to be revised to reflect local revenue capacity and expenditure needs in a rules-based manner, Ultimately, reducing vulnerabilities in this area will necessitate significant progress in fiscal management reforms of treasury and budget management processes. These reforms are now underway.

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Notes

1 Ma and Norregaard (1998). These figures exclude Hong Kong SAR, Macao SAR and Taiwan POC.
2 The term "local" in China is taken to mean all subnational levels of government, including provinces and municipalities, counties and townships.
3 Qian (1999).
4 Wong (1997, 2000).
5 Ahmad (1997), Laffont (1999), Ma (1997), and Wong (1991, 1995).
6 Ma and Norregaard (1998).
7 The central government announced in August 1993 that 1993 would be the base year for the new fiscal federal arrangement introduced in 1994. As a result, local government revenues ballooned during the last four months of the year. See Wong (2000).
8 See Bahl (1999), chapter 3, for a good summary.

9 Unless otherwise specified, revenue, expenditure and deficit figures for the state budget are on IMF definitions, which for revenue differ from official definitions in that losses of SOEs are reclassified from negative revenue to expenditure. (see next Note.)
10 See also Li Shi (2000).
11 Bahl (1999) and Ma and Norregaard (1998).
12 Wong (2000).
13 These grants for the pension and unemployment systems in fact compensate for the financial inability of SOEs to meet their legal obligations under these programs, and hence are also akin to enterprise subsides.
14 Ma and Norregaard (1998).
15 See Oates (1972), Tiebout (1956), and Ter-Minassian (1997).
16 Montinolo, Qian and Weingast (1995).
17 Eichengreen (1999), p. 57; Hemming and Petrie (2000).
18 Tanzi (1995); Webb and Dillinger (1998), and World Bank (1999).
19 See, for example, Feltenstein and Iwata (1999) and Ma (1997).
20 A similar problem arises with respect to local government borrowing through locally owned and managed financial institutions, where bankruptcy may be politically difficult. GITIC, for example, was controlled by the provincial government of Guangdong.
21 Wong (2000).
22 Yunnan province has relatively high per capita fiscal revenue because of the importance of tobacco (which affects "revenue returned" through the excise tax) in provincial public finance.
23 See also Mihaljek in Ahmad (1997).

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Part IV

Developing countries

11 Argentina

Coordination of subnational borrowing

Juan Pablo Jiménez and Florencia Devoto[1]

Introduction

During the 1990s, the relationship between Argentina's federal government and its provinces underwent diverse changes. Specifically, modifications in the tax-revenue-sharing system and social security reform, together with the decentralization of social services, had a strong impact on the financial and fiscal relationship between the federal government and the provinces.

These changes had significant effects on efficiency, equity, and macroeconomic stabilization. Many papers have analyzed the impact of the changes on the first two issues, concluding that the decentralization of health and education expenditure did not necessarily mean gains in efficiency and equity. Several authors conclude that coordination functions and compensation at the federal level were not sufficiently taken into account.

In recent years, the relationship between decentralization and macroeconomic stabilization has increasingly been analyzed in fiscal federalism literature. The debate has shown that in countries with changes in responsibility across different levels of government, the impact of those changes has depended on both the design of the new system of intergovernmental relationship and the institutional setting in which it was implemented.

To analyze the impact on macroeconomic stability, subnational indebtedness must be evaluated. A significant increase in subnational debt is frequently a symptom of an inadequate design for intergovernmental fiscal relations. A question that arises in these cases is the extent to which the growth of subnational debt may be promoted or facilitated by a lack of coordination and control on subnational government borrowing. In recent years, discussion about the control of subnational debt has become a central issue.

In Argentina, because of the ambiguous constitutional mandate on subnational borrowing rights, an idiosyncratic mechanism to coordinate subnational borrowing has been developed in recent years. This paper will focus on provincial debt evolution and the different mechanisms that regulate subnational borrowing.

The next section examines some key elements of fiscal and macroeconomic coordination in a federation. The following sections describe Argentina's fiscal and financial performance in the last decade and the institutional mechanisms implemented to deal with it. The last section presents conclusions and perspectives.

Decentralization and macroeconomic coordination

The traditional approach to public finances in a federation defines macroeconomic stabilization as a central government responsibility.[2] After the significant decentralization process that different countries have experienced, this traditional "fiscal federalism" approach has begun to be rediscovered. Several recent works have focused on this issue.[3]

Tanzi (1996) affirms that in some developing countries decentralization could contribute to the aggravation of macroeconomic problems. He states that there are many channels through which fiscal decentralization may aggravate structural macrofiscal problems, one of which is caused by subnational borrowing, as "few countries have such strict constitutional limitations, markets have proven unable to discipline borrowing and central governments are often unable to refuse assistance to subnational governments that get into trouble."[4]

The contradiction between decentralization and macropolicy will increase when subnational governments have no strict budget constraint. These restrictions make the regulation mechanisms for borrowing by subnational governments central to coordinating fiscal and macroeconomic policy. Ter-Minassian and Craig (1997) identified four basic approaches to controlling subnational borrowing: (1) sole or primary reliance on market discipline; (2) cooperation by different levels of government in the design and implementation of debt controls; (3) rule-based controls; and (4) administrative controls. These different approaches reflect constitutional provisions, the degree of political and administrative control of the central government over the subnational ones, the country's overall tradition of financial discipline, the presence or absence of serious fiscal and macroeconomic imbalances, and the state of development of the country's financial market.[5]

In Argentina the National Constitution is ambiguous about the possibility of subnational borrowing control by the federal government. This characteristic has determined a complex mechanism to control and coordinate provincial borrowing.

Provinces: fiscal and financial evolution in the 1990s

Fiscal performance

During the last decade provincial fiscal performance has varied greatly. As can be seen in Figure 11.1, the deficit changed from 0.9 percent of GDP in 1993 to 1.4 percent in 1995, decreasing to 0.4 percent in 1997 and increasing to 1.6 percent in 1999. This evolution was the result of changes in those years associated not only with the fiscal relationship between provinces and the federal government but also with the macroeconomic context.[6]

The success of the price stabilization program based on the currency board, together with many structural reforms and a favorable international context, determined a fast recovery in economic activity and the deceleration of the inflation rate in the early years of the decade. Provincial revenues showed a significant growth from federal government transfers[7] and provincial taxes. Moreover, these years witnessed a reformulation of the scheme of transfer to provinces. The significant growth in national and provincial revenues allowed the federal government to redirect resources to supply the national pension system.[8] Thus, the system of transfers was acquiring more complex characteristics.

With all these structural changes, the provinces showed clear signs of recovery in their public finances. In the early 1990s, the fiscal deficit fell, and then stabilized in 1993 and 1994. Price stability and economic recovery positively affected tax revenues. At the same time, the provinces received the remaining social services in the national sphere[9] and updated provincial personnel wages. This implied an important increment in expenditure, which did not hinder an improvement in fiscal accounts.

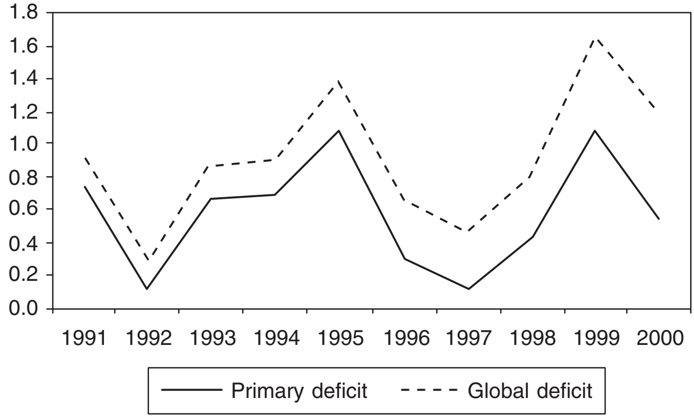

Figure 11.1 Primary and global provincial deficit, deficit excludes privatization revenues (in percentages of GDP).
Source: Ministry of Economy.

The financial crisis in 1995 had its impact on the evolution of the public provincial sector. The provinces suffered from the decline in tax revenues, as well as from the influence of the crisis on the provincial financial sector. Many provinces had to rescue their own provincial banks, first by trying to avert bankruptcy and then by capitalizing them for privatization.[10] Just as the national government did, in some cases provinces adopted emergency laws that helped to contain expenditure. The provincial public sector in 1995 shows a fall in tax revenues and a deceleration in expenditure growth.

The effect of the restricted expenditure lasted until 1997; leading to the lowest provincial deficits in the decade. At this time, some provinces transferred their provincial pension systems to the national government and benefited by not having to finance them. But they had to adapt to the national pension system design[11] and also agree to guarantee the financing of provincial payroll taxes through "coparticipation" funds deposited directly into the national treasury.'[12,12a]

In the late 1990s, the deficit grew once more. The fiscal imbalance was caused not only by poor revenue performance but also by the explicit expansionary expenditure policies of some provincial governments. Thus, the 1999 deficit in terms of GDP surpassed that of 1995. In 2000, although economic activity showed only slight signs of recovery, the provincial deficit decreased.[13] However, the fiscal imbalance of Buenos Aires province widened after 1995 and by 2000 represented 60 percent of overall provincial debt. Transfers from the federal government remained unchanged, given the Federal Agreement of December 1999.[14] Some oil production provinces benefited from exceptionally high oil royalties, but expenditure control largely explains this improvement.[15]

Debt evolution

The financing of deficit analyzed in the previous section varied throughout the decade. Many factors induced a significant change in the way provincial governments incurred debt.

In the early 1990s, the Convertibility Law and the reform of the Central Bank Charter[16] signaled a radical change in the financing of provincial governments. The new monetary rules ended inflation as a way of financing deficits. The second reform had a strong impact on the provincial credit market. This reform introduced two important rules for provinces:

- The central bank could no longer take any domestic assets. So provinces could no longer count on the central bank to discount loans by provincial banks to provincial governments, ending their access to seigniorage.
- The central bank could no longer guarantee provincial bank deposits. So provincial banks had to rely on depositor trust to maintain liquidity.

Both measures tightened the financial constraint for provinces, limiting their capacity to borrow from official banks. Thus, provinces lost one important source of financing. Moreover, with the privatization of many provincial banks following the Tequila crisis, financial constraints became even stronger.[17,18]

A more favorable financial context offset the difficulties produced by the new monetary regime described earlier. Provinces had more fluid access to local and foreign private borrowing.[19] During the first half of the decade provinces were able to easily cover financial necessities through the private market. But this changed with the Tequila crisis produced liquidity problems in the provincial banks. The contraction in the private market in 1995 was accompanied by harder borrowing conditions for provincial governments. This necessitated a more active participation of the federal government from 1995.[20,21]

Provincial debt evolution accelerated at the end of the 1990s. Thus, between 1997 and 1999 the stock in terms of GDP grew from 4.6 to 6.7 percent, increasing 40 percent in only two years. However, there was a large heterogeneity in debt evolution among provinces[22] (Table 11.1).

At the end of the decade, as Table 11.2 shows, the provincial public sector had diverse sources of financing. Provinces were financed mainly by financial entities, and the private bond market, followed by international organizations and delays in payment of wages to provincial employees and to suppliers ("floating" debt). It can be seen that between 1997 and 1999 the debt structure remained stable and that there was some modification in 2000. The implementation of the Program of Fiscal Adjustment and Fiscal Restructuring (PFAFR) from the federal government actually entailed major bank participation since the banks financed the Provincial Development Trust Fund (PDTF). Thus, the financial system represented 44 percent of total debt in 2000, losing their participation, the "floating debt" and international organizations.

Some provinces in particular had a significant debt–revenue ratio, an important proportion of future "coparticipation" transfers used to pay debt services, and large fiscal deficits. These indicators, in addition to high interest rates,[23] proved to be very difficult for some provinces. As Table 11.3 shows, provinces like Chubut, Corrientes, Formosa, Jujuy, Río Negro, and Tucumán faced an extremely serious fiscal and financial situation by December 1999.[24]

In 2000, the federal government implemented the PFAFR as a way to deal with this situation. Provinces participating in this program cannot take additional financing and have to make a fiscal adjustment as established by the National Fiscal Responsibility Law (Appendix D).

Table 11.1 Provincial debt stock[a] December 1997–September 2000 (in thousands of pesos)

	1997	1998	1999	*September* 2000	*Percent change* 1997–99
Total	13,538,607	14,797,614	18,995,220	21,356,345	40.3
Buenos Aires	1,487,370	1,595,100	2,511,400	3,755,380	68.8
Catamarca	385,830	402,359	479,059	534,923	24.2
Córdoba	1,288,571	1,205,692	1,392,694	1,504,090	8.1
Corrientes	761,803	948,491	1,167,878	1,205,496	53.3
Chaco	832,346	1,020,112	1,295,069	1,453,550	55.6
Chubut	408,891	474,552	469,621	518,603	14.9
Entre Ríos	523,592	600,921	795,084	840,275	51.9
Formosa	732,499	768,222	1,007,528	1,177,926	37.5
Jujuy	634,831	676,222	841,714	908,240	32.6
La Pampa	82,726	81,768	81,992	84,713	−0.9
La Rioja	448,267	462,890	392,934	374,445	−12.3
Mendoza	1,143,043	1,013,905	1,263,321	1,147,788	10.5
Misiones	636,312	720,513	946,146	1,055,441	48.7
Neuquén	291,330	400,914	681,061	743,719	133.8
Río Negro	791,309	869,589	1,063,889	1,143,182	34.4
Salta	494,983	517,882	620,761	700,235	25.4
San Juan	373,742	405,093	643,687	671,585	72.2
San Luis	86,701	88,449	94,927	66,572	9.5
Santa Cruz	40,917	137,046	252,359	253,402	516.8
Santa Fe	579,685	931,542	1,074,394	1,106,991	85.3
Santiago del Estero	349,400	333,014	278,678	293,337	−20.2
Tierra del Fuego	154,013	161,296	433,925	570,947	181.7
Tucumán	1,010,448	982,041	1,207,100	1,245,504	19.5

Source: Ministry of Economy.

Note

a Buenos Aires City debt has not been included because it is undergoing a compensation process with the national government.

Table 11.2 Provincial debt structure 2000 (in percent)

	1997	1998	1999	*September* 2000
Total	100.00	100.00	100.00	100.00
Federal government	2.87	1.58	1.21	0.86
Banks	31.34	35.12	34.15	33.35
International organizations	16.97	20.48	19.26	12.03
“Floating” debt	18.49	15.96	17.72	12.00
Consolidated debt	3.82	3.24	5.40	7.18
Public bonds	25.18	23.02	22.26	24.12
Privatization of provincial banks	1.32	0.61	0.00	0.00
PDTF	0.00	0.00	0.00	10.06
Other	0.00	0.00	0.00	0.41

Source: Ministry of Economy.

Table 11.3 Provincial indicators 1999 (in percent)

Province	*Debt stock/ Current revenues*	*Debt services/ Current revenues*	*Affectation of "Coparticipation Revenues"*	*Surplus without Privat./Total expenditure*
Total	68	12.4	—	−12
Buenos Aires City**	—	9.5	—	2
Buenos Aires	29	5.0	3.2	−19
Catamarca*	96	18.0	92.7	−11
Chaco	59	19.9	46.3	−16
Chubut	159	43.2	61.1	−19
Córdoba	140	8.2	67.4	−5
Corrientes	95	29.1	87.0	−6
Entre Ríos	71	17.6	85.0	−14
Formosa	164	37.4	74.2	−17
Jujuy*	143	27.2	67.0	−16
La Pampa	17	2.0	1.2	−4
La Rioja*	60	5.8	59.1	0
Mendoza*	103	15.2	90.9	−21
Misiones	128	25.9	43.1	−22
Neuquén	75	9.8	74.7	−23
Río Negro*	167	30.0	109.4	−17
Salta*	73	15.1	96.8	−5
San Juan*	96	16.3	69.9	−9
San Luis*	19	1.0	26.7	7
Santa Cruz	38	3.1	5.3	−7
Santa Fe	45	4.6	31.3	−8
Santiago del Estero*	37	20.5	50.9	5
Tierra del Fuego	125	16.9	55.7	−10
Tucumán*	124	35.7	104.1	−12

Notes
* These provinces have transferred provisional systems to the federal government.
** Buenos Aires City's debt has not been included because it is in the process of compensation with the federal government.

Mechanisms for borrowing control

In Argentina, provincial borrowing is coordinated and controlled by provincial and federal mechanisms.

Constitutional settings

According to the National Constitution (Art. 121), provinces retain all authority not delegated to the federal government. In this way, provinces retain their autonomy to borrow. Under article 124 provinces can sign international agreements, so long as they are not incompatible with the nation's foreign policy and do not affect national public credit.[25] Thus, provinces can borrow, but allow the federal government to coordinate the national public credit. Several mechanisms, at the federal and provincial levels, coordinate and regulate subnational government borrowing.

Provincial level

Constitutional limits on borrowing

Every provincial constitution sets its own restrictions on its capacity to borrow.[26] These restrictions include mechanisms that authorize provincial governments to borrow (legislative majority to approve authorization), restrictions on the use of loans (some provinces prohibit the financing of current expenditure), or restrictions on the amount of debt service. In sixteen provinces, the constitutions set a maximum on the debt service to provincial revenue ratio (Table 11.4). Eight provinces consider the "golden rule" that would prohibit borrowing to finance current expenditure.

Table 11.5 presents a quantitative evaluation of how these limits on debt service were complied with. Provinces like Corrientes, Formosa, Jujuy and Río Negro borrowed

Table 11.4 Constitutional limits on debt service

Province	*Constitutional limit*
Buenos Aires City	—
Buenos Aires	—
Catamarca[a]	Debt service no higher than 20% of revenues
Córdoba[b]	Debt service no higher than 20% of ordinary revenues
Corrientes	Debt service no higher than 25% of revenues
Chaco[c]	Debt service no higher than 25% of revenues
Chubut	—
Entre Ríos[d]	Debt service no higher than 25% of revenues
Formosa[e]	Debt service no higher than 25% of revenues
Jujuy	Debt service no higher than 20% of revenues
La Pampa	Debt service no higher than 25% of ordinary revenues
La Rioja[e]	Debt service no higher than 25% of revenues
Mendoza	—
Misiones	Debt service no higher than 25% of revenues
Neuquen	—
Río Negro	Debt service no higher than 25% of revenues
Salta	Debt service no higher than 25% of ordinary revenues
San Juan	—
San Luis[e]	Debt service no higher than 25% of revenues
Santa Cruz	—
Santa Fé	Debt service no higher than 25% of revenues
Santiago del Estero	Debt service no higher than 25% of ordinary revenues
Tucumán	—
Tierra del Fuego	Debt service no higher than 25% of ordinary revenues

Notes

a The debt stock plus accrued and unpaid interest at the time of the calculation cannot exceed 20 percent of the effective revenue of the prior five-year period.

b This will be based on the lowest annual ordinary revenue of the last three years at constant values.

c The Constitution stipulates 25 percent of tax collection of the provincial jurisdiction and that coming from the "coparticipation" regime.

d The limit is calculated on unaffected current revenue from the previous year.

e This will be based on the lowest annual ordinary revenue of the last three years at constant values.

Table 11.5 Fulfillment of constitutional limits, debt service–total revenue ratio 1999 (in percentages)

Province			
Buenos Aires City	9.5	Mendoza	14.4
Buenos Aires	4.6	Misiones	25.1
Catamarca	17.7	Neuquén	9.2
Córdoba	8.1	Río Negro	28.9
Corrientes	28.8	Salta	14.6
Chaco	19.1	San Juan	15.8
Chubut	41.8	San Luis	1.0
Entre Ríos	16.8	Santa Cruz	3.0
Formosa	37.0	Santa Fe	4.5
Jujuy	26.7	Santiago del Estero	20.4
La Pampa	1.8	Tucumán	35.3
La Rioja	5.5	Tierra del Fuego	16.1
Total of all provinces	11.9		

Source: Author's calculations based on Ministry of Economy data.

outside these restrictions. This can be explained by the provincial institutions' weakness, and the confused revenue definition leading to these limits in the provincial constitutions.

Provincial fiscal responsibility laws

In recent years, several countries have implemented distinct fiscal policy rules. A fiscal policy rule is defined, in a macroeconomic context, as a permanent constraint on fiscal policy, typically limited in terms of an indicator of overall fiscal performance (Kopits and Symansky, 1998).

In 1999, Argentina approved the National Fiscal Responsibility Law,[27] defined at the central government level. This regime set a path to fiscal balance in the year 2005, a limit on debt growth, and a limit on the increase in public expenditure.[28]

With the signing of the first Federal Agreement[29] (December 1999), provinces committed themselves to achieving fiscal balance and approving a provincial fiscal responsibility law, following the objectives set down by the federal government in the National Fiscal Responsibility Law of September 1999. In December 2000, ten provinces adopted a fiscal responsibility law and three presented bills in their provincial legislatures (Table 11.6).

In some cases, these laws were the consequence of the provincial governments' initiatives (San Luis and Salta). In others, as provinces signed the Federal Agreement of December 1999, some provincial governments promoted fiscal responsibility laws (Córdoba and Misiones). In other cases, these laws were the consequences of conditions of the PFAFR (Catamarca, Chaco, Formosa, Río Negro, Tierra del Fuego, and Tucumán). The Province of Buenos Aires signed an agreement with the federal government in September 2000 to approve a fiscal responsibility law. Every provincial fiscal responsibility law includes achieving a fiscal balance according to the National Fiscal Responsibility Law.

Table 11.6 Provincial fiscal responsibility laws

Jurisdiction	*Status of the norm and no. of the law*	*Date of approval*	*Objective of the law*
National	Law 25152	21 September 1999	Define rules on the administration of public resources
	Law 25401	4 January 2001	Modify goals of the deficit and the evolution of primary expenditure
Catamarca	Law 4997	13 January 2000	Ratify Federal Agreement II, define goals for deficit, disseminate fiscal information and commit themselves to tax alignment between municipalities and the province
Chaco	Law 4725	17 May 2000	Define rules on the administration of public resources
Chubut	Bill		Define rules on the administration of public resources
Córdoba	Law 8836	28 March 2000	Reform provincial public sector
Formosa	Law 1298	30 December 1999	Define rules on the administration of public resources
Jujuy	Bill		
Misiones	Law 3648	4 May 2000	Define rules on the administration of public resources
Neuquén	Bill		Define rules on the administration of public resources
Río Negro	Law 3502	1 February 2001	Define rules on the administration of public resources
Salta	Law 7030	27 May 1999	Fiscal Responsibility Law (regulation of Art. 70 of the Provincial Constitution)
San Luis	Law 5164	3 August 1999	Define rules on the administration of public resources
Tierra del Fuego	Law 487	29 August 2000	Define rules on the administration of public resources
Tucumán	Law 6964	9 September 1999	Create financing program and guidelines for fiscal responsibility

These kinds of fiscal rules can be utilized at various levels of government to impede negative spillovers within a federation. A fiscal law restraining subnational government deficits prevents externalities from fiscal misbehavior in one jurisdiction from being transmitted, through credit downgrading and concomitantly higher interest charges, to other subnational jurisdictions and to the national government (Kopits and Symansky, 1998).

As Appendix C shows, these provincial laws have diverse sources and varying scopes. To coordinate these different initiatives, the federal government and the provinces signed a second federal agreement in November 2000.[30] This agreement included a commitment to freeze primary expenditure at the 2000 level and both sides (federal government and provinces) agreed to reach a balanced budget by 2005.

Federal government level

Subnational governments need authorization from the federal level to borrow in foreign currency as well as from commercial banks. Credits from commercial banks (in domestic and foreign currency) and bonds (in foreign currency) need authorization from the Ministry of Economy.[31] This mechanism works as follows:

- A central bank regulation (Communication 3063) establishes that financial entities cannot lend to the public sector (federal, provincial, or local) without an authorization from the Ministry of Economy.
- A legal norm (Resolution 1075/93) establishes that provinces need an authorization from the National Ministry of Economy to borrow in foreign currency. Resolution 1075/93[32] also establishes the mechanism of pledge "coparticipation" to repay debt service. Provinces use future transfer receipts from "coparticipation" as collateral for borrowing from commercial banks.

The "coparticipation" transfer is used to repay debt service straight from the national bank account (*Banco de la Nación*), where the federal government deposits transfers to the provinces. When one province takes out a credit with future "coparticipation" transfers as collateral, it uses part of these transfers to pay debt service. The national bank, that is, the financial agency of the "coparticipation" system, distributes daily "coparticipation" transfers to provinces. When a loan is arranged, the national bank receives information about interest and amortization to be paid for the provinces, with the authorization to allocate part of the transfers to debt payments. So, the national bank automatically transfers the amount for debt service (interest and amortization) from the provincial account to the commercial bank.[33]

This mechanism facilitates provincial access to financial markets. With this mechanism, there is no likelihood of bank default when facing financial problems as the banks have direct access to the collateral. The most important problem of this mechanism is that it does not generate market discipline. Commercial banks have the incentive to lend without fiscal solvency analysis.[34] For the banks to evaluate repayment ability, the key is not the fiscal situation of the provinces. The important issue for banks is whether provinces have available "coparticipation" to use.

Until 1999, the debt authorization mechanism was used as an administrative control (Sanguinetti and Zentner, 1999). Since 1993,[35] the federal government has never refused an authorization of subnational borrowing.

Since the implementation of the PFAFR in 2000, this federal government authorization has become operative for a group of provinces. This program[36] permitted provinces had facing serious financial problems to restructure debt. To participate in the program, provinces had to commit themselves to fiscal austerity. Through a trust fund, provinces had access to a loan (guaranteed by a "coparticipation" transfer) with lower interest rates and longer debt maturity so as to restructure their annual debt services. To access this fund, provinces had to agree to reach a fiscal balance by 2005 and relinquish additional financing. The federal government began to make use of its power to refuse to sign borrowing authorization to provinces that participate in the PFAFR.

In recent years, loans from international organizations (The World Bank and Inter-American Development Bank) have been significant. As opposed to using credits from commercial banks, the federal government encourages direct credits to provinces because of the affect on credit availability to the country. In addition, this credit requires a federal government guarantee. These loans have to be agreed upon between the international institution, the province, and the federal government. In 2000, the federal government actively participated in the negotiation and monitoring of these loans. The fiscal component of these loans was used by the federal government as a way to fulfill the provincial fiscal commitment to Federal Agreements I and II. The fiscal target deficit of these loans had to be consistent with the path to fiscal balance. Indeed, the agreement with Buenos Aires on September 2000 was a product of this kind of negotiation.

Central bank regulation

Another way to regulate public borrowing is through commercial bank regulation. The regulation analyzed in the previous section works on demand side of credit. The Central bank can regulate on the supply side of the financial market.

As a part of prudential regulation and supervision, the Central Bank of Argentina (BCRA) has implemented a system of capital requirements based on the Basle Committee's recommendations. Capital requirement is defined as a function of the risk of the assets of the bank and is based on three types of risk: counterparty risk, interest rate risk and market risk. In the case of counterparty risk, the required "capital to assets-at-risk" ratio is 11.5 percent.[37] In addition, in 2000, the authorities implemented a new regulation (Communication 3039)[38] on loans granted to the nonfinancial public sector (including provincial and municipal credits with "coparticipation" as collateral). This rule increased the coefficient to calculate the minimum capital requirement for provincial credit.[39] Loans granted to the nonfinancial public sector need to have a ratio from 1 to 5 percent, according to the modified duration of the asset.

Concerning regulation on asset management, financing to the nonfinancial public sector is prohibited, except for:

- the purchase of public bonds,
- other financings when,
- approved by the Ministry of Economy,
- collateralized by royalties or federal share taxes,
- the direct transfer of the funds between the collecting agency and the bank is permitted.

As explained earlier, this kind of bank regulation complements the mechanism of authorization from the Ministry of Economy, regulated by Resolution 1075.

Conclusions and perspectives

Argentina's process of change in areas of responsibility between levels of government throughout the 1990s was implemented without the adequate institutions to regulate it. Successive reforms gave shape to the present system of coordination of financial relations across levels of government, and specifically to the regulation mechanism for subnational borrowing.

The scope of these coordination instruments is limited absolutely by the national constitution.

The provinces' fiscal and financial situation in late 1999 revealed the limitations of the system. The largest provincial fiscal deficit recorded in the decade, provinces with more than 100 percent of future "coparticipation" transfer used to repay debt service, and high interest rates were only some of the symptoms of an inadequate coordination and control framework.

Provincial constitutional limits on borrowing, together with central government administrative control and permissive banking regulation on provincial credits – the instruments in force to deal with this situation – proved to be ineffective.

In some provinces, constitutional limits were not binding. Administrative control of subnational borrowing – with "coparticipation" revenues as collateral and automatic repayment from the "coparticipation" account – does not generate market discipline. The scheme to regulate subnational public borrowing seemed to have reached its limits.

In 2000, many reforms affected the federal government – province relationship. Some of these reforms were designed as ways to complement the mechanisms in force to regulate subnational borrowing.

Changes in banking regulations, increasing the coefficient used to calculate the minimum capital requirement for provincial credit, reduced the banks' incentive to lend to provinces that the repayment mechanisms produce.

At the provincial level, the introduction of provincial fiscal responsibility laws has been a very important step toward more responsible fiscal behavior for the provinces. It is still too early to evaluate the results of these fiscal rules, but one thing that will have to be observed is whether these restrictions are respected. Provincial compliance with constitutional limits has not been fully successful.

Another factor is the heterogeneity of the different provincial laws. As shown in Table 12.6, these laws are significantly different in scope, measure of deficit, treatment of provincial debt, and public expenditure. The Federal Agreement II of November 2000 attempts to coordinate this heterogeneity, achieving a provincial commitment for fiscal balance by 2005 and limiting primary expenditure to the 2000 level. But it needs monitoring to be successful.

After one year in force the PFAFR can be evaluated in a very preliminary way. The central government has a more active use of borrowing debt authorization. Provinces that take part in this program cannot incur more credit than the level agreed upon with the federal government in the program.

It is important to mention that in late 1999, with some provinces experiencing an extremely weak fiscal and financial situation, the new federal government received great pressure to bail them out. The financial implementation of the program through the PDTF allows the federal government to evade a federal bailout. Credits from the PDTF were guaranteed by "coparticipation" transfers and are repaid automatically as with a commercial bank.

In a fiscal sense, the result of a more than 50 percent reduction in the fiscal deficit of the provinces that participate in the program, even in an unfavorable macroeconomic context, is very good news. Although these provinces are the most complicated in the financial sense, their deficits are not significant in the provincial deficit total.

All the provinces committed themselves to decreasing their deficits, and achieving a fiscal balance by 2005. In addition, during 2000 the federal government, together with international organizations, took an active role in designing loans to provinces, setting limits as defined in the objectives of Federal Agreements I and II with respect to the fiscal path.

All these fiscal commitments need monitoring in the future. The fragility of this system of subnational indebtedness compounds the difficulty the federal government has had in managing macroeconomic crises.

Appendix A: Provincial constitutional limits on borrowing

The following table summarizes the most important limits by the provincial constitutions on the approval and use of public credit.[40]

Jurisdiction	*Necessary authorization*	*Indebtedness use*	*Limits on public credit*
Buenos Aires city	Absolute majority of all members of the legislature. Domestic and external public credit must be authorized by law.	Concrete determination of its objective.	
Buenos Aires	Law passed by 2/3 of the members present in each house.	Resources are to target determined objectives. Specify special resources with which to service the debt and its amortization. The law authorizing credit must specify use. Authority that invests or designates it for other objectives is responsible for the credit.	
Catamarca	The legislature empowers the executive branch with a vote of 2/3 of the members present in each house.	Cannot be used to cover the administration's current expenses. Resources cannot be applied to other objectives.	Interests and amortization of debt cannot exceed 20% of the province's effective revenue of the preceding period.
Córdoba	Authorizes the executive branch with a 2/3 vote of the members present in each house.	The financing of public works, the promotion of economic growth and social development, the modernization of the state, and other special or urgent needs.	Amortization and interest cannot exceed 20% of the provincial revenue, based on the lowest annual current revenue of the last three fiscal years at constant values.
Corrientes	Law approved by 2/3 of the votes of the total members of each house. The executive branch must be empowered by the legislative branch.	Must be applied to specific objectives as stated in the law.	In no case to exceed 25% of the province's annual revenue.

(Continued)

Appendix A (Continued)

Jurisdiction	*Necessary authorization*	*Indebtedness use*	*Limits on public credit*
Chaco	Law approved with the vote of 2/3 of the members of the legislature. Executive branch must be authorized by the Chamber of Deputies to incur public loans, release public funds and enter into any other loan.	Specificity of the objective of the transaction and resources affected by its service.	Not to exceed annually 25% of the province's revenues.
Chubut	Empowers the executive branch with a vote of 1/2 + 1 of its members.	Specificity of bases and objectives. Cannot be used to balance the administration's current expenditure.	
Entre Ríos	Empowers the executive branch with a vote of 1/2 + 1 of the members of each house.	Specificity of bases and objectives. Cannot be used to balance the administration's current expenses. Neither the amount obtained nor the public funds released can be applied to uses other than those stipulated in the law.	In no case can the total services of the public loans exceed 25% of the province's revenue.
Formosa	Executive branch must be empowered by the legislative branch to incur public loans based on the province's credit. Two-thirds of the vote on penalty of invalidity.	Financing of public works, agrarian reforms, economic growth and social development or to cover expenditures due to catastrophes and other needs of extreme urgency.	The total service of the authorized debts and those to be authorized cannot exceed 25% of the average of the annual current resources.
Jujuy	The legislature can authorize through a special 2/3 vote of its total members. The legislature can approve or reject payment conditions of the province's domestic and external debt.	For economic promotion the province can incur public loans destined to finance productive works specifically planned, whose financial services are to be covered by the yield of the work.	

La Pampa	The law must be approved with a 2/3 vote of the members of the Chamber of Deputies.	The objective to which the funds are destined and the resources allocated for its service must be specified. Can only be authorized to fund public works, to confirm agrarian colonization plans or to cover expenditures due to catastrophes, public disasters, or other urgent or exceptional state needs, qualified by law. In no case can it be used to finance an administrative deficit.	Cannot exceed 25% of the province's annual current revenue.
La Rioja	With a 2/3 vote of the members of the Chamber of Deputies. The governor must be empowered by the Chamber of Deputies to incur public loans, offer public bonds, and incur any other loan as stipulated by this constitution.	Commitments of this kind can only be used for public works. Resources coming from these loans cannot be applied otherwise even temporarily, under the responsibility of the authority that invests them or designates them for other objectives.	Service of the total of the authorized debts cannot exceed 25% of the province's revenue, based on the lowest level of resources of the last three years.
Mendoza	Law approved by a 2/3 vote of the members present in each house. The legislative branch must regulate the administration of the public credit. Executive branch must be empowered by the legislative branch to incur public loans or release public funds as stipulated in the constitution.	Special resources with which the debt or its amortization cannot be serviced must be specified. The resources arising from the public loan can only be applied to determined objectives that the authorizing law must stipulate, under the responsibility of the authority that invests them or designates them for other objectives.	
Misiones	Executive branch must be empowered by the Chamber of Representatives with 2/3 of the votes of members present.	Specificity of bases and objectives are established and cannot be used to balance the administration's current expenditure. Neither the cash obtained nor the public funds authorized can be applied to other uses.	In no case can the total of the service of the public loans exceed 25% of the province's revenue.

(Continued)

Appendix A (Continued)

Furisdiction	*Necessary authorization*	*Indebtedness use*	*Limits on public credit*
Neuquén	Executive must be empowered by the legislative absolute majority of all of its members to incur loans. The laws that authorize the incurrence of loans are to be established in a special session of the house, with a prior notification of three days to dictate the basic law of public credit. A special law of the legislature is required to authorize loans or public funds with a stipulated base and objective, not to include balancing the administration's current expenditure. For economic promotion in the province with the agreement of the absolute majority of all members of the Chamber of Deputies, it can incur loans to finance productive works specifically determined by the Council of Planning whose financial services are to be covered by the yield of the work.		In no case can the total of the service of the loan exceed 25% of the province's general revenue. The amount obtained of the same can be applied to other ends that are stipulated in the law.

Río Negro	Law approved with 2/3 of the votes of the members of the legislature. The legislature has the power and obligation to consider the payment of the province's domestic and foreign debt .	The resources cannot be designated for any use other than those authorized by the law under the responsibility of the authority that invests or designates them for other objectives. They can only be used to fund public works, to carry out agrarian reform or to cover expenditures due to catastrophes, public disasters, and other exceptional and urgent state needs qualified by the law. In no way can they be used to finance an administrative deficit.	Resources to cover debt services must be specified. In no case can they exceed 25% of annual current revenues.
Salta	The legislature must authorize loans on the province's general credit or the release of public funds. This authorization must be sanctioned by 2/3 of the members present in each house, originating in the Chamber of Deputies.	All laws sanctioning loans are to specify the special resources with which the interests and amortization of the debt are to be covered, as well as the objectives of the loan.	The total of interest and amortization cannot exceed 25% of the provincial treasury's current revenue.
San Juan	The Chamber of Deputies can empower the executive branch to incur loans, determining their interest and the bases and the conditions for the amortization, offer public bonds and any other loan as stipulated in the constitution.		
San Luis	Law sanctioned with 2/3 of the votes of the members of the legislature. Contracts on loans based on provincial credit or other public utility must be authorized by the legislature.	The resources cannot be designated even temporarily to other ends. The law providing for other special commitments must establish the special resources with which the interest on the debt and its amortization will be covered.	In no case will the service of the total of the authorized debts exceed 25% of the provincial revenue, based on the lowest revenues in the past three years.

(Continued)

Appendix A (Continued)

Jurisdiction	*Necessary authorization*	*Indebtedness use*	*Limits on public credit*
Santa Cruz	Executive branch must be authorized by the legislative branch to incur loans with 2/3 of the votes of the members present. Legislative branch must regulate the administration of public credit.		
Santa Fe	Executive branch must be empowered by legislature to establish contracts and approve or reject those concluded "ad-referendum" of the legislature.		The service of the total of the debts from loans cannot exceed 25% of provincial revenue.
Santiago del Estero	Loans on the province's general credit or the release of public funds must be authorized by the Chamber of Deputies. The authorizing law must be sanctioned by 2/3 of the votes of the total of the members. Executive branch must be empowered by the legislative branch to release public funds or authorize loans on the province's general credit. The law must pass with 2/3 of the votes of the total of the members, having foreseen special resources with which to service the debt.	The law must specify the special resources with which it will cover the interest of the debt and its amortization, as well as the objectives of the loan. The amount obtained by the loans cannot be designated for objectives other than those detailed in the law.	The total of interest and amortization cannot exceed 25% of the current revenue of the provincial treasury.
Tierra del Fuego	Through special laws approved by 2/3 of its members, the legislature can incur loans or offer public bonds.	The base and objective are to be specified. Funds cannot be used to balance expenditure of the administration's functioning and services.	
Tucumán	The law must pass with 2/3 of the votes of the total of the members, taking as the total the number of members in office at the time of the sanction. Executive branch must be empowered by the legislative branch to incur loans based on provincial credit.	The special resources with which service of the debt is to be covered must be specified. Public funds that are released and the amount obtained by the loan cannot be designated for objectives other than those determined by the law.	

Appendix B: Federal Agreement of December 1999

In December 1999 elected federal government and provincial authorities signed a federal agreement. This pact defined new outlines for the organization of fiscal and financial relations between the federal government and the provinces.

This agreement established a predictable system of transfers from the federal government to provinces until 2002. Moreover, it promoted the adoption of responsibility laws and with them the commitment to fiscal austerity in the following years. The agreement also implemented the PFAFR.

The main points of the Federal Agreement were:

- Transfer of a fixed monthly sum of 1,350 million pesos for "coparticipation" and special regimes in year 2000 and, in year 2001, a moving average of the previous three-year "coparticipable" amounts.
- Free availability of 50 percent of earmarked transfers during 2000.
- Promotion of provincial fiscal responsibility laws according to National Fiscal Responsibility Law principles.
- Agreement to present a "coparticipation" bill for legislative debate in 2000.
- Commitment from the federal government to implement a program (PFAFR) for provinces with serious fiscal and financial problems with the objective of reducing maturity and interest rates on the debt. This will be seen through individual adjustment commitments, contention, efficiency, and transparency of expenditure and improvement in provincial and municipal fiscal situations.
- Transparency of fiscal information.
- Subnational tax system alignment, including municipalities.
- Possibility of transferring provincial pension systems to the federal government. Provinces had to align systems with the national system within 180 days of signing this agreement and national government agreed to finance 5 percent of the deficit in 2000 and 20 percent in following years until it reaches 100 percent.

Appendix C: Provincial fiscal responsibility laws

Jurisdiction	*Deficit*	*Debt*	*Use of credit*	*Current expenditure*	*Expenditure on workforce*	*Capital resources*	*Long-term budget*	*Counter-cyclical fund*	*Transparency of fiscal information*	*Coordination with municipal governments*
National	The deficit of the Non-financial National Public Sector (NFNPS), excluding revenue from the sale of residual assets from privatized firms and concessions, may be no higher than 7 billion pesos in 2001, 5.45 billion in 2002, 3.65 billion in 2003, and 2.35 billion in 2004. By 2005 a financial equilibrium is to have been achieved.	The national government's public debt cannot increase more than the sum of the deficit of the NFNPS, the capitalization of interests, money transfer, loans from the NG to the provinces, and payments as set out in Laws 23.982, 24.043, 24.070, 24.073, 24.130 and 24.411. This restriction can be exceeded when indebtedness is to cancel a public debt with maturity in the first trimester of the following year.		The increase in the real rate of public expenditure cannot exceed the real rate of growth of the GDP. When the real rate of change of GDP turns negative, primary expenditure may remain constant at most in current money. Until a financial equilibrium is achieved, primary public expenditure of every fiscal year cannot exceed the amount achieved in the year 2000.			Compiling of a detailed long-term budget to cover at least three years.	The creation of the Fiscal Counter-cyclical fund which will be constituted with 50% of the resources coming from privatizations, concessions, the sale of the remaining fixed assets and shares of privatized public enterprises in the hands of the national government. The fund will exist until it reaches an amount equivalent to 3% of GDP and will be used upon a reversion in the economic cycle.	Management and community control mechanisms are to be established for social services programs of the national administration. Presentations by the chief of cabinet ministers in congress on the fulfillment of the prior year's budget and the prevailing year's budget. Elimination of extra-budgetary expenditures.	Invitation to provincial governments to sanction legal norms in agreement with the national law.

Catamarca	The primary operational deficit of the year 2000 cannot exceed 2% of the average of the current and capital expenditures of the fiscal years 1998 and 1999. In 2001 a primary surplus of 30% of the total amount of the interest on the debt is to be achieved. In 2002 there is to be a primary surplus of 60% of the interests. In 2003 there is to be a fiscal equilibrium. Bill modifying the balance up to 2005: deficit as a percentage of total expenditure: 5%, 4%, 2% and 1%.	The executive branch will authorize access to the following information: the state of the performance of the budget and resources, financial and employment data in the system of human resources, fulfillment of revenue liabilities.	The EP will promote tax alignment with municipalities including measures to control tax evasion.

(Continued)

Appendix C (Continued)

Jurisdiction	*Deficit*	*Debt*	*Use of credit*	*Current expenditure*	*Expenditure on workforce*	*Capital resources*	*Long-term budget*	*Counter-cyclical fund*	*Transparency of fiscal information*	*Coordination with municipal governments*
Chaco	The fiscal deficit, excluding the lottery and the Institute for Social Security, may be no higher than 99.16 million pesos in the year 2000. In subsequent years it shall be reduced by 20% until a fiscal equilibrium is achieved.	In each fiscal year, the public debt cannot be greater than the fiscal deficit, the capitalization of interests and loans received from the provincial government that are transferred to the municipalities.		Spending on workforce in the fiscal years 2000–3 cannot be higher than that spent in the fiscal year 1999. Expenditure on consumer goods and services for the same period is 90% of that registered in 1999.			From 2000, the Executive Powerbranch is to remit to the Chamber of Deputies, together with the Budget Bill for each year, a budgetary projection for the following three fiscal years.			The executive branch will agree to encourage the strengthening of the fiscal solvency commitment and the implementation of financial administrative systems of the municipal governments through signed agreements.

Chubut Bill	The primary earnings must be positive, setting the following goals with respect to the accrued interests in the same period: Year 2000: surplus equivalent to 50%; Year 2001: surplus equivalent to 75%; Year 2002: sufficient to generate a surplus in the interests to be accrued in the fiscal year, which will be applied to the partial amortization of the debt.	The provincial state can assume new debts only to finance works, fulfill commitments derived from the floating debt on 31 December 1999 and to cover registered deficits until a fiscal equilibrium is achieved.		The real growth rate of primary expenditure cannot be greater than the real growth rate of provincial GDP except when authorization to spend financed with specific resources that are duly identified has been incorporated into the budget. When the real rate of PBG is negative, primary expenditure is to accompany said decrease or at most remain constant measured in current money.			The executive branch will draw up a long-term budget that will cover a period of at least three years. The first to be presented will correspond to the period 2001–3. These budgets will contain a minimum of the following information: resources by category, expenditures by section, investment program, financing program and description of budget policies.

(Continued)

Appendix C (Continued)

Jurisdiction	*Deficit*	*Debt*	*Use of credit*	*Current expenditure*	*Expenditure on workforce*	*Capital resources*	*Long-term budget*	*Counter-cyclical fund*	*Transparency of fiscal information*	*Coordination with municipal governments*
Córdoba	Total spending cannot exceed total resources (budgetary revenue plus net sources).	The increment in the public debt cannot exceed 1% of provincial GDP. The debt can increase only to finance the expenditure on infrastructure and state reform programs. The real rate of the increase in expenditures targeting the payment of services on the public debt cannot exceed the growth rate of provincial GDP. Debts prior to July 1999 are to be consolidated.		Current expenditure must be covered by current resources except for the financing of state reforms. The increase in current expenditure cannot exceed real growth of the provincial GDP and is to remain constant when provincial GDP declines.		Capital revenue can only be applied to the payment of capital and interest, the development of infrastructure of the province and to the integration of the "Growth in Córdoba." Fund which targets the promotion, assistance, development, and financing of small- and medium-sized enterprises located in the province.				The executive branch will promote agreements with municipalities and town councils for them to adopt norms that fit with the administration of their resources with the guidelines established in said norm.

Formosa	The fiscal deficit in 2000 is not to exceed the net sum of the payment of the services on the consolidated provincial public debt. From the year 2003 there must be a financial equilibrium and the fulfillment of the following parameters: The service of the interest on the debt is not to exceed 15% of the current resources. The debt stock initially equivalent to 127% of the expenditures is to diminish gradually.	The total public debt of the province cannot increase more than the corresponding fiscal deficit, the capitalization of interest, loans by the provincial government that are transferred to municipalities, and the payment established in special laws whose annual limit is to be determined in each budget.		The real rate of growth of primary expenditure is not to exceed the rate of the real rise in resources of national jurisdiction. If the rate of change of the resources turns negative, primary expenditure, at most, can remain constant.			The executive branch will draw up a long-term budget that will cover a period of at least three years.	This fund will be constituted with 50% of the resources coming from privatizations, with the financial surplus that is generated in each fiscal year no less than 1% of the current resources in the Treasury in 2000, 1.5% for 2001, and 2% from 2002. It is to be constituted until it reaches a total of $100 million and will be utilized upon a reversion in the economic cycle.	Documents produced in the provincial administration are of public domain and are freely available to the public.	The municipalities are invited to adhere to the prevailing law.

(Continued)

Appendix C (Continued)

Jurisdiction	*Deficit*	*Debt*	*Use of credit*	*Current expenditure*	*Expenditure on workforce*	*Capital resources*	*Long-term budget*	*Counter-cyclical fund*	*Transparency of fiscal information*	*Coordination with municipal governments*
Misiones	The fiscal deficit is not to exceed the net sum of the payment of the services on the consolidated provincial public debt in the year 2000. From 2003 it is to achieve a financial equilibrium and to fulfill the following parameters: The service of the interest on the debt is not to be higher than 15% of the current resources. The debt stock cannot exceed 100% of the expenditures and must gradually diminish.			The real rate of growth of the primary expenditure is not to exceed the rate of the real increase in the resources in the national jurisdiction. If the rate of change of the resources turns negative, the primary expenditure, at most, can remain constant.				This fund will be constituted with 50% of the resources coming from privatizations, with the financial surplus that is generated in each fiscal year no less than 1% of the current resources of the treasury in 2000, 1.5% in 2001, and 2% from 2002. It is to be constituted until it reaches 12% of the budget for prevailing expenditure and is to be utilized upon a reversion in the economic cycle.	Documents produced in the provincial administration are of public domain and are freely available to the public.	The municipalities are invited to adhere to the prevailing law.

Neuquén Bill	The primary surplus is to reach a minimum of 3% of total resources in the fiscal year 2001, a minimum of 6% in 2002, and a minimum of 10% in 2003, 2004, and 2005.		Current and primary expenditure in the year 2000 must be less than $833.4 million, which is the nominal level of the performance of the same in 1998. During the fiscal years 2001–5 an annual ratio must be maintained between primary current expenditure and current resources, that is less than that of the budget for the year 2000.				The municipalities are invited to adhere to the prevailing law.

(Continued)

Appendix C (Continued)

Jurisdiction	*Deficit*	*Debt*	*Use of credit*	*Current expenditure*	*Expenditure on workforce*	*Capital resources*	*Long-term budget*	*Counter-cyclical fund*	*Transparency of fiscal information*	*Coordination with municipal governments*
Río Negro	The net current fiscal result is to be balanced by 2005, according to the following guidelines as indicated by the reductions for 2000: 20% in 2001, 40% in 2002, 60% in 2003, 80% in 2004, and 100% in 2005. The net current fiscal result is defined as the difference between collected current revenue and accrued current expenses. Resources from FONAVI, royalties of any origin, and specific domestic funds influencing infrastructure are excluded. Likewise,	The debt cannot increase more than the sum of the authorized annual deficits until 2005. This restriction can be exceeded when indebtedness is designated to cancel public debt with maturity in the following year, contingent debt and programs financed by international credit organizations.				Provincial tax collection must represent 6% of provincial GDP in 2005.	From 2002 the executive branch is to elaborate a long-term budget covering a period of three years including resource projections by category, expenditure targeting investment programs during the period, loans with multilateral organizations, a savings investment scheme as carried out in the previous four years and of the first budgeted fiscal year, and the provincial GDP at current prices of the previous four years and of the first budgeted one.	The creation of the Fiscal Counter-cyclical Fund will be constituted with 50% of the surplus of financial results, 50% from the net revenue of liabilities and expenditure in the hands of the state coming from concessions, sale of residual assets, from privatized enterprises or organizations. The fund will continue until it reaches 1% of provincial GDP at 1999 current prices and the revenue that the fund itself generates.	The following information is of public domain: state of the application of expenditure and calculation of resources; purchase orders, any contract signed by the appropriate authority as well as accountability for extended funds; payment orders deposited in the provincial treasury and those to decentralized organizations as well as corresponding payments, financial information and the use of the System of Human Resources; state of the	The executive branch will invite provincial municipalities to dictate norms in accordance with the prevailing law.

"coparticipation" to municipalities coming from royalties are not to be considered in the current expenses.	situation, profile of maturities and cost of the public debt; list of accounts of money to be received; inventory of real estate and financial investment; index of payment conditions of tax liabilities in the hands of the general revenue department, information about the regulation and control of public services; all other necessary for the control of social expenditure and any other relevant information to oversee the fulfillment of the norms of the financial administration system and those stipulated in the law.

(Continued)

Appendix C (Continued)

Jurisdiction	*Deficit*	*Debt*	*Use of credit*	*Current expenditure*	*Expenditure on workforce*	*Capital resources*	*Long-term budget*	*Counter-cyclical fund*	*Transparency of fiscal information*	*Coordination with municipal governments*
Salta	Budgetary equilibrium. A budgetary deficit will only be acceptable if it is generated by unforeseen events, qualified by state investigator upon request of the governor.	There is not to be an excess of 70% of the annual current resources. To calculate this, loans assumed by the province to be transferred to municipalities are not to be computed.			This cannot exceed 65% of the net current resources.					The municipalities are invited to adhere to the prevailing law.
San Luis		The total debt cannot exceed 3% of the provincial GDP nor the equivalent to provincial tax collection corresponding to a period of	The use of credit is to respond to the following guidelines: It is to be used for capital expenditure, to be taken out in the long term,	The annual growth rate of the current expenditure is not to exceed the annual growth rate of provincial GDP. If the rate of			The executive branch will draw up a long-term budget that will cover a period of three years.		The executive branch is obliged to publish biannually a detailed report on the budget explaining expenditures, resources, deficits and indebtedness.	The executive branch and the municipalities will reach agreements on the legal norms in accordance with the prevailing law.

1.5 years. The amortization of the public debt is to be financed exclusively by resources coming from the sale of public assets, the current fiscal surplus, and the use of credit, in this order.	and is committed, at most, to the interest rate resulting from the average of the rates of the national or international financial markets.	change of provincial GDP turns negative, current expenditure, at most, can remain constant. The current expenditure is not to be higher than 50% of the total budget. Current expenditures must be financed exclusively with current tax revenue. That coming from the sale of assets and other capital transfers is not to be used to finance current expenditures.

(Continued)

Appendix C (Continued)

Jurisdiction	*Deficit*	*Debt*	*Use of credit*	*Current expenditure*	*Expenditure on workforce*	*Capital resources*	*Long-term budget*	*Counter-cyclical fund*	*Transparency of fiscal information*	*Coordination with municipal governments*
Tierra del Fuego	The promotion at least of an equilibrium between the resources and current expenditures.	Loans that affect federal resources, tax or nontax revenue, or the granting of backing or guarantees on the same or on real or intangible wealth goods of the province must count with legislative approval.				Capital resources cannot be affected by current expenditures except in the case of emergencies or catastrophes, or when external factors deem it necessary to allocate the resources to these ends. They can only be allocated to public investment, to pay off the public debt or to carry out promotion policies for private and economic development.				

Tucumán	There can be no current deficit; current expenditures will be covered exclusively with current revenue. Nonrecurring expenditures are excluded from this calculation.	The province can make use of only credit in order to finance investment or strengthen institutionally its organization, or re-finance liabilities. No current expenditure can be financed with long-term loans.		The rate of the increase in current expenditure cannot exceed the rate of the increase in current revenue. When the rate of change of these revenues turns negative, real expenditure can, at most, remain constant. Nonrecurring expenditures are excluded. The proceeds from the sale of assets cannot be used for current expenditures.	This cannot exceed 65% of the net current expenditures. Net revenue is the total of the current revenues less the transfers to municipalities and rural townships.		The executive branch will draw up a long-term budget that will cover a period of at least three years.

Appendix D: Program of fiscal and financial assistance

Early in 2000, the federal government designed the PFAFR. The PFAFR was one of the results of the Federal Agreement signed in December 1999.

Eligibility criteria for participation in this program targeted those provinces facing the most serious financial and fiscal problems.

The program includes a fiscal and a financial component.

The fiscal component contains a provincial commitment to reaching a fiscal balance in keeping with the National Fiscal Responsibility Law.

The financial component involves provincial access to a restructuring loan through Provincial Development Trust Fund (PDTF) to service the annual debt, to extend debt maturity, and to lower the interest rate.

The requirements of the implemented program included the approval of a provincial fiscal responsibility law and a financial administration law compatible with the national law. In addition, one of the program's conditions was to improve the dissemination of provincial fiscal information.

Provinces in this program had access to PDTF. Funds were disbursed every three months after verifying that fiscal and legal targets had been fulfilled. As explained in the document, by participating in this program, provinces relinquished access to extra borrowing, except to restructure debt.

The program was designed to cover 100 percent of the year's financial needs, thus the federal government could make the constraint on new indebtedness operative through Resolution 1075.

Trust Fund financing was obtained from a group of private banks for a period of ten years with one year of forgiveness at a variable interest rate.[41] Credits from PDTF to provinces are guaranteed by "coparticipation" transfers and debt services are repaid automatically, as with commercial banks.

Besides these common characteristics, each province signed a particular agreement with the federal government, which established annual global assistance, three-month fiscal targets, measures to reach them, service obligations, and a schedule of legal requirements.

Evaluation of the program is preliminary but it showed good fiscal results in the first year. While the whole provincial public sector had a reduction of 26.6 percent in the

Table 11.D1 Financial results of PFFA by province (in thousands of dollars)

Province	*Deficit 1999*	*Deficit 2000**	*Deficit change 1999–2000 (in percentages)*
Catamarca	64,350	19,780	−69.3
Chaco	218,725	153,165	−30.0
Chubut	122,288	18,423	−84.9
Formosa	159,239	88,343	−44.5
Jujuy	117,747	77,132	−34.5
Neuquen	291,185	87,870	−69.8
Río Negro	129,779	71,292	−45.1
Tierra del Fuego	32,695	−2,458	−107.5
Tucumán	130,120	18,525	−85.8
Total nine provinces	1,266,125	532,074	−58.0

Source: Ministry of Economy.

deficit, the group of provinces that participated in the program showed a 58 percent decrease (see Table 11.D1). Also the program implied that seven provinces approved their own responsibility laws. While the program is in force, federal government can make these laws operative through debt authorization.

Appendix E: Federal Agreement for Growth and Fiscal Discipline of November 2000

In November 2000, the provinces and the federal government signed the Federal Agreement for Growth and Fiscal Discipline (Federal Agreement II).

This agreement ratified the intention of the parties to approve a new "coparticipation" law. But knowing the complexity that a norm of this nature implies, it designed a scheme of transfers until 2005. This design gave predictability and made it possible to diminish the effect of procyclical transfers in provincial and national budgets. It also extended some commitments of the previous federal agreements, such as the PFAFR, and made progress in some aspects of the fiscal performance between federal and subnational governments

The main points of Federal Agreement II are the following:

- Fixed monthly sum transfer for "coparticipation" and special regimes during 2001 and 2002, consisting of 1,364 million pesos. Between 2003 and 2005, the monthly sum will be the result of moving averages of "coparticipable" resources of the three previous years with a guarantee of 1,400 million pesos for 2003, 1,440 million pesos for 2004 and 1,480 million pesos for 2005.
- Commitment to present a new "coparticipation" bill in 2001 and if a new law has not been passed by December 2003, the federal government will do so.
- Free availability of 50 percent of earmarked transfers until 2005.
- Promotion of provincial fiscal responsibility laws' approval in provinces that not have done so up to that moment.
- Payment of the FONAVI (housing funds) guarantee debt which originated in 1999, 50 percent in 2001 and 50 percent in 2003.
- Definition of procedures and contents for the dissemination of federal and provincial fiscal information.
- Commitment to signing a federal agreement for provincial tax system alignment within 180 days of signing Federal Agreement II. Provinces agreed to adhere to the National System of Tax and Social Identification (SYNTIS).
- Increment of 225 million pesos in the 2001 federal budget to finance employment and social programs.
- Commitment to sign a Federal Agreement for Austerity, Equity and Transparency that includes a wage equalization of public administration across different levels of government.
- Commitment to sign an agreement for state modernization.
- Promotion of local adhesion to the main aspects of this agreement.

Notes

1 Advisors of Undersecretariat of Relations with Provinces, Ministry of Economy of Argentina. The views expressed in this paper are those of the authors alone and should not be attributed to the Ministry of Economy.
2 See Musgrave (1959).
3 For a global view of this discussion see World Bank (1999).

4 The other two are the assignment of major tax bases to subnational governments and the sharing of major tax bases.

5 Kopits *et al.* (2000) relate the way to control subnational borrowing with the country model to promote fiscal responsibility. According to this paper, countries have two basic models for promoting fiscal responsibility: the autonomy model and the coordination model.

6 For a more extensive explanation of the relationship of macroeconomic context, reforms, and their fiscal impact during the 1990s, see Cetrángolo *et al.* (2000).

7 Argentina has three basic mechanisms for revenue sharing between the national and the provincial level: (1) the "coparticipation" scheme, which provides automatic, nonearmarked transfers; (2) other automatic transfers, all of which are earmarked for specific purposes; and (3) discretionary, that is, nonautomatic transfers and grants that may be either earmarked or nonearmarked. See Schwartz and Liuksila (1997).

8 Since 1991, transfers to provinces have undergone a number of modifications. The main reforms provided that a portion of the VAT and income tax were detracted from the revenue-sharing system ("coparticipation") to finance the national pension system and some earmarked transfers; 15 percent of "coparticipable" revenues was redirected to finance the national pension system, according to Fiscal Pact I and II. For a complete version of the reforms, see Cetrángolo and Jiménez (1995).

9 Educational services under the charge of the National Education and Culture Ministry, the National Committee of Technical Education ("Consejo Nacional de Educación Técnica") and a small group of hospitals and programs were decentralized to provinces and Buenos Aires City. The decentralization process of social expenditure began in 1978 when the federal government transferred a group of hospitals to provinces under Law 21883 (OB: 11/2/78). Educational transfers corresponded to Law 24049 (OB: 1/7/92). For a complete version of the reforms, see Bisang and Cetrángolo (1997) and Carciofi *et al.* (1996).

10 On this occasion the Provincial Development Trust Fund (PDTF) was created and its first objective was to extend loans to provincial governments for the privatization of provincial banks.

11 In July 1994, a new national pension system was established (Law 24241. OB: 18/10/93). This system is a mixed program consisting of a public pay-as-you-go institutional arrangement and an individual retirement account program known as the "capitalization regime." This reform, in addition to a cut in payroll taxes accorded by Federal Pact of August 1993, signified a major allocation of public funds to the national pension system.

12 The Federal Pact of August 1993 (Law 24.130. OB: 22/9/92) established the possibility of transfer of provincial systems to national jurisdiction. Between January 1994 and October 1996 Buenos Aires City, Catamarca, Santiago del Estero, Salta, San Juan, Mendoza, Jujuy, La Rioja, Río Negro, Tucumán, Municipality of Tucumán and San Luis made the transfer operational.

12a These funds increased the level of "coparticipation" resources used to pay obligations (as seen in Table 11.3).

13 As shown in the statistical appendix, the provincial fiscal deficit in 2000 was estimated at 3.4 billion pesos. According to this estimation, between 1999 and 2000 the global deficit fell by 26.6 percent and total expenditure by 2.4 percent after it had registered an increment of 8 percent between 1997 and 1998 and one of 6 percent between 1998 and 1999.

14 See Appendix B.

15 This global performance was more marked in provinces that participated in the Program of Fiscal Adjustment and Financial Restructuring (PFAFR). They achieved a 58 percent decrease in the deficit, with a drop of 4.8 percent of total expenditure. While current expenditure remained stable, capital expenditure showed a major fall. Current revenues had a similar evolution to the total provincial sector, but provincial revenues showed some recovery and royalties registered a bigger increment.

16 Law 24144 (OB: 10/22/92).

17 Between 1995 and 1998 fourteen provincial banks were privatized. Also, two municipal banks and the Mendoza Bank of Social Security benefited from the assistance from the PDTF.

18 For a more extensive explanation of borrowing conditions in the first half of the decade, see Schwartz and Liuksila (1997).

19 In addition, between 1993 and 1994 some provinces obtained important resources from the federal government, in some cases four or five times the budget of one year, as old debt payments, especially royalties. These resources played a significant role in the financing of some provinces in the early 1990s.
20 There were many episodes in which the federal government rescued provinces with problems of financing. For example, direct loans (in National Treasury Bonds) were extended between 1994 and 1995. For a detailed explanation see Nicolini *et al.* (2000).
21 La Rioja observed a special case of bailout. During the 1990s, this province received more than 40 percent of National Treasury Contribution Fund (ATN) discretionary funds managed by the Ministry of the Interior. See Cetrángolo and Jiménez (1997).
22 While some provinces, such as Neuquén and Santa Cruz, had an increase in their debt stock of more than 100 percent, others, such as Santiago del Estero, La Rioja and La Pampa, were able to reduce it. Also each province's trajectory shows a nonlinearity and a wide variety of reasons behind their performance.
23 Some provinces arranged operations with almost a 20 percent interest rate at the end of 1999.
24 In 1999 these provinces had a debt stock–revenue ratio that surpassed 95 percent and showed deficits of around 10 percent of total expenditure. Río Negro registered the highest use of "coparticipation" revenues as collateral (109 percent).
25 For more details about this constitutional debate, see Zapata (1999).
26 See Appendix A.
27 Law 25152 (OB: 21/09/99), modified by Law 25401(OB: 04/01/01).
28 This law includes a commitment to publish a detailed long-term budget and ensure transparency of fiscal information. For more details, see Appendix C.
29 Law 25235 (OB: 07/01/00). See Appendix B.
30 Federal Agreement for Growth and Fiscal Discipline. Law 25400 (OB: 10/01/01). See Appendix E.
31 Resolution 1075 (Ministry of Economy) establishes that provinces are subject to supervision, coordination, and authorization from the Ministry of Economy in every credit negotiation that includes payments in foreign currency.
32 To be authorized, the provinces need to present specific information: objective of the credit, amount of the credit, interest rate, provincial debt stock, collateral, list of provincial personnel, debt authorization from provincial congress, and provincial attorney.
33 Another modality of debt arrangement consists of using "coparticipation" transfers as collateral, but without the automatic repayment mechanism. In this case, the national bank should deduct resources only if a commercial bank demands payment.
34 Sanguinetti and Zentner (1999) showed that, in the Argentine case, there is no relationship between credit cost to assume for provinces and fiscal variables.
35 Resolution 1075 was approved in 1993.
36 See Appendix D.
37 Substantially higher than the 8 percent ratio recommended by the Basle Committee.
38 Effective from 30/6/2000.
39 The previous regulation (Communication 2253) established that to determine minimum capital requirements, credit to provinces that used "coparticipation" as collateral was set at 0 percent.
40 Extract from Kopits *et al.* (2000).
41 This variable interest rate was determined by the average fixed-term rate plus 525 basic points. In May 2000, this meant an interest rate of 12.01 percent, significantly lower than the interest rate these provinces had access to.

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12 Brazil

An evolving federation

José Roberto R. Afonso[1] *and Luiz de Mello*[2]

Brazil is a highly decentralized federation. The twenty-seven states (including the Federal District) and over 5,500 municipalities together account for more than one-third of total government spending and revenue collection. The states and municipalities combined also account for almost 40 percent of the public sector's net debt stock. Revenue mobilization capacity is concentrated in the more prosperous states and municipalities of the South and Southeast, and some equalization of expenditure capacity has been pursued through mandated revenue sharing. Political and administrative decentralization are extensive. Each subnational jurisdiction has its own directly-elected legislature and executive branches, as well as an independent judiciary. The federal government has limited control over subnational tax administration; budget formulation, execution, and oversight; and wage and investment policies.

Brazilian federalism had oscillated between decentralization and centralization, reflecting to a large extent the political forces at play throughout the country's recent history.[3] The 1988 Constitution is considered a benchmark in Brazilian federalism; it deepened the process of decentralization, rather than mere deconcentration, of revenue mobilization and expenditure functions. Over time greater autonomy was granted to the states and municipalities in debt and expenditure management and control. Reflecting the return to democracy, and the ensuing strengthening of regional political forces, important tax bases were devolved to subnational governments, and the country's revenue-sharing system was reformed.

A detailed analysis of the recent developments in Brazilian federalism is overdue. Most of the recent literature on Brazilian federalism focuses on the impact on macroeconomic governance of decentralization following the promulgation of the 1988 Constitution.[4] This is because, in the absence of strict budgetary oversight and fiscal discipline at the subnational level, the implementation of decentralization in the late 1980s and early 1990s was not conducive to macroeconomic stability.

The paper will shed some light on a few aspects of Brazilian federalism that have been overlooked in recent literature. First, the need to improve the quality and efficiency of government spending has placed municipal governments at the forefront of service delivery, particularly in the social area. Second, recognition of capacity bottlenecks has motivated a number of government-sponsored programs to strengthen tax administration and expenditure management and control at the subnational level. Third, institutional developments have ensured that decentralization is compatible with, and supportive of, the implementation of recently achieved fiscal adjustment and macroeconomic stability, as well as improving governance. The Fiscal Responsibility Law is emblematic of these developments.

An overview of Brazilian federalism

The stylized facts

Subnational spending in Brazil is high by international standards. The share of subnational government spending in total government expenditures in Brazil is comparable with the OECD average and that of other large, decentralized federations, such as the United States, Germany, Canada, and Australia, and far exceed those of most Latin American countries (Table 12.1). Other decentralization indicators, such as tax autonomy ratios, are also in line with those of other decentralized federations. Collection of nontax revenues, such as royalties, user charges, and fees, is limited in Brazil. This suggests *prima facie* that there is some scope for strengthening mobilization of these revenues at the subnational level.[5]

The 1988 Constitution introduced important changes in revenue assignments. Federal excises on fuel, electricity, telecommunications, and transport were eliminated. The states were assigned a broad-base, high-yield value-added tax (ICMS), which they also administer, with autonomy to set their VAT rate and tax expenditures, particularly tax deferrals and incentives. At the same time, the new Constitution limited the base of the federal VAT to industrial goods and increased the share of federal revenues (income tax and the federal VAT) to be transferred to the states and municipalities. To compensate for at least some of these revenue losses at the federal level, the new Constitution widened the base of social contributions, and increased the tax burden on payroll and earnings, and subsequently on financial transactions. These revenues are not shared with the subnational governments.[6] Finally, the municipalities were granted a tax on services (e.g. intermunicipal transport) and property, in addition to a wide range of nontax instruments (user charges, licenses, among others).

Decentralization has been characterized by a mismatch in the assignment of revenue and expenditure functions at the subnational level. In the 1988 Constitution, subnational expenditure functions are not clearly and systematically defined, including health care and education, social security and welfare, agriculture and food distribution, sanitation and housing, policing, public transport, and natural resources and the environment. This leads to a duplication of spending assignments across different levels of government. More importantly, because of significant disparities in institutional capacity at the subnational level, even in cases where expenditure mandates are clearly defined, the states, and sometimes the federal government, did not devolve the relevant expenditure functions to lower tiers of governments for fear of disruption in service delivery.

Constitutional provisions on revenue sharing favor subnational governments to the detriment of the federal government, without a clear decentralization of expenditure functions to lower levels of government. The federal government has little jurisdictional power over expenditure management and control at the subnational level. These institutional rigidities also contributed to delaying subnational fiscal adjustment. Moreover, federal government efforts to increase revenues also lead to an increase in total subnational revenues, via revenue sharing.

Expenditure functions and revenue assignment

The share of subnational spending in total government outlays has increased over time since the promulgation of the 1988 Constitution (Table 12.2), due mainly to the rise in

Table 12.1 Brazil: fiscal decentralization indicators, 1972–98 (period averages in percent)

	Tax autonomy[a]		*Nontax autonomy*[b]		*Vertical imbalances*[c]		*Government size*[d]		*Expenditure share*[e]		*Number of countries*
	Avg.	*St. dev.*	*Avg.*	*St. dev.*	*Avg.*	*St. dev.*	*Avg.*	*St. dev.*	*Avg.*	*St. dev.*	
Brazil	54.6	6.3	13.0	3.9	31.8	2.9	12.4	3.4	34.3	3.6	1
Latin America	46.1	11.8	22.1	10.5	25.5	10.6	2.5	1.0	12.2	3.2	17
OECD	40.8	7.5	16.7	2.9	39.1	5.9	13.3	1.5	31.6	2.3	27
Large federation[f]	52.1	3.3	16.1	2.6	31.3	3.2	17.5	1.7	47.4	2.4	6
World	46.6	9.1	19.3	5.6	33.5	8.3	7.0	1.1	20.9	3.0	99

Source: Government Finance Statistics.

Notes

Defined as the share of:

a own tax revenues in total subnational government revenues.
b nontax revenues in total subnational government revenues.
c transfers and grants from the central government in total subnational government revenues.
d subnational government spending in GDP.
e subnational government spending in total government spending.

f Comprises Australia, Canada, Germany, India, Russian Federation, and United States.

Table 12.2 Public nonfinancial spending by jurisdiction, 1991–98[a]

	Federal			*State*			*Municipal*		
	1991	*1998*	*Change*	*1991*	*1998*	*Change*	*1991*	*1998*	*Change*
In percent of GDP									
Consumption	2.1	1.7	−0.4	1.5	2.3	0.8	1.4	2.1	0.6
Payroll	2.6	2.9	0.3	4.2	4.1	0.0	1.8	2.4	0.6
Investment[b]	0.8	0.5	−0.3	1.1	0.6	−0.5	0.9	1.1	0.2
Social security and assistance[c]	7.0	11.5	4.6	1.3	2.4	1.1	0.6	0.4	−0.2
Total	16.5	25.2	8.7	9.2	12.2	3.0	5.3	5.8	0.5
In percent of total nonfinancial spending[a]									
Consumption	41.8	28.3	−13.5	29.7	37.4	7.7	28.5	34.3	5.8
Payroll	30.7	30.7	0.0	48.6	43.7	−4.8	20.7	25.6	4.8
Investment[b]	27.7	22.5	−5.2	39.3	27.8	−11.6	32.9	49.7	16.8
Social security and assistance[c]	78.3	80.1	1.9	14.8	16.9	2.1	6.9	3.0	−3.9
Total	53.2	58.4	5.1	29.6	28.3	−1.3	17.2	13.4	−3.8

Sources: IBGE (*Regionalização das Transações do Setor Público 1991–98* and *Contas Nacionais do Brasil 1991–98*).

Notes

a Nonfinancial spending excludes debt service and amortization.

b For 1998, available from IBGE (*Contas Nacionais do Brasil*).

c Includes outlays on pensioners and retirees, family support, other INSS benefits, and withdrawals from FGTS and PIS/PASEP.

subnational outlays on payroll, public consumption, and investment. The federal government's share in total nonfinancial spending is only higher than that of the subnational governments in social security outlays. Subnational governments thus play a key role in service delivery.

The municipalities were the main beneficiaries of the re-assignment of tax bases after 1988 and increases in revenue-sharing transfers (Table 12.3).[7] The states and municipalities together collect nearly 32 percent of total tax revenues. More importantly, municipal revenue collection, excluding revenue sharing, now exceeds the mandated federal transfers to the municipal governments allocated to the Municipal Participation Fund (FPM). Nevertheless, revenue mobilization capacity is unequal across municipalities and concentrated in large municipalities and state capitals.[8]

The state transfers to the municipalities in their jurisdictions exceed the revenue-sharing transfers from the federal government. The relative share of the states in total government revenues has fallen since 1988, reflecting lower revenue mobilization than at the federal and municipal levels. This is due, at least in part, to the poor performance of the state VAT, which was adversely affected by the deceleration in economic activity in recent years, and because of tax competition among the states. Total revenue collection (excluding revenue-sharing transfers) amounts to approximately 36 percent of state GDP in the most prosperous states, against less than 27 percent of state GDP in the less prosperous states of the North, Northeast and Center-West with lower ability to collect taxes. More recently, the earmarking of revenues for primary education has benefited the municipal governments. By increasing the coverage of their primary education system, the municipalities became eligible for funds that had hitherto been transferred to the states.

Table 12.3 Tax revenues by jurisdiction, 1960–99[a]

	Gross tax revenues[b]				*Net tax revenues*[c]			
	1960	*1980*	*1988*	*1999 (prelim.)*	*1960*	*1980*	*1988*	*1999 (prelim.)*
In percent of GDP								
Total	17.4	24.6	22.5	31.8	17.4	24.6	22.4	31.8
Federal government	11.1	18.5	15.8	21.7	10.4	17	14	18.2
States	5.5	5.4	6.0	8.4	5.9	5.5	6.0	8.1
Municipalities	0.8	0.7	0.7	1.7	1.1	2.1	2.4	5.5
In percent of total revenues								
Total	100	100	100	100	100	100	100	100
Federal government	64	75.1	70.6	68.2	59.4	69.2	62.3	57.2
States	31.2	22	26.5	26.3	34	22.2	26.9	25.4
Municipalities	4.8	2.9	2.9	5.5	6.6	8.6	10.8	17.4

Sources: IBGE, FGV, STN (*Balanço Geral da União, Finanças do Brasil*), SFR, Ministry of Social Security and Assistance, CEF, CONFAZ, and ABRASF.

Notes
a For 1960, available from IBGE. Revisions added. For 1980–88, available from IBGE. For 1999, estimated by SF/BNDES.
b Refers to tax revenues collected by each jurisdiction.
c Excludes constitutional revenue-sharing transfers.

Table 12.4 Revenue-sharing transfers, 1991–98[a]

	Total		*Federal*		*State*		*Municipal*	
	1991	*1998*	*1991*	*1998*	*1991*	*1998*	*1991*	*1998*
In percent of GDP								
To other jurisdictions	5.1	6.5	3.3	4.3	1.8	2.1	0.0	0.0
From other jurisdictions	5.1	6.5	0.0	0.0	2.2	2.4	3.0	4.1
In percent of total								
To other jurisdictions	100.0	100.0	64.0	66.8	36.2	32.2	0.0	0.6
From other jurisdictions	100.0	100.0	0.0	0.0	42.2	36.9	57.8	63.1
In percent of total gross revenues[b]								
To other jurisdictions	20.9	22.1	20.1	21.3	25.6	27.8	0.1	2.5
From other jurisdictions	20.9	22.1	1.1	1.1	29.9	31.7	298.3	277.8
In percent of total net revenues[c]								
To other jurisdictions	20.9	22.1	25.2	27.7	22.7	26.4	0.0	0.6
From other jurisdictions	20.9	22.1	1.4	1.4	26.6	30.1	87.6	70.8

Source: IBGE (Regionalização das Transações do Setor Público 1991–98).

Notes
a Refers to constitutional revenue-sharing transfers plus other current transfers.
b Refers to tax revenues collected by each jurisdiction and excludes debt revenues, civil servants' social security contributions, certain nontax revenues, and civil servants' income tax.
c Excludes revenue-sharing transfers.

The share in GDP of revenue-sharing transfers rose by nearly 1.5 percent in the 1990s to 6.5 percent of GDP (Table 12.4). The federal government transfers approximately 4.0 percent of GDP to the states and municipalities, and the states transfer approximately 2 percent of GDP to the municipalities in their jurisdictions. Revenue sharing is the main source of revenues at the municipal level and intergovernmental transfers are instrumental in financing public spending in poorer states, where revenue mobilization is low.

Revenue-sharing arrangements are rigid and equalization of expenditure capacity among the states has not been pursued vigorously. Three basic characteristics can be singled out in Brazilian revenue-sharing arrangements. First, most transfers are of the constitutionally-mandated, revenue-sharing type. This reduces the scope for nontransparent, politically-motivated discretionary grants.[9] Second, the 1988 Constitution deepened vertical imbalances in intergovernmental fiscal relations by requiring the federal government to share with the states and municipalities the revenues of two of its main tax revenues: the income tax and the federal VAT.[10] Because of excessive earmarking of sharable revenues, the federal government has increased emphasis on mobilizing revenues that are not shared with the states and municipalities, such as payroll and turnover taxes, which encourages the development of informal labor markets and affects competitiveness adversely. Third, the 1988 Constitution tried to correct horizontal imbalances through equalization transfers. As a result of an agreement among the states in 1989, 85 percent of the State Participation Fund (FPE) is transferred to the poorer states of the North, Northeast and Center-West, with the more prosperous states in the South and Southeast relying to a much lesser extent on revenue sharing.[11]

The emphasis on "municipalization"

Background

Local governments are becoming more important in service delivery relative to the states. It has been argued that the fiscal decentralization provisions in the 1988 Constitution paved the way for a more comprehensive process of *municipalization* of revenue mobilization and service delivery.

The main challenges currently facing municipal governments are to: (1) avoid the rise in payroll expenditures relative to outlays on more productive programs, particularly in the social area and urban infrastructure; (2) improve the efficiency of public spending by, for instance, reducing outlays on the legislature and public administration; and (3) boost local revenue mobilization, particularly in light of growing demands for social security spending at the local level.[12]

The increased social spending at the municipal level has been facilitated by federal transfers, but as local governments strengthen their role in service delivery, it is expected that federal outlays on those programs will be reduced in the years to come.

Incentives for local revenue mobilization

Municipal governments are said to have weak incentives to fully exploit their tax bases, given the magnitude of mandated transfers from the federal and state governments. The absence of a tax effort parameter in the revenue-sharing formulas has not encouraged local revenue mobilization in Brazil. Also, generous revenue-sharing provisions have been an important factor leading to a rapid increase in the number of municipalities in the early 1990s. Between 1984 and 1997, 1,405 municipalities were created in Brazil (Serra and Afonso, 1999); thereby increasing subnational outlays on personnel and administration, in addition to transfers to their legislatures, at the expense of more productive spending on, for instance, social programs and urban infrastructure.[13] Lack of specific criteria for the creation of municipalities was an additional contributing factor to the proliferation of municipalities in the early 1990s.[14]

To boost local revenue mobilization, recent reforms have focused on the modernization of municipal tax administration. In the absence of more detailed information on municipal finances and better national accounts data, it is difficult to estimate the compliance gap of Brazilian municipal revenues.[15] The federal government sponsored a number of programs in this area, but technical assistance was discontinued during most of the 1980s and early 1990s. It would have been crucial to strengthen these programs at the time of implementation of the decentralization provisions of the 1988 Constitution, which, as discussed above, devolved important tax bases and tax administration functions to subnational governments. More recently, the federal government has provided financial, rather than technical, assistance to state and municipal governments to improve their tax administration capabilities. Other programs are now available reflecting the wider diversity in local demands and capacity building needs (Box 12.1).

Despite regional discrepancies in tax bases, local demands and needs are best met through local revenue mobilization, rather than grants and transfers from higher levels of government, so as to strengthen the link between costs and benefits of local service delivery. Moreover, local revenue mobilization is also associated with social capital development at the local level and stronger accountability in local government.[16]

Better municipal tax administration will also reduce the regional concentration of revenue collection.[17] Improvements in revenue performance in recent years have been concentrated in large municipalities, particularly state capitals, and those localities in more prosperous states. Although large municipalities tend to be less dependent on grants and transfers from higher levels of government, they also face a growing demand for local goods and services. Expenditure needs are high in large metropolitan areas, with high costs of provision and spillovers of benefits to residents in neighboring jurisdictions.[18] Rather than aiming at a rapid increase in municipal revenues in the short term, improvements in tax administration should focus on longer term, permanent, self-sustained increases in revenue mobilization capacity.

Progress has been remarkable in the implementation of information technology systems at the local level of government. It is interesting to note that the more prosperous jurisdictions are not necessarily the ones that use the best systems and have the highest standards in tax administration and expenditure management and control.[19] A variety of e-government systems have also been implemented not only for the dissemination of information and public relations initiatives, but also for service delivery and quality control.[20] Tax administration has benefited from the dissemination of modern information systems to municipal governments. Various states are also processing VAT tax returns through the internet, including the on-line provision of services to large taxpayers. More recently, the federal government and the state of São Paulo have not only started to register suppliers electronically, but have also implemented procurement systems through the internet via electronic auctions.[21]

Social spending and policies

Local governments have been enjoying greater autonomy in service delivery, particularly in the provision of social services, such as health care and education.

Box 12.1 Technical assistance programs: a brief survey

CIATA (*Convênio de Incentivos ao Aperfeiçoamento Técnico-Administrativo das Pequenas Municipalidades*) was one of the first technical assistance programs implemented by the federal government in the area of tax administration. Small municipalities were targeted. The program was implemented in the period 1973–81 and benefited 769 municipalities (one-fifth of the Brazilian municipalities at the time). In the case of local property taxation, for instance, over 3.5 million properties were cadastred with an unprecedented impact on local revenue collection.[33] More recently, attention has been focused at the Ministry of Finance on capacity building at the state, rather than municipal level. A core program – PNAFE (*Programa Nacional de Apoio à Administração Fiscal para os Estados Brasileiros*), implemented in December 1996, was motivated by the need to improve local revenue mobilization in the context of the state debt restructuring process. Given the success of PNAFE, a program (PNAFEM, *Programa de Modernização das Administrações Tributárias Municipais*) was launched in 2001 to foster capacity building at the municipal level.

Past experience suggests that the most important obstacles to improving revenue mobilization at the municipal level are (1) the maintenance and upgrading of the cadastre of properties for the collection of local property taxes and the selection of appropriate property valuation mechanisms, and (2) weak municipal tax administration capacity, particularly in auditing. Inadequate municipal tax codes have also been singled out as an important institutional weakness impeding improvements in local revenue mobilization.

In line with the programs implemented by the Ministry of Finance, the National Development Bank (BNDES) launched in 1996 a program to strengthen tax administration at the municipal level – PMAT (*Programa de Modernização das Administrações Tributáriais Locais e de seus Setores Sociais Básicos*). Financial support is provided through PMAT for upgrading information technology equipment, software, and infrastructure; human capital development and training; and contracting-out of technical assistance, among others. Initially, the programs focused on tax administration activities (institutional capacity building, systems and legislation; filing, payment, audit and enforcement; and taxpayer services). At the request of municipal governments, the services were extended to expenditure management and control (budget formulation, accounting, and auditing), as well as public administration in the areas of education, health care, and social assistance, among others. Currently, PMAT's portfolio is in the neighborhood of US$ 200 million, benefiting 92 municipalities, home to 24 percent of the country's population and 55 percent of total municipal tax revenues. The program is under way in 26 municipalities with a loan portfolio of US$ 75 million. In small municipalities not eligible for assistance under these programs, capacity building has been pursued through the distribution of manuals (FGV/EAESP, 2000) with basic legislation and provisions for a local tax code. The increase in collection in the period covered by the program is on average 60 percent. The program is also cost effective in that the increase in revenues during the program exceeds the total cost of the program in most beneficiary municipalities. Efforts have also been made by BNDES to disseminate successful experiences and best practices, especially through the internet (see internet site *www.federativo.bndes.gov.br*).

Social spending

Subnational spending on social programs is characterized by extensive earmarking of revenues. The 1988 Constitution requires subnational jurisdictions and the federal government to earmark, respectively, 25 and 18 percent of their revenues to finance outlays on education. However, these targets were not always met at the subnational level due to financing shortfalls, particularly in poorer states and municipalities. In 1998, a fund (FUNDEF) was created to finance subnational spending on education. Key objectives of the fund are to reduce shortfalls in financing at the subnational level and to increase the coverage of the municipal, rather than state, primary education system. States and municipalities are required to earmark 15 percent of their revenues to finance outlays on primary education.

Earmarking has also been used extensively to fund health care. The 1988 Constitution sought to ensure universal access to publicly-provided services by combining centralized financing with decentralized service delivery.[22] The federal government reimburses private health care providers and subnational governments, particularly the municipalities, for the provision of health care and the maintenance of public hospitals and clinics (Table 12.5). As in the case of education, the municipalities were not always able, or willing, to perform the functions assigned to them by the Constitution.[23] To deal with this problem, a new federal levy on bank debits (CPMF) was created with revenues earmarked for financing health care spending, and the states and municipalities are now required to earmark 12 and 15 percent, respectively, of their revenues (net of intergovernmental transfers) to finance outlays on health care.

The equalization of expenditure capacity across and within the states has also been pursued through FUNDEF. A floor was introduced for municipal outlays per student and the federal government is required to top up spending in case the subnational jurisdictions are not able to finance the minimum spending requirement. Also, to reduce pay inequality across the states and within the education sector, 60 percent of the resources spent on primary education are earmarked for wages and salaries, leaving 40 percent to finance capital outlays and operations and maintenance. These measures seek to protect the quality of education services through teachers' compensation. However, perverse incentives have been created, as the emphasis on capital spending in the education sector has led to some municipal pork-barreling.

In health care, federal transfers are based on the costs of the services provided at the municipal level, rather than needs, and past trends in budget allocations. As a result, the health care system does not ensure equalization of spending across municipal jurisdictions. More prosperous municipalities – where a wider range of more sophisticated, costly health care services is provided – receive more transfers on a per capita basis than poorer municipalities.[24] Better equalization has nevertheless been pursued in recent years through increases in budget allocations for poorer states, where coverage has been extended. Funding for basic and preventive health care programs has also increased, and minimum per capita transfers have been introduced for a number of preventive care programs, including prenatal and dental care, and immunization.

These reforms have yielded encouraging results. Since 1998, the coverage of the municipal primary education system has increased significantly, pay differentials have been reduced across and within the states, and the municipalities have become the main providers of primary education, even in the states where the coverage of the municipal primary education system was limited (Table 12.6). In the health care sector, reforms in

Table 12.5 Consolidated spending on health care and education, 1995–97/99 (in units as indicated)

	1995				*Latest*[a]			
	Federal government	*States*	*Municipalities*	*Total*	*Federal government*	*States*	*Municipalities*	*Total*
In percent of GDP								
Total (net of intergovernment transfers)	4.1	2.9	2.5	9.4	3.5	2.9	2.3	8.8
Total	2.6	3.3	3.5	9.4	2.3	3.2	3.3	8.8
Education, culture, and science	1.8	2.3	1.4	5.5	1.4	2.3	1.4	5.1
Health and nutrition[b]	0.9	0.9	2.1	3.9	0.8	0.9	1.9	3.7
In percent of total government spending								
Total (net of intergovernment transfers)	43.3	30.5	26.2	100.0	40.4	33.0	26.7	100.0
Total	27.9	34.8	37.4	100.0	25.9	36.5	37.6	100.0
Education, culture, and science	32.0	42.2	25.8	100.0	28.0	44.8	27.1	100.0
Health and nutrition[b]	22.1	24.3	53.6	100.0	23.0	24.9	52.0	100.0

Sources: BGU, SIAFI, SIAFEM, *Balanços dos Estados e Municípios*, and Ministry of Health.

Notes

a Refers to 1997 for education and 1999 for health care.

b Includes subnational spending in addition to revenue-sharing transfers.

Table 12.6 Brazil: school enrollment indicators by government level, 1996–99

	1999					*1996*				
	Public schools			*Private schools*	*Total*	*Public schools*			*Private schools*	*Total*
	Federal	*State*	*Municipal*			*Federal*	*State*	*Municipal*		
Total enrollment (in thousands)	122	23,111	19,245	5,557	48,034	149	23,365	13,722	5,904	43,141
Pre-schools	0	380	2,799	1,055	4,234	2	759	2,489	1,019	4,270
Primary education	0	16,589	16,164	3,277	36,031	34	18,469	10,921	3,708	33,131
Secondary education	122	6,142	281	1,224	7,769	113	4,137	312	1,177	5,739
In percent of total enrollment										
Total enrollment (in thousands)	0.3	48.1	40.1	11.6	100.0	0.3	54.2	31.8	13.7	100.0
Pre-schools	0.0	9.0	66.1	24.9	100.0	0.1	17.8	58.3	23.9	100.0
Primary education	0.0	46.0	44.9	9.1	100.0	0.1	55.7	33.0	11.2	100.0
Secondary education	1.6	79.1	3.6	15.8	100.0	2.0	72.1	5.4	20.5	100.0

Source: IBGE (*Base de Informaçoes Municipais*).

funding arrangements have been implemented, and their impact on service delivery remains to be assessed more carefully. Preliminary evidence shows that the introduction of explicit targets for coverage, as well as a progressive funding schedule for increased coverage in certain programs, have increased access to health services in poorer regions. A better match between the supply and demand for health services has also been achieved through greater involvement of civil society in program design and implementation.

Subnational governments, particularly the municipalities, have enjoyed greater autonomy in program design and implementation. This is unprecedented in Brazil, given that policymaking had been concentrated at the federal level, often with little concern over differences in regional preferences and needs. In education, concomitantly with the expansion of the municipal primary education system, more policymaking autonomy has been exercised at the local level with increased use of demand-driven, result-oriented, participatory administration in public schools, particularly after 1995. These entities are involved in the school's administrative, financial, and educational decision-making process. Schools are enjoying more autonomy in the organization of curricula and pedagogical projects (subject to minimum standards set by the federal government), personnel management, teaching planning and methods, and procurement.

Municipal governments are often too small to reap the benefits of economies of scale in health care provision and cannot finance more specialized curative care services. To overcome these difficulties, intermunicipal administrative ventures have been created within the national health care system. These ventures also perform functions such as personnel management, including the hiring of new staff, licensing private health care providers, and procurement. Early experience with these joint ventures dates back to the late 1980s. More recently, efforts have been made to strengthen the institutional framework within which these ventures are set up.[25] In addition to dealing with economies of scale in service delivery, intermunicipal ventures are also important given the regional externalities associated with the provision of health care.

Human development

Most existing social programs in Brazil are not designed to deal with regional disparities in human and social development indicators. More prosperous states often oppose increases in federal spending in poorer states for fear of losing federal funds. Regional development programs are often designed to benefit regions that are considered poor relative to the state where they are located, rather than in relation to a national benchmark. As a result, poorer regions in richer states often benefit from regional development programs although they may be more prosperous than richer regions in poorer states. Past experiences with reducing regional inequalities in social and economic development have proven unsuccessful.

Recent initiatives have favored joint ventures between the federal government and the municipalities, consisting of focusing social policies and public outlays on existing social programs in poorer states and municipalities.[26] The priority programs are in the areas of preventive health care, primary and secondary education, and income support. These initiatives also focus on output-oriented service delivery. Targets have been set for each program to facilitate monitoring and evaluation. These targets are defined in terms of output indicators, such as coverage of the sanitation and water networks, school enrollment rates, and number of beneficiaries of income support programs.

Multi-level fiscal adjustment

Macroeconomic stabilization in the mid-1990s, with high real interest rates and the imposition of hard budget constraints at the subnational level, in the context of state debt restructuring arrangements with the federal government, exposed the fragility of subnational finances. In the absence of arm's length relations between state governments and their banks in the high-inflation period prior to 1994, many state governments financed their deficits by borrowing from state banks, without regard for normal commercial standards of creditworthiness, and in anticipation of federal bail-outs. The states and municipalities recorded an operational surplus of 0.6 percent of GDP in 1991, when decentralization was fully implemented, followed by persistently rising deficits until 1997, when their fiscal position deteriorated sharply (Table 12.7). The subnational domestic debt almost tripled as a share of GDP in the 1990s. Recently, some key legislation was passed to impose hard budget constraints and restore budgetary discipline at lower levels of government, as well as to strengthen federal control over subnational borrowing and indebtedness.

Subnational debt restructuring has been as a catalyst for subnational fiscal adjustment, involving the consolidation of foreign and domestic liabilities of the state and major municipal governments. The federal government assumed these liabilities through successive debt restructuring agreements since the late 1980s,[27] and the National Treasury has therefore become the main creditor of subnational governments. These agreements are legally binding and provide for a fixed repayment schedule based on the jurisdiction's revenue mobilization capacity. Subsidized interest rates have imposed costs on the federal budget. Nevertheless, the agreements also involved federal intervention and subsequent liquidation and/or privatization of most state government banks.[28] Also, new state and municipal debt issuance has been limited through restrictive clauses in the debt restructuring contracts. Continued enforcement of these contracts and limited access to financing have required considerable fiscal adjustment at the state level to generate the needed primary surpluses to service their outstanding debt obligations. A broad subnational privatization program, particularly in the sectors of transportation and energy, was also strengthened in support of the accompanying fiscal adjustment effort.

New institutions: the Fiscal Responsibility Law

The enactment of the Fiscal Responsibility Law has been instrumental in imposing hard budget constraints at the subnational level.[29] It has been widely accepted that state debt restructuring with the federal government could be interpreted as a bail-out operation unless accompanied by institutional changes aimed at imposing hard budget constraints at all levels of government. These regulations include provisions for borrowing, indebtedness, tax expenditures (e.g. tax exemptions, deferrals, etc.), and governance.[30] The law forbids further restructuring of subnational debts contracted after May 2000. The key provisions of the legislation are:

Limits on current spending. Outlays on payroll (including social security benefits, pensions, and payments to subcontractors) cannot exceed 50 percent of net revenues for the federal government (60 percent for the subnational governments). Separate sub-ceilings apply to personnel outlays in the executive branch of government, the legislature, and the judiciary.

Ceilings on borrowing. These are also provided for and the actual ratios have been set by the Senate for each level of government in a separate piece of legislation. Accordingly, total

Table 12.7 Subnational budget indicators, 1990–99 (in percent of GDP)

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999 (prelim.)*
Net debt	38.8	39.9	38.2	32.8	28.5	29.9	31.1	35.4	42.2	53.8
Of which: Subnational governments	7.1	7.5	9.5	9.3	9.5	10.4	10.8	15.1	16.3	20.4
Consolidated public sector borrowing requirements[a]										
Nominal	29.6	28.3	47.3	65.0	26.5	7.1	5.9	6.1	7.9	10.0
Operational	−1.3	0.5	2.0	1.4	−2.0	4.9	3.8	4.3	7.4	3.4
Primary	−4.6	−2.9	−1.6	−2.3	−5.1	−0.3	0.1	1.0	−0.01	−3.2
Subnational public sector borrowing requirements[a]										
Nominal	—	10.3	17.5	27.2	11.9	3.5	2.7	3.0	2.0	3.2
Operational	0.4	−0.6	0.7	0.4	0.4	2.3	1.8	2.3	1.8	0.5
Primary	—	−1.5	−0.1	−0.6	−0.8	0.2	0.5	0.7	0.2	−0.2
In percent of net revenues[b]										
Net debt	134.8	158.1	152.7	127.2	95.8	101.7	107.5	121.8	143.3	168.9
Of which: Subnational governments	409.0	432.4	451.1	406.0	297.7	298.8	314.2	363.6	439.2	530.8
Consolidated public sector borrowing requirements										
Nominal	102.8	112.1	189.0	252.1	89.0	24.3	20.3	21.0	26.9	31.4
Operational	−4.5	2.0	8.0	5.4	−6.7	16.7	13.0	14.8	25.1	10.6
Primary	−16.0	−11.5	−6.4	−8.8	−17.2	−0.9	0.3	3.5	0.0	−10.2
Subnational public sector borrowing requirements										
Nominal	—	111.6	206.7	336.7	124.3	35.1	27.3	31.1	21.0	31.4
Operational	4.2	−6.5	8.3	5.0	4.2	23.3	18.3	23.2	18.5	4.8
Primary	—	−16.3	−1.2	−7.4	−8.4	1.8	5.5	7.6	2.0	−2.2
Memorandum items:										
Real percentage change in GDP (IBGE)	—	1.03	−0.54	4.92	5.85	4.22	2.66	3.60	−0.12	0.8
Inflation (IGP-DI, period average)	1,476.6	480.2	1,157.9	2,708.6	1,093.8	14.8	9.3	7.5	1.7	20.0

Sources: Central Bank, IBGE, FGV, STN (*Balanço Geral da União, Finanças do Brasil*), SFR, Ministry of Social Assistance, CEF, and CONFAZ e ABRASF.

Notes
a Includes constitutional intergovernmental transfers.
b SF/BNDES calculations.

borrowing cannot exceed 16 percent of net current revenues, and total outlays in debt service, including interest and amortization spending, cannot exceed 11.5 percent of net current revenues for the states and municipalities. In addition, to avoid the rise in subnational spending in line with the electoral cycle, borrowing is banned in the 8-month period before the end of the incumbent's term in office. The ban applies to all subnational jurisdictions, including the Federal District.

Improved governance. The Law requires three-year budget targets for revenues, expenditures, and indebtedness. The Law does not set these limits but governs the procedures for monitoring compliance and sanctions on the noncompliant jurisdiction (such as a ban on voluntary transfers) and the incumbent (fines, loss of office, ban on re-election, and legal prosecution). In addition, civil society participation is required in the budgetmaking process at all levels of government.

Additional provisions. These include ceilings for borrowing in relation to the total capital expenditures approved by the budget law ("golden rule"). The law, subject to complementary legislation, requires ceilings on the outstanding debt stock in relation to revenues. The debt ceilings have been set at twice the net current revenues for the states and 1, 2 times the net amount revenues for the municipalities. Limits on loan guarantees by subnational governments have also been set.

A key policy question is whether Brazil has achieved a cooperative solution to its federalism problems.[31] The recent changes in the legislation have laid the foundations for a rules-based system of decentralized federalism that leaves little room for discretionary policymaking at the subnational level. These changes have been motivated by the recognition that market control over subnational finances should be replaced, or strengthened, by fiscal rules as well as appropriate legal constraints and sanctions for noncompliance at all levels of government. More importantly, top–down coordination in intergovernmental fiscal relations has been preferred to more horizontal, collegial forms of multi-level fiscal policymaking.

Tax reform

With the purpose of modernizing the tax system, a number of proposals are being discussed. The main objectives of tax reform are to reduce tax evasion and to strengthen local revenue mobilization, particularly at the municipal level, within the broad parameters of the current tax legislation. As discussed above, emphasis on local revenue mobilization reflects the efforts to reduce dependency of lower levels of government on grants and transfers from higher levels of government, and to foster transparency and accountability of public finances, with greater social control and civil society participation in service delivery.

The need for tax reform is stronger at the state level. Emphasis on the municipalities as the key agents of service delivery and the fall in the share of state government spending and revenue mobilization have highlighted the need for reform in the Brazilian tax system. Collection of the state VAT – the main source of revenues at the state level – at the origin, rather than destination, has penalized the less prosperous states that are net importers of taxable goods and services. The states that are net exporters of electricity and petroleum products have been particularly penalized. More importantly, tax competition among the states to attract investment, particularly FDI, has eroded their tax bases through the proliferation of tax incentives. The federal government has submitted a tax reform package to Congress calling for, among other things, a level playing field for state VAT taxation, thus reducing the scope for predatory tax competition among the states, and for replacing the existent cascading social contributions levied by the federal government by federal VAT-type tax.[32]

Conclusions and future reform

The innovation of on-going decentralization in Brazil is the emphasis on the municipalities, rather than the states, as key agents of service delivery, particularly in the areas of social services and public investment. This is particularly important given that local governments are in principle best able to extract information on local preferences and needs. Municipality-oriented decentralization has been favored in the recent developments in social policies, where emphasis has been placed on poverty reduction and human development through a concerted policy effort at local levels of government. It is widely accepted that accountability has been strengthened in the process. Although recent reforms in funding arrangements for social programs are likely to reduce financing shortfalls at the subnational level, further rigidities in subnational budgets may be at odds with the on-going efforts to grant policymaking autonomy to the states and municipalities.

The states have lagged behind, but are now catching up with, the federal government in fiscal adjustment. Despite the political influence of state governors in Congress, and the regional fragmentation of the Brazilian political system, recent reforms in intergovernmental fiscal relations have affected state government finances adversely. Both the increase in mandated transfers from the states to the municipalities in their jurisdictions and the increased emphasis on the municipalities in the provision of social services have reduced the share of the states in total government spending and revenues. Against this background, most states now spend more on payroll, as a share of their net revenues, than on the provision of social services. This situation is likely to deteriorate in light of the states' growing pension liabilities and, therefore, more ambitious reform of state finances will become imperative. The provision of services funded through revenue sharing with the federal government, such as health care and education, is not likely to be affected. However, the provision of those goods and services that have regional externalities will certainly suffer from the reduction in the states' ability to finance their own expenditures.

Recent reforms have focused on strengthening vertical, as well as horizontal, intergovernmental fiscal relations. A solution to the problem of underprovision of regional public goods could involve closer coordination among the states and municipalities. In the absence of more cooperative federalism, institutional rigidities have worsened. To avoid shortfalls in transfers from the federal government, extensive earmarking has been used to encourage subnational jurisdictions to take on the expenditure functions assigned to them by the 1998 Constitution. At the same time, earmarking of subnational revenues has been used to avoid financing shortfalls at the subnational level, once the expenditure functions have been decentralized. To circumvent these rigidities and to allow for swifter fiscal adjustment at the federal level, more earmarking has been used to withhold a percentage of the federal revenues that are shared with the subnational governments. More importantly, there are few formal channels for this type of horizontal, cooperative federalism, in addition to CONFAZ, which deals primarily with the administration of the state VAT. If Brazil is to adopt a more cooperative system of fiscal federalism, efforts are needed to strengthen horizontal cooperation among the subnational governments and to create the necessary fora for discussions.

Recent legislation has also favored rules-based policymaking. The key provisions in the Fiscal Responsibility Law and complementary legislation preclude, at least in principle, discretion in fiscal policymaking, particularly at the subnational level. The legislation contains the key incentives for fiscal probity at all levels of government, as well as formal sanctions for non-compliance. Important challenges remain. On the one hand, the implementation of the new legislation may prove difficult, given the technical capacity required for the states and municipalities to make the new fiscal rules operational and for the federal government to monitor compliance. On the other hand, the new legal framework may not be conducive to, and supportive of, horizontal coordination in multi-level policymaking. Instead, it may strengthen an already rigid, predominantly vertical system of intergovernmental fiscal relations.

Notes

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2 Economist, Fiscal Affairs Department of the IMF; e-mail: ldemello@imf.org.
3 See Shah (1990, 1994), Serra and Afonso (1991), Ter-Minassian (1997), and de Mello (1999a).
4 For more information, see Afonso (1994, 1996), Lobo and Afonso (1996), Ter-Minassian (1997), Dillinger and Webb (1999), and Kopits *et al.* (2000).
5 See de Mello (1999b, 2000a) for a cross-country analysis of intergovernmental fiscal relations.
6 More recently, the *Fundo de Estabilização Fiscal* was created to withhold a percentage of the federal tax revenues that are shared with the states and municipalities.
7 See Serra and Afonso (1991) for more information on the tax reform of 1988.
8 Only in 6.2 percent of the municipalities that collect their local taxes do own revenues exceed transfers (Afonso *et al.*, 1998).
9 Until the 1980s, discretionary grants were more common and highly correlated with the electoral cycle. See de Mello (1999a), for more information.
10 These resources are allotted to two revenue-sharing funds: the State Participation Fund (FPE) and the Municipal Participation Fund (FPM). The 1988 Constitution mandates that 22.5 percent of the revenues from the income tax and the federal VAT be transferred to the states and that 21.5 percent of the revenues from these federal taxes be transferred to the municipalities. Taking into account all mandated transfers to states and municipalities, 47 percent of income tax revenues and 57 percent of the revenues from the federal VAT are transferred to subnational governments.
11 The 15 percent ceiling on revenue-sharing transfers to the more prosperous states in the South and Southeast replaced the revenue-sharing formula used until 1989 in which revenues were shared in direct proportion to the resident population and the inverse of income per capita.
12 States and municipalities taken together already spend more on pensions and other social security benefits than on health care or housing, urbanization, and sanitation.
13 See also Gomes and MacDowell (1999) for more information on municipal finances in Brazil.
14 Preliminary estimates show that, between 1993 and 1997, 534 new municipalities were included in the sharing formula for FPM resources, leading to a re-distribution of over R$ 600 million in favor of these new jurisdictions (Afonso *et al.*, 1998).
15 According to Araújo and Oliveira (2000), the gap between the potential and effective revenue collection in Brazilian municipalities is in the neighborhood of 20 percent. Closing this gap would

therefore raise the ratio of municipal revenues, excluding intergovernmental transfers, from approximately 1.7 percent of GDP to nearly 2.0 percent of GDP. See also Afonso *et al.* (1999).

16 Municipal governments have also used participative budget formulation processes to encourage accountability in expenditure management. The municipality of Porto Alegre is a case in point, where consultations with residents and subsequently local lawmakers are commonplace in the formulation of public investment budgets. See Souza (2000), for more information. To strengthen accountability and to improve public governance, the federal government has launched a program (*Brasil Transparente*) aimed to encourage civil society control over budget formulation and expenditure management. The internet will be the main vehicle for dissemination of information and civil society control of government actions, including procurement activities and tenders, among others. For more information, see *www.redegoverno.gov.br*. Also, see de Mello (2000b) for more information on the relationship between social capital development and decentralization in a sample of developing and developed countries.

17 A recent study by ABRASF (Brazilian Association of Finance Secretaries of the State Capital Municipalities) shows that, in a sample of the 19 largest municipalities (home to 19 percent of the country's population and 53 percent of total municipal tax revenues), 17 municipalities use bar-coded tax return forms; 15 municipalities use state-of-the-art integrated systems; 12 municipalities collect all taxes through the banking system; 11municipalities provide training and re-training courses for civil servants; and 10 municipalities provide services to taxpayers through the internet.

18 Based on data for the municipalities of São Paulo and Rio de Janeiro, Rezende (1998) shows that, in these metropolitan regions, outlays on urban investment often exceed their own-revenue mobilization and grants and revenue-sharing transfers.

19 See Instituto Polis (2000), for more information on municipal tax administration.

20 For instance, electronic voting was implemented for the municipal elections held in October/November 2000 in all municipalities in the country benefiting 108 million registered voters in both rural and urban areas. Voters and candidates have been registered electronically, and electronic ballots have been used for a speedier counting of votes.

21 See Fernandes (2000) for more information on the use of IT systems in state capitals and state governments. A recent study on tax administration shows that Brazilian states and municipalities offer a wider range of services on-line than in their European and North American counterparts.

22 The national health care system created by 1988 Constitution replaced a system, which provided health insurance only to formal-sector workers and their families. The new system was implemented in the early 1990s to extend publicly-provided health care services to the poorer states of the North, Northeast, and Center-West, where the coverage of the old system was limited, and to informal-sector workers and their families.

23 Shortfalls became commonplace because financing for health care is linked to that of the social security system. Therefore, increased demand for funding in the social security system, as a result primarily of growing pension liabilities, has crowded out financing for health care. This led to uncertainty in the allocation of funds at the federal level, delays in transfers from the federal government to the providers of health care services at the subnational level and in the private sector, and a reduction in the number of private sector providers associated with the public health care system.

24 Input-based funding does not rely on performance targets to encourage efficiency in service delivery and creates incentives that distort spending toward more expensive in-patient care.

25 See Ribeiro and Costa (1999), for more information. According to the Ministry of Health, as of July 1999, there were 143 intermunicipal ventures in Brazil, covering a total of 1,740 municipalities. These intermunicipal ventures have been particularly active in the South and Southeast, with 126 ventures in 1,587 municipalities.

26 A case in point is the *Alvorada* Program, originally named IDH-14 Program given its focus on the 14 states with scores in the UNDP's Human Development Index (HDI) below the national median. The program was subsequently enlarged to benefit poorer regions

within richer states that would not be eligible for assistance under the IDH-14 program. These states have HDI scores above the national median but, nevertheless, contain 81 micro-regions and 389 municipalities with HDI scores below the national median. Another initiative in this area is the on-going *Comunidade Solidária* Program, which focuses on poor municipalities and facilitates joint ventures with the private sector and the federal government in social programs.

27 The subnational government debt is held almost entirely by residents. See Kopits *et al.* (2000), for more information on subnational debt rescheduling.

28 At the end of 1994, the largest state bank in the country (BANESPA, belonging to the government of the State of São Paulo) was taken over by Central Bank management and it is now scheduled to be privatized over the short run. Since 1996, at least four large state banks have been privatized (Rio de Janeiro, Pernambuco, Paraná, and two institutions in Minas Gerais) and another four state banks have been liquidated. At the same time, a federal program (PROES) was created to coordinate financial restructuring in these institutions prior to privatization or liquidation.

29 Brazil's first experience with fiscal responsibility legislation was the *Código de Finanças Públicas* of 1920. The code, comprising over 900 articles, provided the legal framework for multi-level public finances. A precursor of the recently enacted Fiscal Responsibility Law was Senate Resolution No. 78 of July 1, 1998, which re-defined the legal framework for subnational borrowing by, for instance, restricting new borrowing unless the subnational government's ratio of debt to revenues was equal to 1, and it did not have a primary deficit. It also promoted transparency in the relationship between subnational governments and the National Treasury, and banned borrowing before local elections.

30 The Fiscal Responsibility Law is a complementary law approved by absolute majority in Congress. It cannot be amended by the Executive. See Tavares *et al.* (1999), for more information.

31 On reviewing the law and economics literature, Inman and Rubinfeld (1997) refer to cooperative federalism as the situation in which decentralized policies are agreed upon through bargaining. In this case, policies that are unanimously approved by all parties in a central legislative body or through intergovernmental agreements are likely to be Pareto-improving.

32 The joint VAT to be levied by the states and the federal government would be applied on a destination basis. More information on the shared ICMS projects currently under discussion in Brazil and Argentina (also known as the "little boat model" as a result of the treatment it gives to interstate transactions) is available in Varsano (1999). See also Bird (1999).

33 See Ministry of Finance (1981), for more information on these programs. For a more detailed analysis of more recent efforts in improving tax collections at the local level, and information on specific programs, see Afonso *et al.* (1998).

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13 Fiscal decentralization in Indian federalism

M. Govinda Rao

Introduction

Fiscal decentralization has been considered as a component of human well-being and therefore, an end in itself. It is expected to achieve efficient allocation of resources, improve governance, accelerate economic growth, reduce poverty, achieve a gender balance, and empower weaker sections of society. The argument for decentralization is based on a notion that it will necessarily result in more efficient delivery of public services irrespective of the institutional setting, or capacity of the institutions and economic environment in which they are rooted. Empirical evidence suggests important preconditions for decentralization, and there is much to be done to create appropriate conditions for fiscal decentralization to be successful in achieving its objectives. Tanzi (1996) cautions us that even in achieving allocative efficiency, a number of preconditions must be met for the decentralization to be successful. More stringent requirements are needed in regard to achieving effective macroeconomic stabilization and desired redistribution, especially in developing and transition countries.

India with a federal constitution has relatively greater fiscal decentralization than most developing countries. However, in terms of delivering public services, mobilizing physical and human resources, harnessing the synergies and unleashing incentives to exploit the developmental potential, regional and local fiscal autonomy has achieved varying degrees of success.

The adoption of market-oriented reforms in India since 1991 has redefined the role of the state, and has necessitated a reexamination of fiscal arrangements between different levels of government. In fact, there have been opposing forces at work. While the transition from centralized planning to market-based resource allocation has enhanced the role of subnational governments in delivering social and physical infrastructure, the increasing trend in regional inequalities[1] has necessitated a greater central role. There is also considerable debate concerning a slow decline in poverty despite acceleration in economic growth. Efficient anti-poverty interventions are needed within the co-operative federalism framework (Inman and Rubinfeld, 1992). It must be noted that despite a decade of fiscal adjustment, fiscal imbalances at both central and state levels continue to pose serious threats to macroeconomic stability in the country.

In India, statutory recognition was given to the third tier by the 73rd and 74th constitutional amendments in 1993. The third tier of fiscal authority has had varying degree of success in delivering public services in different states. The institutional environment for the delivery of services has significantly changed with emergence of regional parties in the states, and as partners in a coalition at the center.

The large body of literature on Indian fiscal federalism is mainly confined to the discussion of fiscal relationship between the union and state governments. There is little assessment of the role and functions of the third tier in conjunction with the first two tiers. This paper is an attempt to provide a more complete picture of the fiscal federalism in India incorporating the relative roles of all the three tiers of government.

Evolution of Indian federalism

Evolution of two-tier federalism

India is a federation with a constitutional demarcation of functions and sources of finance between the union and state governments. The seventh schedule to the Constitution divides the legislative, administrative and judicial powers into central, state and concurrent subjects. The 73rd and 74th amendments to the Constitution in 1992 bestowed constitutional recognition to the third level of government though, in a strict legal sense, India remains a two-tier federation. This is because the constitutional division of powers is only between the center and states, and state legislatures are free to determine the powers and functions of the third level. The constitutional amendments only made it mandatory for the states to institute a third tier of local governments in rural areas and one/two tiers in urban areas.

Historical factors have played an important role in the adoption of a federal constitution with strong unitary features in India. During the British rule, administrative and fiscal centralization were a colonial necessity. At the same time, the difficulty of administering a large country with a number of principalities, different languages, cultures and traditions forced the central government to devolve some powers to regional units. Indeed, for a period of about two decades in British India prior to the enactment of Government of India Act 1935, the system required the provinces to make transfers to the union.

There were strong arguments for decentralization before independence and the Cabinet Mission sent by the British colonial government envisaged limited powers for the union in a three-tiered federal structure. Nevertheless, the Constitution eventually adopted by the Indian Republic closely followed the Government of India Act, 1935, with pronounced "quasi-federal" features. The shift probably occurred for two reasons: First, once the Muslim majority areas opted out of India to form a separate country (Pakistan), the principal reason for a loose federal structure vanished. Second, a strong center was found desirable to safeguard against fissiparous tendencies among constituent units (Chelliah, 1991). The decentralization framework provided by the founding fathers of Indian Constitution was an experiment in adopting the federal idea to a large and extremely diverse economic, cultural, social, and linguistic society. The heavy reliance on the 1935 Act was justified on the grounds of "continuity and harmony" (Chanda, 1965). Naturally, many important features of the Act, including a central bias and administrative and judicial arrangements enacted for the limited purpose of colonial administration, were formally incorporated into the Constitution.

The Constitution of Indian Republic, like the 1935 Act, provided for a threefold division of powers. Matters of national importance were placed in the union list, those of regional importance were placed on the state list and those that would require a co-operative solution were placed on the concurrent list. Residuary powers were assigned to the union government.

The central bias in fiscal matters was seen mainly in the assignment and vesting of residuary powers with the center. The most important factor that concentrated economic powers with the union government, however, was entry 22 on the concurrent list – "Economic and Social Planning," and the consequent attempts for centralized planning – leading to concentrated economic, fiscal, and financial powers with the union government. Greater central concentration of the financial powers resulted by the nationalization of major financial institutions, including banking and insurance.

Sub-state decentralization

Prior to 1992, local government units in urban and rural areas acted as agencies of the state government. Historically, village panchayats in rural areas provided basic community services and dispensed justice. A committee, was appointed by the Government of India to review the functioning of these local government agencies (India, 1957), and recommended that: (i) local governments should be constituted through democratic electoral process; (ii) elected members should represent the local interest and should ensure proper selection and supervision of various projects to conform to the preferences of the residents; and (iii) local government units should be vested with adequate financial powers.

Since 1957, most state governments introduced the third level of government in rural areas. In many states, a three-tier structure of local government unit evolved with panchayats (at villages), taluk (block), and district levels. Similarly, in urban areas, the state governments instituted municipal corporations, town municipalities, and notified area committees, and devolved some revenue and expenditure powers to enable them to provide urban services.

However, this framework was not adequate for the development of local self-government in most states. The entrenched power structure in local jurisdictions ensured that socially disadvantaged groups and poorer sections of society did not effectively participate in the decentralization process. There was no mechanism to prevent the state governments from suspending the elected local governments, nor was there any mechanism forcing states to hold regular elections to local bodies. Local governments did not have adequate revenues, and continued to depend upon state government grants to provide services. In the event, the third level was not effective as a unit of self-government, and was unable to provide services to meet local needs and preferences. However, local bodies performed better than others.

The union government established another committee to address local governments (India, 1978). This committee also recommended a three-tier rural structure, the only difference being that a cluster of villages (Mandal Panchayat), with a total population of 8,000–12,000 rather than each village formed the lowest level of local government. The report recommended the devolution of fiscal powers, including borrowing, to local bodies. Again, not much was done to implement the recommendations, except perhaps in the State of Karnataka.[2]

Under the 73rd constitutional amendment in 1992, each state government was required to pass legislation establishing Panchayat Raj institutions. Elections to these panchayats were to be held within the stipulated period. If the elected governments at local levels are superseded, elections should be held within a period of six months. An illustrative list of functions and sources of finance for both rural and urban local bodies was also set out in separate schedules. Each state government was required to appoint a state finance commission to assign taxes and fees to local governments, and recommend tax devolution and grants.

The evolution of urban local governments was slightly different. After the 74th amendment in 1992, each state legislated separate municipal acts assigning civic functions and sources of revenue. In general, the assignment of revenues was inadequate. Though all municipal bodies could levy property taxes, the revenues generated by this tax were low. Most of the states were allowed to levy "octroi," a pernicious tax on the entry of goods into a local area for consumption, use or sale. In general, the standards of services provided by the municipal bodies were poor, and the state governments had to create a number of independent agencies, such as housing boards, water supply authorities, and various improvement trusts, to ensure minimum services.

The amendment of the constitution also assigned a list of eighteen items to urban local governments. In addition to functions already assigned, the new arrangement assigned the functions of secondary and adult education, housing and land use, promotion and development of industrial and commercial estates, and electricity distribution to the urban local bodies, and concurrently to state governments.

The Indian experience shows that the impetus to decentralize below the state level has come more from the center than the states. States, such as Karnataka, took a proactive approach to decentralization, but this initiative was an exception, rather than the rule. Thus, sub-state decentralization in India is mostly a "top-down" process.

The system

Federalism in India is characterized by a constitutional demarcation of revenue and expenditure powers between the center and states. After the 73rd and 74th amendments of the Constitution, state legislatures, were also required to entrust powers and functions to local bodies for items listed under 11th and 12th schedules, for "the implementation of schemes for economic development and social justice."

The structure of multilevel provision of public services is shown in Chart 13.1. There are 28 states and seven centrally administered territories. The seventh schedule to the Constitution specifies the legislative, executive, judicial, and fiscal domains of union and state governments, with union, state and concurrent lists. The Constitution also requires the President to appoint a finance commission every five years, or earlier, to review the finances of the union and states, and recommend devolution of taxes and grants-in-aid of revenues to states for the ensuing five years. In addition, the Planning Commission also gives assistance to the states based on a formula determined by the National Development Council,[3] and specific purpose transfers for various central schemes required by different ministries of the union government.

Below the states, there are over a quarter million local bodies – about 3,000 are urban, and the remaining rural. Rural local bodies again are at three levels: district panchayats, taluk panchayats, and village panchayats. Each state has legislated three levels of rural local bodies at village, taluk (block), and district levels. The urban local governments consist of municipal corporations in large cities, town municipalities in smaller cities and town panchayats, and notified area committees in smaller towns. Each state government has devolved powers to levy certain taxes and fees to village panchayats and urban local bodies. The states have also instituted a system of sharing of state revenues and giving grants to both urban and rural local bodies. Each state government is required to appoint a state finance commission to review the finances of the local

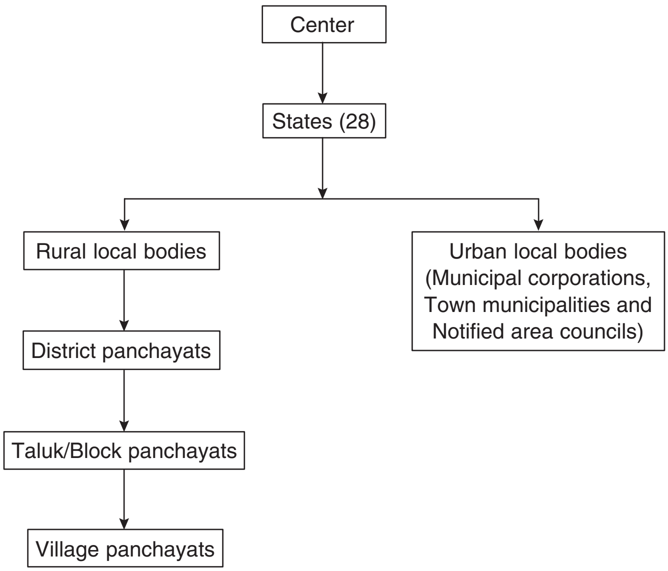

Chart 13.1 Structure of multilevel government in India.

bodies and assign tax shares and make grants. In addition, a number of central sector, and centrally-sponsored schemes undertaken by the states, are actually implemented by these local bodies and the earmarked funds are passed on to them from the state governments for implementation.

Fiscal assignment and transfer system in India

Assignment between center and states

The functions related to money supply, external borrowing, international relations, defense, atomic energy, space, national highways, airways, international waterways, and those having significant scale economies are assigned exclusively to the center. The functions involving benefits spanning across states and matters with significant developmental potential are undertaken concurrently with the states. These include economic planning, energy, education, health, and family welfare. The functions with statewide implications are assigned to the states. Most progressive tax handles are assigned to the center. Taxes assigned to the states include land revenue, taxes on agricultural incomes and wealth, taxes on sales and purchase of goods, excise duties on the sale of alcoholic products, motor vehicles, and goods and passengers transported through roads and inland waterways, stamp duties and registration fees, and the terms of revenue potential, the sales tax is the most important. The residual functions and tax powers are assigned to the center.

The tax powers are assigned on the basis of the principle of separation and are assigned exclusively either to the center or the states. However, the separation is legally defined, but not in economic terms. Thus, the center can levy taxes on production (excises) whereas the tax on sale or purchase of goods should be levied by the states.

The most anomalous part of the revenue assignment between the union and the states is the distinction drawn between goods and services for tax purposes. Entry 54 in the state list empowers the states to levy "taxes on the sale and purchase of goods other than newspapers." Taxation of services does not find a specific mention in any of the schedules. As all residuary powers are vested with the union government, it has imposed taxes on services selectively. The compartmentalized treatment of goods and services for tax purposes has violated neutrality in taxation, made it difficult to coordinate consumption taxation, and generated significant evasion and avoidance of the sales tax (NIPFP, 1994).

Similarly, only the states can levy taxes on agricultural incomes and wealth, and only the central on nonagricultural incomes and wealth. The states have found taxing agricultural incomes politically infeasible, besides being administratively difficult. At the same time, the separation of the tax base has opened up a floodgate for both avoidance and evasion of the personal income tax.

The Constitution assigns borrowing powers to both the union and state governments. The states can borrow from the market as well as from the union government. However, if a state is indebted to the union government, it has to obtain the latter's permission, to borrow from the market. As all the states are heavily indebted to the center, borrowing by the states is essentially determined by the Union Ministry of Finance, the Reserve Bank of India (RBI), and the Planning Commission. The states can also resort to some borrowing from public accounts, and the most important items include the share of small savings loans[4] and borrowing from the public provident fund. The Constitution has largely enabled the union government to exercise overall control over subnational borrowing. In practice, the states have found several ways to circumvent borrowing constraints, as discussed further.

The Constitution provides for transfers from the union to state governments by tax devolution and grants-in-aid. To avoid subjectivity in making transfers, the Constitution provides for the appointment of a finance commission every five years. The functions of the commission include: (i) distribution of the proceeds from sharable taxes; (ii) provision of grants-in-aid to the states in need of assistance; (iii) measures to augment resources of state governments to supplement the resources of the panchayats and municipalities in the states; and (iv) other matters referred to the commission in the interest of sound finance. Eleven finance commissions have been constituted.

The planning commission also gives substantial assistance to the states for developmental plans. The assistance is given through grants and loans in the ratio 30 : 70 for the larger states, and 90 : 10 for special category states. In addition, central ministries give assistance to the states to implement central schemes. Such central sector schemes are entirely funded by the central government, and states are merely implementing agencies. Some centrally sponsored schemes, are shared cost programs requiring the states to make matching contributions, the matching ratio differing with projects.

Assignment between state and local governments

The constitutional amendments in 1992 specified roles and responsibilities of rural and urban local governments, with twenty-nine items to rural local bodies, and eighteen items to urban local bodies. However, the revenue and expenditure assignments in the lists are concurrent with the states' responsibilities, and the actual assignment of specific revenue sources and expenditure depends on the extent to which a state is willing to devolve responsibilities. Despite wide variations, some of the common functions performed by the panchayats at the three levels as well as urban local bodies are listed in Appendix.

Although potential responsibilities of the local governments are specified, their revenue sources are not. The revenues of local governments in each state are determined by the state finance commission to be appointed by the state every five years. These commissions determine (i) the distribution of revenues of the states between states and local governments, and specifying *inter se* allocation of individual local governments; (ii) the assignment of tax and nontax powers to village panchayats and urban local bodies; (iii) the determination of grants-in-aid to the local governments from the consolidated fund of the state.

In addition to the transfers to local bodies recommended by the state finance commissions, the state governments pass on funds for implementation of various central schemes to the local governments, most importantly for poverty alleviation, and also for social and community services in which the local implementation is preferred. Analysis shows that local governments have very little flexibility in their use of funds. After deductions of charges for electricity and for other facilities provided by state government from the general-purpose transfers, very little is left. Much of what is available is needed for administration, and the local governments are scarcely able to execute any new development schemes.

Fiscal federalism in India

Fiscal decentralization

An important feature of Indian fiscal federalism is the pronounced asymmetry between revenue and expenditure assignments. Thus, while the central government raised 11.4 percent of GDP or about 62 percent of total revenues, after transfers, the revenues accruing to it were just 6.3 percent of GDP or about one-third. In contrast, state and local governments raised only a third of revenues but had control over two-thirds. Between them, local governments raised just about 0.6 percent of GDP or 3 percent of total revenues, whereas the expenditure by local governments was 2.1 percent of GDP or 10.5 percent of total revenues. Among the local governments, the revenue-raising role of rural local governments was abysmal. The rural local governments together raised just 0.04 percent of GDP, and their expenditure share was 1.4 percent of GDP.

Like in many federal systems, the states play a significant role in both raising revenues and spending. States raise 34 percent of total revenues and incur 55 percent of expenditures. In social services, particularly in education and health, states' expenditure shares are more than 80 percent, and in economic services about 50 percent. Of course, states still depend on central transfers to finance substantial portion of expenditures. Almost 42 percent of states' revenues accrue from transfers.

Table 13.1 shows that fiscal decentralization in India applies to the state level and does not effectively extend to local governments. As mentioned above, total revenue raised by local bodies was just about 0.6 percent of GDP. In fact, the quarter million rural local governments raised negligible revenues amounting to 0.04 percent of GDP and, after transfers, they had control over resources of just 1.4 percent of GDP. Thus local government share in total expenditures was less than 5 percent, which also include

Table 13.1 Fiscal decentralization in India, 1997–98 (Percent of Gross State Domestic Product)

	Revenue collection	%	*Revenue accrual*	%	*Total expenditure*	%
Center	11.4	62.45	6.8	34.43	12.0	43.2
States	6.3	34.56	10.9	55.03	13.6	48.9
Local bodies	0.6	2.99	2.1	10.53	2.2	7.9
Urban local bodies	0.5	2.74	0.8	4.07	0.8	2.9
Rural local bodies	0.04	0.24	1.3	6.46	1.4	5.0
District panchayats	n	0.03	0.6	3.21	0.6	2.2
Taluk panchayats	n	0.01	0.3	1.44	0.4	1.4
Village panchayats	0.04	0.21	0.4	1.82	0.4	1.4
Total	18.3	100.00	19.8	100.00	27.8	100.00

Sources: 1 Public Finance Statistics 1999–2000, Ministry of Finance, Government of India, 2000.
2 Report of the Eleventh Finance Commission, Ministry of Finance, Government of India, 2000.

Notes
n – negligible; * – Revenue accrual estimates are taken as proxi for expenditures.
Therefore,

1 States' total expenditure has been netted out transfers to local bodies;
2 center's expenditure is net of grants and loans to states and union territories;
3 core services are water supply, street lighting, sanitation, and roads.

locally implemented expenditures on various centrally sponsored schemes, such as poverty alleviation and social development. Thus, rural local governments act as agencies of the central government to implement some of their minor expenditure schemes. The situation is not very different in the case of urban local governments. Thus, below the state level, Indian fiscal federalism is characterized by fiscal "deconcentration."

Fiscal decentralization and allocative efficiency

The advantage of a decentralized fiscal system is in its potential to match public services to varying consumer preferences, while preserving the advantages of a unified common market. The efficiency of the system is in its ability to minimize transaction and coordination costs, and the preservation of a common market. Minimization of costs depends on a variety of factors, including the state of technology, efficiency of information flows, and educational levels of the electorate. Some of these factors are exogenous, and others will have an impact only in the medium and longer term. The preservation of a common market is critical in ensuring efficiency in resource allocation. The fiscal system in India, however, imposes a number of impediments to internal trade, arising from the nature of assignments, asymmetric arrangements in the federal system, and autarchic developmental strategy. In addition, there are impediments caused by the lack of market development and social, political, and linguistic diversities.

Perhaps the most important impediment to internal trade in India is caused by the assignment of tax powers. Despite the constitutional requirement that internal trade should be kept free, the center has empowered states to levy taxation on the interstate sale of goods by the exporting state, subject to a ceiling rate of 4 percent. As the sales tax is predominantly a first point levy, and there are additional taxes on inputs and capital goods, and, in some states, turnover taxes in addition to sales taxes, the levy of interstate sales tax can cause significant interstate trade distortions. In addition, states are empowered to levy a tax on the entry of goods for consumption, use or sale. Some states have levied an account based levy "entry tax," and some others have allowed the urban local bodies to levy a check-post based levy called "octroi" on entry of goods into local body jurisdictions. This tax on imports into local jurisdictions has created several tariff zones within the country. Besides, the erection of checkposts at the borders of local jurisdictions has created physical impediments to internal trade, with scope for rent-seeking.

There are also a number of regulatory impediments against the free mobility of factors and products. Until recently, the "freight equalization" scheme sought to subsidize transportation cost for items such as steel and coal, negating forward and backward linkages of large public sector investments in the less-developed states of Bihar, Madhya Pradesh, and Orissa.[5] Similarly, under the essential commodities act, basic food items cannot be moved from one state to another. Besides these, there are market impediments caused by the centrally planned economic regime, and labor immobility caused by linguistic barriers.

Fiscal decentralization and macroeconomic stability

In the literature, macroeconomic stability is considered to be mainly the function of the central government (Oates, 1972). Nevertheless, the method of raising resources and spending at subnational levels could have macroeconomic implications. In a multilevel fiscal system where subnational functions and sources of finance are clearly defined and the local governments are required to strictly manage their expenditures within their means, decentralization does not pose serious problems for macroeconomic management (Tanzi, 1996). This will lead to efficient allocation of resources so long as subnational governments cannot export the tax burden to nonresidents. The extent to which existing fiscal arrangements contribute to structural macroeconomic problems in India is addressed.

Subnational borrowing and macroeconomic implications

Despite a decade of fiscal reforms to reduce both the current budget and fiscal deficits, the overall general government deficit has shown a deteriorating trend since 1995–96, at both central and state levels (Chart 13.2), largely due to a sharp increase in current budgetary deficits. Thus, not only the volume of deficit increased, there is an increasing inability to finance current expenditures.

The important question is whether increasing overall fiscal imbalances can be attributed to the states. There are two ways in which states' fiscal operations can adversely affect structural deficits. First, if the states have high bargaining power to secure higher transfers to cover increasing expenditures, an increase in the overall deficit results.[6] Second, the states may find mechanisms to soften their budgetary constraints through indirect borrowing.

The increasing deficit at the center cannot be attributed to higher transfers to the states. In fact, while the percentage of current budgetary deficits at the central level has shown a steady increase, particularly after 1996–97, current transfers from the center to the states has shown a decline, continuing the longer term trend (Chart 13.3). The inability of the central government to maintain fiscal discipline has been a major shortcoming in overall macroeconomic management in India.

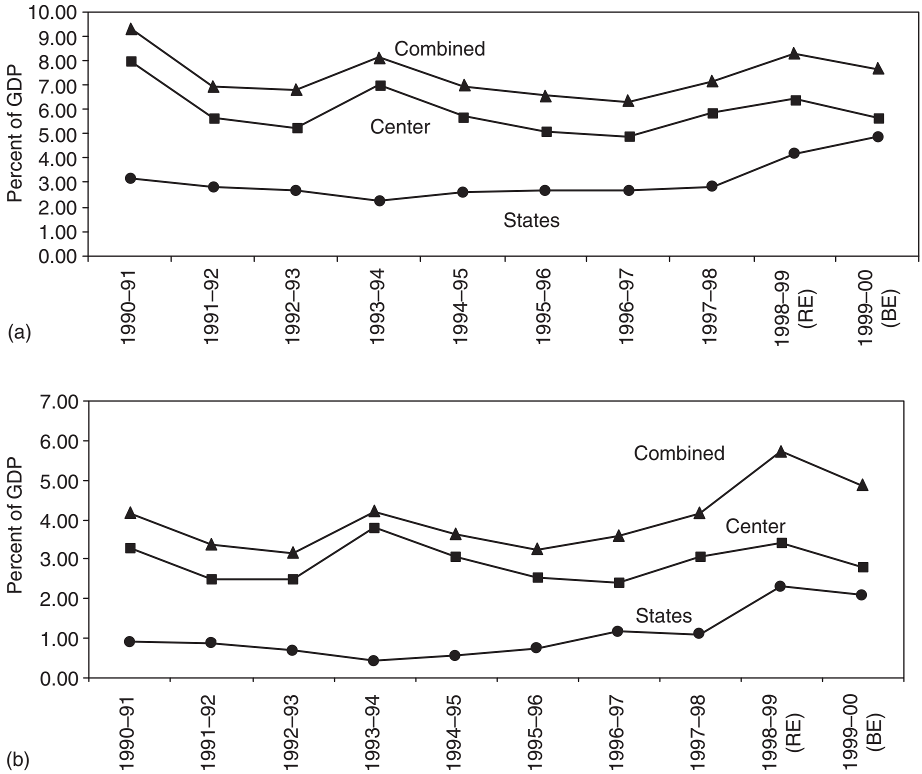

Chart 13.2 (a) Revenue and (b) fiscal deficits of center and states in India.

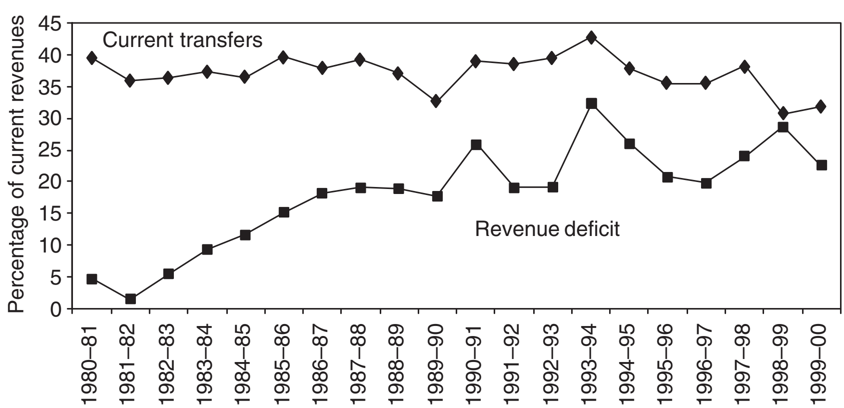

Chart 13.3 Revenue deficit and current transfers to states.

Softening the states' budget constraint

There has also been a steady increase in the deficits of the states, adding to the structural imbalances. Although the system has provisions for the central government to exercise strict control over states' borrowing, the latter have found ways and means of softening their budget constraints. Thus, more stringent measures to contain states' borrowing are needed.

The emphasis on large development plans, in the absence of resources, has led both central and state governments to indulge in unsustainable borrowing. States have done so by (i) creating contingent liabilities by floating corporations and borrowing through them; (ii) borrowing from public enterprises; (iii) borrowing from public accounts such as public provident funds and post-office small savings; and (iv) obtaining overdrafts from RBI (Lahiri, 2000).

Creating separate corporations to implement many infrastructure projects and borrowing from the market to finance them is the most widespread practice of undermining the hard budget constraint at the state level. The contingent liabilities thus created do not form a part of the fiscal deficit. Such liabilities in eighteen states have increased at 12 percent per year during 1992–97, and constituted 9.1 percent of their Net State Domestic Product (NSDP) in 1997. Borrowing from public enterprises to overcome liquidity problems is another method employed by status.

Certain liabilities, which do not form a part of the main account of the government and in respect of which government acts only as a banker, are kept in the public account. These liabilities include transactions relating to provident funds, small savings collections, and other public deposits with the government. A major item in these is small savings loans. States received 75 percent of the net collections from post-office national saving certificates collected in their respective jurisdictions. This, in fact, is a high-cost borrowing, as high interest rates and income-tax concessions are involved. Many states implicitly borrow from employees through arrears on pay increases and dearness allowance (payment made to offset higher-living costs).

Each state has been given within year overdraft limits for normal and special purposes by the RBI and all the states resort to them. In the past, these overdrafts had to be converted into medium-term loans. However, since 1985, an overdraft regulation scheme is in operation and, if a state runs an overdraft for ten continuous working days, the RBI can dishonor checks issued by the state governments.

A major source of the contingent liability of the states is the guarantee given to autonomous bodies created by the states for providing urban infrastructure or local governments guarantees to borrowing by water supply and sewerage boards. Similarly, urban local bodies borrow from the market with state government guarantee to augment urban infrastructure facilities, such as water supply and sanitation, roads and housing from public sector financial institutions. The Life Insurance Corporation and Housing and Urban Development Corporation have also made significant loans to urban local and autonomous bodies. In recent years, multilateral institutions, including the World Bank and Asian Development Bank have given substantial assistance to augment infrastructure of urban local governments. Such lending to local governments adds to the contingent liability of the state governments.

Thus, despite the formal arrangement with central government control after the states' fiscal deficits, states have found a variety of ways to overcome the constraints. The fiscal system and formal arrangements have not been able to prevent the states from fiscal profligacy. Disincentives to fiscal prudence in the transfer system, the irrelevant distinction between plan and nonplan expenditures, growing populism associated with coalition politics, and the culture of free-riding are some of the major factors responsible.

Intergovernmental transfers and regional equity

The transfer system

In all multilevel fiscal systems, efficient assignments of expenditure powers are not likely to correspond to efficient revenue powers. Further, variations in revenue capacity among subnational units can cause horizontal inequity. The resulting vertical and horizontal fiscal imbalances have to be offset though a system of unconditional transfers. In addition, for efficient provision of public services with significant spillovers at subnational levels or for merit good reasons, specific purpose transfers will have to be made.[7] It is generally recognized that (i) the transfer system should be formula based rather than negotiated; (ii) general purpose transfers should be designed to offset shortfalls in revenue capacity and excess expenditure needs of subnational governments, and specific purpose transfers should be designed to ensure minimum standards of targeted services, and (iii) the design of transfers should not have adverse incentives on fiscal management.

Central transfers to states

The Constitution of India makes an implicit assumption that the assignments will result in surpluses for the central government, with fiscal space for transfers to states through tax devolution and grants. To determine transfers, the Constitution provides for the institution of finance commission every five years by a presidential order. The commission is required to recommend devolution of taxes from the center to the states, and provide grants to the states in need of additional assistance. A recent amendment to the Constitution has enabled the central government to share total revenues from all centrally levied taxes rather than from selected taxes. The Eleventh Finance Commission has recently recommended distribution of 28 percent of net proceeds from central taxes to the states (India, 2000).[8]

The planning commission is a major dispenser of funds. It provides grants and loans to the states for plan expenditures, according to the formula evolved and modified by the National Development Council (NDC) from time to time.[9] Various central ministries also make transfers for specific purposes. Some of the specific purpose transfer schemes are entirely funded by the center and others are shared cost programs. Major programs on poverty alleviation, family planning, and adult literacy fall in this category. In 1998–99, the finance commission transfers constituted 60 percent of total transfers, the planning commission 22 percent, and the remaining were for central sector and centrally sponsored schemes.

Implicit transfers occur through the planned control of prices and regulations, including subsidized loans to the state governments by the center. Moreover, resource transfers (not necessarily through governments) occur also due to subsidized lending to priority sectors by the financial and banking system, and more importantly, interstate tax exportation. The implications of such implicit transfers are not examined here.[10]

The efficiency and equity implications of the Indian fiscal transfer system have been a subject of considerable critical scrutiny and yet the problems have continued (Rao and Sen, 1996). The multiplicity of agencies making transfers, often at cross-purposes, makes achievement of objectives difficult. Second, although the transfers are formula-based, they are not targeted to offset fiscal disabilities of the states. The finance commission formula for tax devolution is based predominantly on general economic indicators (Table 14.A2). The plan assistance to the states is also based on general economic indicators rather than fiscal disabilities. Often, the planning and finance commissions work at cross-purposes.

The worrisome issue pertaining to the transfer system in India lies in its disincentives for fiscal management of states. The grants recommended by the finance commissions are based on the estimated post-tax devolution gaps in the nonplan current budgets of the states. This "fiscal dentistry" contributes to widening "budgetary cavities" year after year. Thus, the transfer system is targeted to offset fiscal disabilities, moreover, it rewards the states with poor fiscal management.

The design and implementation of specific purpose transfers has also attracted criticism. There has been a proliferation of populist causes and, at present, there are more than 180–90 schemes in operation. Thinly spread resources in implementing schemes diffuse the ability of the objectives of specific purpose transfers. Most schemes satisfy political objectives and are not objectively determined.

Equalizing impact of central transfers

Special category states have higher per capita income levels than many of the poorer states and yet, receive more favorable treatment in the transfer system. However, the overall impact of central transfers to states is equalizing for the major states, although the effect is not significant when all the states are considered (Table 13.2). The equalizing impact is primarily due to the finance commission's transfers, particularly to tax

Table 13.2 Equalizing effect of central transfers to states, 1997–98

Transfers	*Income elasticity*	
	Major states	*All states*
Tax devolution	−0.414* (3.361)	−0.471 (−1.196)
Non-plan grants	−1.027 (−1.780)	−1.001 (−1.285)
Total finance commission Transfers	−0.508* (−4.027)	−0.558 (−1.351)
Plan grants-state plan Schemes	−0.040 (−0.212)	−0.817 (−0.943)
Plan grants-central sector and centrally sponsored schemes	0.197 (0.737)	0.114 (0.221)
Total plan grants	0.041 (0.240)	−0.585 (−0.798)
Gross current transfers	−0.375* (−3.518)	−0.594 (−1.118)

Figures in parenthesis are *T* values. * – Significant at 1 percent level.
* Income elasticity has been estimated by regressing the transfers with NSDP in a log–linear model.

devolution. Neither the grants given by the planning commission nor the specific purpose transfers have a significant equalizing impact.

The equalizing impact of the transfer system is apparent in the parameters of state finances presented (see Table 13.2). In general, while the revenue–NSDP ratios are higher in more prosperous states, expenditure–NSDP ratios are higher in low-income states. Thus, the shares of states' own revenue in total revenue are lower for states with higher per capita income levels. In other words, central transfers constitute 16.3 percent of the total revenues in high-income states, 32.9 percent in middle-income states and 51.4 percent in low-income states. In special category states, 73 percent of their revenues accrue from transfers.

Central transfers from 36 percent of total expenditures in high-income states, 62 percent in low-income states, and 77 percent in the special-category states. Despite its progressivity, the transfer system in India does not satisfactorily resolve horizontal fiscal imbalances. Although the expenditure – NSDP shares are higher, per capita expenditures in poorer states are lower. Since a higher proportion of expenditures in these states are preempted for administrative purposes (due to near uniform pay scales in the states), per capita expenditures on physical and social infrastructure are much lower. Moreover, the implicit transfers are disequalizing. It is, therefore, not surprising that, after market-based reforms were introduced in 1991, regional inequalities have shown a sharp increase (Rao, Kalirajan and Shand, 1998).

Fiscal transfers from the states to local governments

As mentioned earlier, the states required to appoint a finance commission every five years to make recommendations on the transfers to urban and rural local bodies. They are required to make recommendations on the assignment of tax revenues to local bodies, sharing of tax revenues between the states and the local governments, and their distribution among individual local bodies and grants to be made to them.

State finance commissions are designed on the union model and should report every five years. But the experience of implementation of local transfers by various states does not bring much cheer. Of the twenty-five states, five are yet to constitute the commissions and in six states, the commissions are yet to submit the reports. In states where they have submitted reports, very little has been done in term of giving revenue-raising powers to the local bodies. The volume of state transfers is inadequate, as the states themselves have been facing a severe financial crunch. Due to paucity of information at local levels, the sharing of taxes and grants are not based on scientific criteria. Village panchayats often receive a lump-sum distribution irrespective of their capacity or need. In fact, after deducting the cost of electricity at source by the state government, very little is available for actual spending by the local bodies. In many states, village panchayats mainly implement the centrally sponsored schemes (Aziz, 2000). Of course, these generalizations are simplistic and there are states where local bodies play more active roles than portrayed here, but these are exceptions.

Fiscal indicators of local bodies in different states (Table 13.3), bring out the importance of state transfers in local revenues and expenditures. A summary of these indicators (Table 13.4), shows that local governments play a marginal role in the provision of public services, and much less in raising revenues. On average, in 1997–98, they raised just about 0.5 percent of NSDP, and this constituted less than 5 percent of subnational revenues (total revenues of state and local governments). Even in high-income states, local revenues contributed less than 10 percent of subnational revenue. In fact, the share of rural local

Table 13.3 Selected indicators of state government finances, 1997–98

State	*Percent of states' own revenue to NSDP*	*Percent of states' own revenue to total revenue*	*Percent of current expenditure to NSDP*	*Percent of states' own revenue to total expenditure*
High-income states	11.50	83.71	15.56	64.26
Middle-income states	10.94	67.18	18.02	54.52
Low-income states	8.46	48.64	19.74	37.66
Smaller states	11.46	27.14	40.13	23.40
25 states	7.16	61.48	12.86	48.77

Table 13.4 Fiscal indicators of local governments in India

State category	*Percent of own revenues to NSDP*	*Percent of total revenues to NSDP*	*Percent of total expenditure to NSDP*	*Percent of own revenues to total expenditure*	*Percent of local revenue to subnational revenue*
High-income states	1.60	3.64	35.37	43.91	10.42
Middle-income states	0.67	3.5	15.61	19.08	3.94
Low-income states	0.31	2.38	2.51	13.03	1.75
Special-category states	0.16	0.88	1.12	18.52	0.38
All states	0.58	2.13	12.02	27.11	4.73

Table 13.5 State transfers to local governments (percent of NSDP)

	Rural local bodies	*Urban local bodies*	*All local bodies*
High-income states	1.73	0.3	2.04
Middle-income states	2.16	0.47	2.58
Low-income states	1.74	0.33	2.07
Special-category states	0.21	0.20	0.21
All states	1.3	0.25	1.55

bodies was negligible – less than 0.05 percent of NSDP and, even among the urban local bodies, the revenue contribution was just about 0.5 percent of NSDP (Table 13.A3).

Table 13.3 shows that expenditure levels were relatively high, almost 10.6 percent of NSDP in urban local bodies. This is entirely due to the high expenditures incurred in Maharashtra and Andhra Pradesh financed by bonds and borrowing from multilateral institutions. In all other states, expenditure levels of both urban and rural local bodies were extremely low.

Local bodies raised relatively more revenues in more affluent states (Table 13.5), but state transfers to local bodies do not show any clear pattern. Even in high-income states, local bodies, both in urban and rural areas, do not provide significant public services, except in Maharashtra and Andhra Pradesh, where the urban local bodies have taken substantial loans to improve urban infrastructure.

Concluding remarks

The paper analyzes fiscal decentralization in a three-tier federal framework in India. This facilitates an understanding of the relative roles of the three levels of government in a comprehensive assessment of deficits, including contingent liabilities. The inclusion of local finances shows that aggregate fiscal deficits are much higher than that is usually measured. There has been an increasing trend in structural deficits, and both center and states are guilty of fiscal profligacy. The deficits are not the result of higher transfers. The states, on their part, have not bothered to observe fiscal discipline, and have found several ways to soften their budget constraints at the cost of macroeconomic stability. A large part of the deficit arises form the borrowings undertaken by local bodies in two states, Andhra Pradesh and Maharashtra in recent years.

The paper brings out the anomalies in assignments both between center and states and states and local bodies. There is a considerable need to rationalize the assignment system to enable the decentralized governments to raise revenues and incur expenditures according to the preferences of their citizens.

The transfer system from the center to the states has continual and inherent moral hazard problems. Multiple agencies make transfers, making it difficult to target the transfers to meet objectives. The gap-filling role adopted by the finance commissions has only contributed to fiscal indiscipline.

Despite weaknesses, the central transfers are generally equalizing. The major contributor to equalization is the finance commission transfer. The planning commission transfer and assistance given to centrally sponsored schemes are not equalizing. Despite the overall equalizing impact, per capita expenditures of states are positively related to taxable capacity.

In spite of constitutional recognition to the third tier, the local governments play a very limited role both in raising revenues and in spending. It would be correct to characterize decentralization at the third level as mostly top-down. It is also seen that initiative for decentralization at the third level has come from the center and not the states. In raising revenues, their role is negligible, nor have the states given enough transfers to enable them to play a meaningful role, even in implementation. The only way they could play a meaningful role is to resort to heavy borrowing, as seems to have happened in urban local bodies in Andhra Pradesh and Maharashtra. But this has significantly added to their deficits.

The transfers at local level do not follow any clear pattern. Of course, the level of development of the states does seem to be a factor contributing to the success of decentralization in terms of raising revenues. However, in absolute terms, the local role is not substantial. From this, it will not be an exaggeration to say that the institutional environment is not conducive to the success of decentralization at local level in India. It is necessary to understand the policies and institutions necessary to make local fiscal governance successful.

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Appendices

Table 13.A1 Illustrative list of important functions of local governments

Village panchayat	*Taluk panchayat*	*District panchayat*	*Urban local governments*
1 Preparing annual plans. 2 Preparing and implementing annual budget. 3 Promotion of: Agriculture, horticulture, animal husbandry, poultry, dairying, fisheries, afforestation, and cottage industries. 4 Provision of drinking water. 5 Distribution of house sites. 6 Implementing various centrally sponsored schemes on poverty alleviation, social development and family welfare. 7 Promotion of adult literacy, ensuring school enrollment and attendance at primary level. 8 Rural water supply and sanitation. 9 Monitoring the functioning of public health centers. 10 Monitoring the public distribution system.	1 Preparing annual plans and consolidating the plans of village panchayats. 2 Preparing annual budget. 3 Promotion of agriculture, animal husbandry, agricultural extension. 4 Maintenance of irrigation works. 5 Rural water supply and sanitation. 6 Social forestry. 7 Construction and maintenance of public roads and communication. 8 Monitoring the implementation of various programs and policies at village levels. 9 Promotion of health, family welfare, and development of women and children.	1 Preparation of annual plan for the district; consolidation of village and taluk panchayat plans. 2 Construction and maintenance of roads, buildings, and bridges. 3 Construction of rural water supply works. 4 Co-ordinating the implementation of various activities and programs on poverty alleviation and social development at village and taluk panchayat levels. 5 Watershed development and wasteland development. 6 Management of hospitals and dispensaries. 7 Monitoring the public distribution system.	1 Urban planning including town planning. 2 Regulation of land use and construction of buildings. 3 Construction and maintenance of roads and bridges. 4 Water supply, sanitation public health, conservancy, and solid waste management. 5 Urban forestry and protection of environment. 6 Slum improvement and upgradation. 7 Formulation and implementation of urban poverty alleviation programs. 8 Provision of urban amenities, parks, gardens and playgrounds. 9 Management of burial grounds, crematoriums. 10 Vital statistics on births and deaths. 11 Public amenities like street lighting, parking lots, bus stops, and public conveniences. 12 Regulation of slaughter houses and tanneries.

Table 13.A2a Criteria for tax devolution: Eleventh Finance Commission (2000–05)

Criteria	*Share (%)*
States share	29.5 percent of the net proceeds of all union taxes and duties
Criteria for distribution	
1 Population	10.0
2 Income (distance method)	62.5
3 Area	7.5
4 Index of infrastructure	7.5
5 Tax effort	5.0
6 Fiscal discipline	7.5

Distance formula $= (Y_h - Y_i)P_i / \Sigma(Y_h - Y_i)P_i$, where Y_i and Y_h represent per capita SDP of the *i*th and the richest state, P_i the population of the *i*th state, $(Y_h - Y_i)$ for the '*h*' state is to be equivalent to that of the second highest per capita SDP state.

Table 13.A2b Formula for distributing state plan assistance

Variable	*Weight*
Population (1971)	60.0
Per capita SDP, of which,	25.0
i. Deviation from the average to the states below average per capita SDP	20.0
ii. Distance formula	5.0
Fiscal performance, of which,	7.5
i. Tax effort	2.5
ii. Fiscal management	2.5
iii. National objectives	2.5
iv. Special problems	7.5
Total	100.0

Note: This formula is applied to general category states. They receive 70 percent of the total plan assistance of which, 30 percent is given as grants and the remaining as loans.

Table 13.A3 Selected indicators of state government finances

Major states (State)	*Percent of state's own revenue to NSDP*	*Percent of state's own revenue to total revenue*	*Percent of current expenditure to NSDP*	*Percent of state's own revenue to total expenditure*	*Percent of revenue deficit to fiscal deficit*	*Percent of fiscal deficit to total expenditure*
High-income states	11.50	83.71	15.56	64.26	43.87	23.23
Punjab	12.06	85.04	17.49	61.18	59.89	28.06
Maharashtra	10.55	85.45	13.91	64.88	40.05	24.08
Haryana	15.03	84.77	19.89	71.17	63.80	16.05
Gujarat	11.70	79.21	16.12	61.62	32.06	22.20
Middle-income states	10.94	67.18	18.02	54.52	45.79	18.84
Tamil Nadu	12.69	72.18	19.34	62.43	64.28	13.51
Kerala	13.30	70.99	21.69	53.01	46.52	25.32
Karnataka	13.25	72.33	18.79	62.80	17.19	13.17
Andhra Pradesh	11.31	64.31	18.48	54.72	28.96	14.92
West Bengal	6.16	55.01	14.04	38.10	57.24	30.74
Low-income states	8.46	48.64	19.74	37.66	46.45	22.56
Rajasthan	10.73	59.17	19.39	45.39	22.80	23.29
Madhya Pradesh	10.79	58.48	19.22	50.34	25.78	13.92
Uttar Pradesh	7.33	47.18	19.62	32.96	61.03	30.13
Orissa	8.14	42.37	22.97	30.50	50.18	28.01
Bihar	6.02	31.98	19.38	28.74	26.89	10.14
Smaller states						
Arunachal Pradesh	4.73	7.70	48.71	6.73	##	12.63
Assam	6.70	29.20	21.41	28.27	##	3.18
Goa	32.58	85.52	38.57	76.88	11.24	10.11
Himachal Pradesh	11.09	32.17	42.87	20.70	43.97	35.65
Jammu & Kashmir	9.74	14.93	52.98	13.53	##	9.38
Manipur	4.30	8.84	44.94	7.26	##	17.85
Meghalaya	5.87	14.85	38.84	12.57	##	15.36
Mizoram	5.53	7.44	68.09	6.35	##	14.69
Nagaland	4.04	7.94	51.44	6.58	5.39	17.04
Sikkim	168.08	73.66	220.91	70.05	##	4.90
Tripura	5.72	9.84	56.92	8.33	##	15.32
Smaller states	11.46	27.14	40.13	23.40	##	13.78
25 States	7.16	61.48	12.86	48.77	40.23	20.67

These states are revenue-surplus states. NSDP is Net State Domestic Product.

Notes

1 Inter-regional distribution of incomes has shown increasing inequality during the 1990s (Rao, Shand and Kalirajan, 1998).

2 Some of the state governments implemented the recommendations of the committee in modified forms subsequently. Karnataka was one of the states, which pioneered in implementing the recommendations with certain modifications in 1985.

3 This is called the 'Gadgil' formula after the name of the Deputy Chairman of the Planning Commission (Prof. D. R. Gadgil) who introduced the formula for the first time in 1969.

4 Investments in national saving certificates issued by the post-offices get income tax concession. The Union government is required to lend 75 percent of the net collections which account to the states according to the current agreement.
5 The steel plants and coal mines are located mainly in these states, and large public investments have been made in them to develop them based on these resources.
6 If the center has greater bargaining power *vis-à-vis* the states, it could pass the burden of fiscal adjustment to the states, resulting in larger state deficits (if possible), or reduced state-spending.
7 For a normative model of intergovernmental transfer system, see Ahmad (1997) see also Boadway and Flatters (1982).
8 In addition, 1.5 percent of net proceeds of central taxes is assigned to states as part of tax rental arrangement with them for not levying sales tax on sugar, textiles, and tobacco products.
9 NDC is a body constituted by the prime minister and central cabinet, deputy chairman, and members of planning commission and the chief ministers of states.
10 For a more detailed analysis of such transfers, see Rao (1997).

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14 Indonesia

Managing decentralization

Ehtisham Ahmad and Ali Mansoor

Context

The Governance and Fiscal Balance Laws,[1] enacted by the Indonesian Parliament in May 1999 aim to decentralize both political and economic power away from the central government after decades of highly centralized and autocratic rule. The new legislation recognizes political reality – Indonesians across the country want greater involvement in the management of their day-to-day affairs. In particular, the natural resource-rich regions want a larger share of the resource pie – which was seen as being preempted and often misused by the elite in Jakarta. Thus, the political pressures for decentralization reflect in part the reaction to the demise of an authoritarian regime.

The pressure for decentralization in many parts of the world often is driven by the need for improved service delivery (Dillinger, 1994). However, in Indonesia, distinct ethnic and geographic factors have exacerbated the frustration with central domination, and the demand for decentralization is associated more with control over resources and political and legal autonomy than with a perceived need to improve local service delivery.

The conflicting agendas have had a visible hand in defining the implementation of the decentralization program. From the outset, Parliament modified the draft legislation to accommodate demands from producing regions for a share of onshore oil and gas revenues. In addition, the legislation established a floor of 25 percent of domestic revenues (including all oil and gas revenues) for transfers to regions through a General Allocation Fund aimed at supplementing local revenues and equalizing regional needs and revenue capacities. The appeasement of regional interests (especially relating to oil and gas-rich districts) created an inconsistency in the approach. Furthermore, while Law 22/99 remained vague on functions to be transferred and the process to be adopted, Law 25/99 assured financing for subnational administrations without linking resource sharing to delivery of services. This dichotomy increases the risks from decentralization in that financing has been assured before the effective devolution of responsibilities – which may have to continue to be borne by the center.

Decentralization, nevertheless, offers considerable opportunities for better governance. In principle, decentralization could improve the local provision of public goods, tailored to local preferences and local responsibility. Combined with more efficient taxation and spending, this should bring greater prosperity to all regions. To actually realize these benefits, however, international experience suggests that decentralization must be properly sequenced and phased. Ill-sequenced reforms can threaten service delivery and result in "capture by local interests," thereby threatening good governance.

Moreover, unless implemented to be fiscally neutral, decentralization could jeopardize Indonesia's hard-earned stabilization by substantially increasing deficits of general government.

There are many different ways to manage the decentralization process. Political realities and the conflicting perspectives on decentralization generally shape the outcome, as is the case in Indonesia. Yet international experience often provides no more than a guide as to appropriate sequencing. However, inappropriately designed institutions may make the overall economy less able to cope with external shocks. While the hierarchical and cooperative relationships characterizing Indonesian society may help offset some of the inherent problems (see Hofstede, 1991), traditional response mechanisms may not reflect future responses in a completely different political environment, with conflicting interests and incentives. Political issues – particularly the pressures for sharing of revenues – could divert attention from proper sequencing of decentralization measures.

This paper focuses on the key issues that need to be addressed in order to achieve the desired decentralization in a systematic manner, and thus secure the benefits without endangering either macroeconomic stabilization or Indonesia's territorial integrity.

Institutional setting

Under Suharto's "new order" regime that governed Indonesia from 1965 through 1999, the country had a very centralized government, albeit with a veneer of decentralization. Law 5/1974 provided the framework for decentralization, but there was little implementation or effective devolution of authority to lower levels of government. Formally, there were three main levels of government: the central government, twenty-seven provinces, and 333 districts. In practice, the center dominated all levels. Indonesia was more a model of deconcentration than of decentralization, with central government exercising significant control over the appointment of local officials and uses of funds by these officials (Shah, 1999).

After decades of highly centralized diktat, the movement toward multiparty elections, particularly at central and district levels, should lay the foundations for greater accountability in government operations and improved efficiency in the delivery of public services.[2] Although the political reforms are important in setting the stage, the sequencing and design of the devolution of administrative responsibilities and financial arrangements will be critical in ensuring macroeconomic stability and integrity of the Indonesian State.

The Habibie Government enacted Laws 22/99 and 25/99, responding to pressures for more autonomy, while aware of the fault lines that provincial boundaries might offer to separatists. Thus, the legislation focused on decentralization at the district level.[2] This arrangement also suited bureaucrats in Jakarta since the central government is likely to have more influence over relatively weak districts than over strong provinces. This approach provides the central government a natural role to arbitrate between districts and provinces. However, the negative experience with Law 5/1974 led Parliament to impose a tight deadline for implementation (by June 2001). The specified minimum revenues to be transferred, and district-level decentralization were seen as a way to diffuse separatist tendencies in the natural resource-producing regions.

Law 22/99 assigns all government expenditure functions to districts except for finance, foreign affairs, defense, religion, and state administration.[3] Under Law 22/99, the provinces have no hierarchical authority over districts, and perform largely coordinating tasks. Also, in the transition period, provinces may undertake tasks that specific districts may not be in a position to perform. Article 11 of Law 22/99 spells out the functions that the district *must* perform – and which cannot be handed back to the province – including education, health care, and local infrastructure.

The Wahid administration, relying on regional parties, reinforced the decentralization process. Despite the backing of the President, progress on implementation was stalled by disagreement on either a "big bang" decentralization to districts (as provided by Laws 22/99 and 25/99), sequenced decentralization to districts, or initial decentralization to the provinces. After some discussion that might have led to a modification of the legislation leading to decentralization to provinces, the opposition from key players within the Government led to implementing Laws 22/99 and 25/99 and rapidly devolving responsibilities to districts without modification. The functions to be decentralized to districts are thus defined by default.

The risks

Given the political imperatives, the challenge for Indonesia is to draw on the international experience to maximize the benefits and minimize the risks of the decentralization process. Litvack *et al.* (1998) argue that *design flaws are responsible for failures of decentralization*. Hommes (1995) argues that local governments overspend when they have relative budget autonomy, but do not have to raise taxes to support their spending. There can be little accountability if local administrations do not have the ability to modify tax rates: they cannot finance additional expenditures from taxation at the margin that impinges on their own residents (Brosio, 1997). Under the decentralized structure, Indonesia local governments do not have control over rate structure for a major source of revenue, including the property tax, a common source of local-owned revenues in many countries.

Other challenges include: provisions to safeguard public services by building local capacity and pooling skilled technical staff; ensuring fiscal neutrality; and establishing an effective budget and public expenditure management system to achieve properly sequenced decentralization *function should follow capacity; revenue should follow functions; and decentralization should be deficit neutral*, that is, resources transferred from central to district and provincial governments should match the expenditure transferred. If districts fail to deliver assigned services, the central government may need to step in, at a cost to the budget, to avoid service disruptions. This may happen if, for example, districts take responsibility for control of tuberculosis but lack trained staff to follow up. Such improperly sequenced decentralization may lead to a reversal of the decentralization process (Shah, 1999).

Deficit neutrality would suffer with an expansion of spending financed by subnational borrowing based on guaranteed revenue shares or transfers, as has occurred in several countries in Latin America (Ter-Minassian, 1997). To avoid these pitfalls, there have to be sufficient prudential or legal safeguards, especially where capital markets are not sufficiently developed to provide appropriate signals or a disciplining role. Moreover, the Ministry of Finance has to be sufficiently strong (Von Hagen, 1992).

Macroeconomic imbalances

A mismatch between revenues and expenditure functions devolved to regional governments can have serious fiscal implications. Decentralization would lead to a 50 percent increase in transfers to regional governments. For this to be fiscally neutral, the transfer of expenditure responsibilities to regional governments should amount to at least

1.7 percent of GDP. Initial estimates suggested that the provinces would need to take on activities equivalent to about 0.3 percent of GDP, whereas districts would need devolved functions amounting to 1.4 percent of GDP.[4]

In the medium-term, once all the functions assigned by Law 22/99 have been decentralized, subnational public services, estimated at about 6 to 9 percent of GDP, would exceed minimum transfers. However, during the initial stages, it may not be possible to decentralize enough staff and development expenditures to absorb the resources being transferred. This is particularly true for the twenty or so districts, which benefit from the arrangements for sharing of natural resource based revenue (see below). In these districts, the local authorities may be under irresistible pressures for new, possibly unproductive, spending.

Even after the transition period, a mismatch between the additional transfers and the functions could jeopardize continued public services in the majority of districts that do not benefit from the natural resource sharing arrangements and possibly also the transfers, as well as some resource rich but sensitive regions.

Expenditure assignments and service delivery

In the Suharto era, Indonesia relied extensively on "deconcentrated" expenditure functions – that is, most public services provided at the local level at the behest of the center, usually with staff paid for directly by the center. Financing came through a plethora of special purpose grants.[5] Local administrations had little in the way of own-source revenues, and even the property tax was administered by the center and shared with local administrations. The new legislation focuses on devolving expenditures to districts, but is not sufficiently explicit in this regard.

The Governance Law 22/99 requires that virtually all functions be transferred to districts in 2001. It contains the only references to the *devolution of expenditure responsibilities*. These are defined in very general terms, assigning most functions to the regency/district level – including "public works, health, education and culture, agriculture, communications, industry and trade, capital investment, environment, land, cooperative and manpower affairs (Governance Law, Article 11)." This very broad allocation of responsibilities does not carry much operational significance, and a more detailed specification, taking into account administrative capabilities, needs to be developed.

Another issue, insufficiently developed in the present legislation, is the role of the central government in determining policy objectives, such as minimum standards for education, health or the safety net, and the implications these policies may have for financing issues (where these policies affect sectors allocated to lower levels). Given that in the past most of these public services were performed through "deconcentrated" delivery, a minimum requirement for effective continuation of these services into the "decentralized" era would entail that the deconcentrated staff previously employed by the center needs to be reassigned to lower-level administrations. As in other countries, such as Colombia, there may be difficulties in attempting to "unload" centrally paid staff onto local administrations. First, staff show resistance to permanent assignment to district level jurisdictions, with which they have few ties. Second, there may be resistance in the regions to take on such staff, partly because these staff tended to represent Jakarta or come from different ethnic backgrounds. Thus, replacing the entire staff providing current central or deconcentrated functions may not be feasible in the short- to medium-term. To compound the problem, most civil servants outside Jakarta are in provincial capitals and may resist being relocated to districts with even fewer amenities. Moreover, it is unlikely that the replacement staff hired in the districts would have the requisite skills to ensure effective and continued service delivery.

In the short run, appropriate sequencing would suggest that functions, together with the requisite staff, be devolved to the districts and provinces, and that the transfers be sufficient to cover these costs. In the medium-term, the devolution of functions provides an opportunity to evaluate improvements in the efficiency of existing public programs, reorienting them more toward the poor, and improving their delivery including through greater private sector participation. This should then become the foundation for more efficient service delivery. This sequencing to changing employment patterns is contentious because local governments see decentralization as a means of creating jobs for locals.

One consequence of this lack of attention to continuation of service delivery is that the central government is likely to face a large bill for social expenditure on subsidies, social safety nets, and poverty alleviation programs, that under Law 22/99 are the responsibility of the districts. To address this problem, the National Planning Board (BAPPENAS) would need to formulate proposals to transfer these functions to the districts.

Indeed, the political process that has driven decentralization makes it difficult, at least initially, for Indonesia to seize the potential welfare gains from improved service delivery more attuned to local needs. Instead, this lack of planning of expenditure assignments raises risks to service delivery. Thus, a process that should have been driven by local consultations may, in the end, require strong central direction to enable a smooth transfer of services.

Arrangements for financial management

In the centralized model of the Suharto era, there was little need to develop a capacity for local financial management. Since most of the financing was through special-purpose grants administered by centrally appointed officials, there was little attention to information on actual current spending – generally put together by the Ministry of Home Affairs and made available to the Ministry of Finance with a substantial lag, usually up to two years for expenditures at the district level. The quality of information produced is not verified. The flow of information is not timely, nor suited to provide early warning signals when corrective action might be warranted. These issues have been even more neglected than expenditure assignments. As a result, the central authorities may be unable to monitor outlays, assess the needs of districts and track the use of transfers. The absence of appropriate budget information systems adds to the risks of a breakdown in service delivery. To address this gap in preparations for decentralization, the central government would have to minimize risks of a breakdown in budget management.

Unfortunately, even the expenditure management system at the center is weak, with numerous extrabudgetary funds and poor cash management, accentuating a lack of transparency that has led to numerous avenues for the misuse of resources. As the decentralization process unfolds, the center is attempting to strengthen its treasury functions and the functioning of a treasury single account. Once the central treasury is fully functional, it could provide services also to district level administrations that may lack the resources to establish independent treasury and payment systems of their own.

The lack of transparency in public expenditure management at the center threatens to complicate revenue-sharing arrangements, and there is evidently considerable scope for disagreement. Reform needs to focus on monitoring and control to minimize possibilities of mismanagement or graft and to provide early warning of potential disruption in public service delivery.

The center needs to establish standard budgeting, auditing and reporting procedures for all local budgets, and mechanisms to monitor the sharing of natural resources revenue and transfers.[6] Central government should require subnational governments to adopt standardized mechanisms for enhancing transparency and accountability.

The fact that the legislation provided no safeguards against excessive subnational borrowing is particularly worrying, especially given the contingent liabilities facing the center and the overall level of general government debt and contingent liabilities (e.g. for bank restructuring) as the decentralization is implemented.

To help monitor fiscal decentralization during the execution of the budget, regulations should be issued to link the release of revenue sharing and General Allocation Fund allocations to the submission of reports on district/provincial budget execution, and to sanction districts and provinces that fail to submit timely, accurate, and comprehensive fiscal reports. In addition, systems are needed to monitor development and social spending at the district level. In particular for effective monitoring of special purpose transfers, the center would need to establish the performance it is expecting from local governments for each devolved function, including minimum reporting standards.

Subnational taxes and charges[7]

Provincial and local taxes and charges are principally regulated by Law 18 of 1997 (Law on Regional Government Taxes and Charges) which came into effect during 1998, rationalized local taxes, and eliminated a number of nonproductive taxes and charges. Under the law, the taxes assigned to provincial governments include the motor vehicles transfer tax; motor vehicles registration tax; and fuel tax. The rates for these taxes are set by the central government, within ranges specified in the law. The motor vehicle transfer tax, the largest source of provincial tax revenue, is levied at the time of resale of a motor vehicle. Currently, the first sale is taxed at 10 percent of the value, while subsequent sales are taxed at 1 percent of the value. The motor vehicle tax is an annual tax on the value of the vehicle. The current tax rate is 1.5 percent. For both taxes, the determination of value is done by the MOHA periodically and made available to provincial governments who then collect the tax. The fuel tax is a new provincial levy at 5 percent shared with district governments.

District governments are authorized under the law to levy a number of small taxes: hotel and restaurant tax; entertainment tax; advertisement tax; street lighting tax; base mineral extraction tax; and water tax. Districts have some flexibility in choosing rates for these taxes within specified maxima, but changes must be approved by the MOHA after consultation with the MOF.[8]

Although districts receive most of the revenues from the land and property tax, they have no control over the rate structure and it is like a shared source of revenue administered by the center. The complicated sharing arrangements for the land and property tax are designed to introduce "equalization" elements into the tax. However, this equalization function would become redundant with a large general allocation transfer (exceeding the combined revenues from the land and property tax), also distributed on the basis of "equalization" principles.

The Fiscal Balance Law 25/1999 also introduced revenue sharing for oil and gas. For onshore oil, 15 percent of non-tax revenues are to be distributed to subnational governments, of which 3 percent to the producing province, 6 percent to the producing district and 6 percent to be shared by nonproducing districts in the producing province. For onshore gas, 30 percent of the non-tax revenues is to be shared, of which 6 percent to the producing province, 12 percent to the producing district and 12 percent to the nonproducing districts in the producing province. This formulation is relatively opaque, further complicated by the inclusion of offshore oil within 12 miles. Also, the nonproducing provinces may need to be compensated by an "equalization" transfer system that reduces the interregional disparities created by the oil and gas sharing formula.

This arrangement is opaque, subjects the local producing governments to the full variance in international oil and gas prices, and may be implemented before the expenditure devolution is effective, thereby providing revenues to some districts that they may not be able to use effectively. In the absence of effective safeguards and monitoring mechanisms, the possibilities for misuse of resources are magnified.

It is not a priori evident that the sharing of resources with a producing region will in itself satisfy the aspirations of separatists – since by definition they could always do better by keeping all the revenue generated in the region. Thus, for the center and the producing regions it may be difficult to establish the politically acceptable level of resource sharing, particularly of oil and gas revenues, and there is plenty of scope for building up further resentment. National unity would thus have to rest on other factors, such as the services that the center could provide with greater efficiency, national defense and the fact that the center is, in principle, better able to smooth expenditures given its access to many sources of revenues, and the volatility of natural resources prices.

In addition to adding to "unsatisfied aspirations," the sharing of oil and gas could:

- actually widen regional disparities;
- prove difficult to administer, particularly at district level, as volatile oil prices lead to a divergence between budgets and realized revenues;
- in some cases may provide more revenues to nonproducing districts in a province than producing districts;[9] and
- complicate the functioning of a grants system.

Yet, special provisions may need to be found to "compensate resource-rich regions," and encourage them to stay part of Indonesia, akin to the asymmetric decentralization in many parts of the world. One way of addressing the dilemma could be to emphasize improvements in public services as the main objective of decentralization. Within the context, the central and regional governments in resource-rich districts could agree on the targeted improvements to be achieved.

The Decentralization Legislation Laws 22/99 and 25/99[10]

Macroeconomic context

Ahmad *et al.* (2001) provide an illustrative scenario of the macroeconomic effects of the proposed decentralization of public finances to the regional level. Many of the calculations are based on assumptions rather than stated policies, and the results should therefore be interpreted with great care. For simplification, regional government is treated as one level.

The regional share of general government spending will eventually more than double to over 40 percent with full implementation (Figure 14.1). Some 60 percent of the development budget will be managed at subnational levels. Under the framework, the districts will manage most of the government's services, including health, education and infrastructure. Regional tax revenues, however, will rise only slightly, and the difference be made up by grants from central to regional governments. The largest component is the General Grant (Alokasie Umum), which will consist of least 25 percent of domestic revenues (Figure 14.2).

The general grant and regional own resources will have to cover some of the development expenditures devolved to the regions. Overall, regional development spending will rise to some 4 percent, whereas specific grants from central government are unlikely to be higher than 2 percent of GDP. The general grant of some 3.8 percent of GDP will cover personnel spending (2.5 percent) but leaves only 1.3 percent of GDP as a contribution to development spending. Thus, some 0.7 percent of GDP will have to be covered by own revenue sources, and borrowing. Regions without oil, gas or forestry, resources will find it difficult to finance their decentralized expenditure responsibilities. For now, the assumption in the projections is no local borrowing. The implicit assumption here is that international borrowing is done by the center, and passed on to the province as a specific grant. This is not a realistic assumption, but it is likely that – if the regions can borrow from abroad – their special grants would be reduced. Any domestic borrowing is not taken into account in the projections. Own revenues may increase in the future (e.g. by devolving control over the rate structure of the land and building tax), but this is likely to be offset by a cut in special grants.

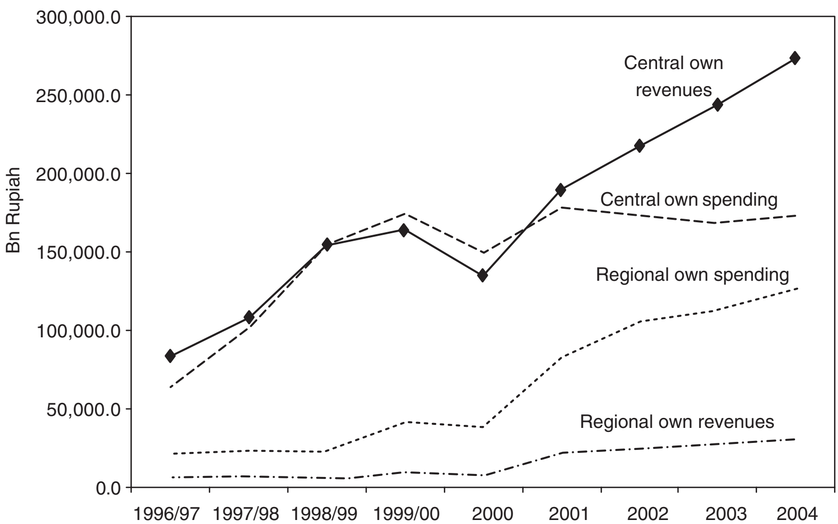

Figure 14.1 Regional share of general government.

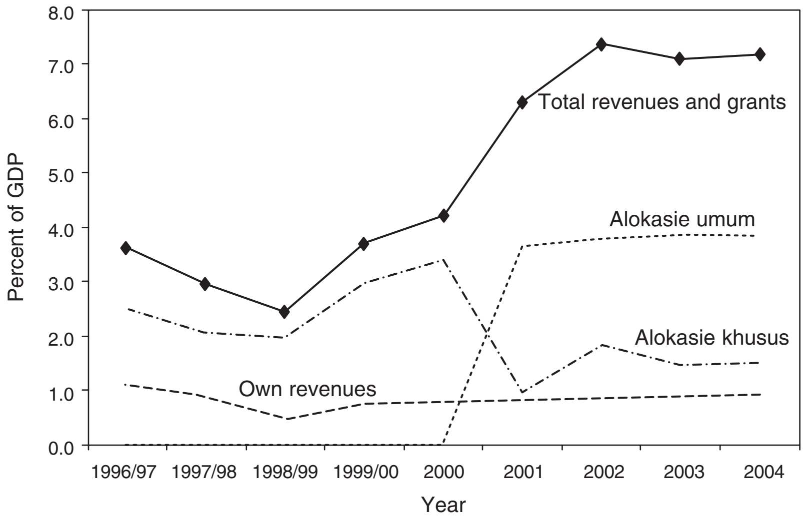

Figure 14.2 Regional revenues.

Vertical fiscal imbalances

Using data from the state budget and estimated provincial and district budgets for 1999/2000, three scenarios are undertaken:

1 "*Pre-reform policy*," as implied by the 1999/2000 central and subnational budgets;
2 "New policy under existing expenditure assignment," which shows the additional budgetary deficit or surplus that would be generated by the implementation of the Governance Law at each level of the government, if the pre-reform division of expenditure responsibilities is unchanged; and
3 "*New policy under reassignment of expenditure responsibilities*," which shows the extent to which central government expenditure responsibilities have to be devolved to local levels, if each level of the government is to maintain its current level of fiscal deficit.

The simulation results (see Table 14.1) suggest the following:

- The rules for oil and gas revenue sharing and general allocation *will significantly increase the central government deficit* (or require a sharp reduction in central government expenditure).[11]
- Under the expenditure assignments and budget estimates for 1999/2000, the implementation of the new legislation increases the central government deficit by about 1.2 percent of GDP, as a result of the oil and gas revenue sharing and a sharp increase in general allocation transfer.[12] Alternatively, if the central government is to maintain the budgeted level of deficit, it has to transfer expenditure responsibilities of about 1.2 percent of GDP to lower level governments in 1999/2000 terms.

Table 14.1 Impact of the Fiscal Balance Law using 1999/2000 data (in billions of rupiah)

	Old policy[a]	*New policy*	
		Old expenditure assignment[b]	*Reassignment of expenditure responsibilities*[c]
Central government			
Domestic revenue	142,204	142,204	14,204
Expenditure and transfer	219,604	231,518	217,694
Expenditure	190,337	190,337	176,513
Transfers	29,267	41,181	41,181
General allocation	23,637	35,551	35,551
Special allocation	5,630	5,630	5,630
Oil and gas sharing	0	1,910	1,910
Deficit	77,400	91,224	77,400
Provinces (excluding Jakarta)			
Revenue and transfer	9,068	9,283	9,283
Own and shared revenue	3,661	3,661	3,661
Oil and gas revenue	0	382	382
Transfers	5,408	5,240	5,240
General allocation	3,687	3,520	3,520
Special allocation	1,721	1,721	1,721
Expenditure	9,068	9,068	9,283
Deficit	0	(215)	0
Districts and lower (excluding Jakarta)			
Revenue and transfer	29,205	42,695	42,695
Own and shared revenue	5,700	5,700	5,700
Oil and gas revenue	0	1,528	1,528
Transfers	23,505	35,467	35,467
General allocation	19,714	31,676	31,676
Special allocation	3,791	3,791	3,791
Expenditure	29,205	29,205	42,695
Deficit	0	(13,490)	0
		(In percent)	
Memorandum items			
General allocation as percent of domestic revenue	16.6	25.0	25.0
Provincial general allocation as percent of total general allocation	15.6	9.9	9.9
District general allocation as percent of total general allocation	83.4	89.1	89.1
General allocation to Jakarta as percent of total general allocation	1.0	1.0	1.0
		(In billions of rupiah)	
General allocation to Jakarta	236	356	356
Special allocation to Jakarta	118	118	118

Source: Ahmad *et al.*, 2001.

Notes

a Provincial and district level data for "current policy" are estimates based on 1998/99 budget data and previous years' budget outcomes, and do not necessarily match the 1999/2000 budgets.

b Under existing expenditure assignment, deficit is treated as residual.

c Under reassignment of expenditure responsibilities, expenditure at each level of government is adjusted to maintain the budgeted level of deficit.

Existing horizontal imbalances

Indonesian local governments' capacities to raise revenue from their own sources and revenue-sharing arrangements vary significantly. In 1996/97, per capita own-source revenue and shared revenue in East Kalimantan (including provincial and district levels) was 5.4 times that in Nusa Tenggara Barat. If Jakarta were included in this comparison, the ratio of maximum to minimum level of per capita own-source and shared revenue among provinces would reach 27.

Local expenditure needs also differ vastly across provinces and districts. For example, at the provincial level, life expectancy ranged from 55 years in East Nusa Tenggara to 70 years in Jakarta in 1997; poor quality roads as a proportion of the total length of provincial roads ranged from 24 percent in Sulawesi Selatan to 70 percent in Kalimantan Barat in 1997.[13] It is expected that even larger variations in expenditure needs exist across districts and municipalities.

The old transfer mechanisms, including the Regional Development Funds and Routine Expenditure Funds for decentralized staff salaries (SDOs), contain some elements that are designed to equalize revenue capacities and compensate for differences in expenditure needs across regions. However, the *transfer system was highly segmented*, with many subprograms distributed on a range of different, and sometimes conflicting criteria, resulting in a very weak equalization effect on local governments' abilities to provide public services, and may even be *disequalizing* when measured by revenue capacity.

Based on provincial data, simple regressions show that the per capita transfer to provinces in 1997/98 was positively related to per capita own-source and shared revenues (Chart 14.1), and had no statistically significant relationship with per capita GDP. A similar analysis using district level data for 1996/97 suggests that per capita transfers to districts were significantly and positively correlated with per capital own source and shared revenues and had no relation with per capita GDP.

The Fiscal Balance Law and horizontal (dis)equalization

The sharing of oil and gas revenue, as required by the Fiscal Balance Law, would further disequalize regional revenue capacities, as the sources of oil and gas revenue are concentrated in a small number of provinces and districts. According to the law,

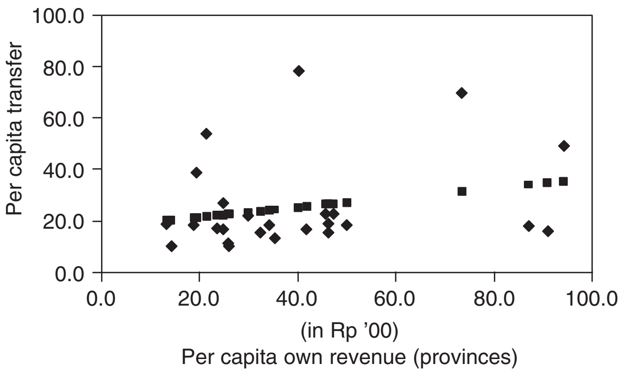

Chart 14.1 Disequalization under the current transfer system.

3 percent of onshore oil revenue will be distributed to provincial governments based on production origin, 6 percent will be distributed to the producing districts, and the other 6 percent will be distributed to nonproducing districts in the producing province. Similarly, 6 percent of onshore gas revenue will be distributed to provincial governments based on production origin, 12 percent will be distributed to the producing districts, and the other 12 percent will be distributed to nonproducing districts in the producing province.[14] Based on very conservative assumptions of oil and gas prices, it is estimated that, if the law were implemented fully for the 1999/2000 budget, about Rp 2 trillion would be distributed to local governments as a result of the oil and gas revenue sharing, and three provinces (Riau, East Kalimantan and Di Aceh) would receive about 82 percent of the total local share. For Riau and Di Aceh, the provincial governments' oil and gas receipts would amount to 70–80 percent of their existing revenue capacities. In the meantime, twenty-one provinces would receive almost no oil and gas revenue.

Table 14.2 Revenue capacities of provincial governments, 1999/2000 (in thousands of rupiah)

	Per capita existing revenue capacity	*Per capita oil and gas revenue*	*Per capita total revenue capacity*
Dista Aceh	18.99	16.60	35.59
Sumatera Utara	22.66	0.11	22.77
Sumatera Barat	18.65	0.00	18.65
Riau	53.71	40.58	94.29
Jambi	21.57	1.54	23.10
Sumatera Selatan	20.29	2.88	23.16
Bengkulu	18.56	0.00	18.56
Lampung	10.38	0.00	10.38
Jawa Barat	16.83	0.67	17.50
Jawa Tengah	13.31	0.00	13.31
DI. Yogyakarta	22.99	0.00	22.99
Jawa Timur	18.40	0.36	18.77
Kalimantan Barat	16.57	0.00	16.57
Kalimantan Tengah	48.10	0.00	48.10
Kalimantan Selatan	26.69	0.00	26.69
Kalimantan Timur	78.01	39.49	117.49
Sulawesi Utara	15.50	0.00	15.50
Sulawesi Tengah	18.03	0.00	18.03
Sulawesi Selatan	18.52	0.03	18.55
Sulawesi Tenggara	15.39	0.00	15.39
Bali	38.97	0.00	38.97
Nusa Tenggara Barat	11.08	0.00	11.08
Nusa Tenggara Timur	10.28	0.00	10.28
Maluku	16.77	0.06	16.83
Irian Jaya	69.60	1.99	71.59
Mean	25.2	4.0	29.2
Standard deviation	17.8	11.1	26.3
Coefficient of variation	0.70	2.77	0.90

Source: Ahmad *et al.*, 2000.

Note: Jakarta is excluded from the above table as available statistics do not distinguish between its provincial and district functions.

The sharing of oil and gas revenue exacerbates horizontal differentials with the coefficient of variations across twenty-six provinces (excluding Jakarta) increasing from 70 to 90 percent due to the oil and gas revenue sharing. In other words, the average deviation of per capita revenue capacity from the national mean would rise by nearly 30 percent (see Table 14.2).

Despite the obvious need for an equalization transfer, care has to be taken to ensure that the initial allocation of funds does not vary too greatly from the distribution of public service expenditures – to prevent a major disruption in the delivery of such services.

Conclusion

The focus on rapid decentralization approach of the authorities may not be adequate to stem separatist pressures, and could exacerbate vertical and horizontal disparities. However, some asymmetric decentralization may be required for political reasons. This argues for limiting the sharing of natural resources revenue while emphasizing improved service delivery over transfer of revenue. Specific conclusions include:

- The absence of emphasis on service delivery and concentration on resource allocation raise the risks of local capture and increase the fiscal risks. These risks are magnified by weak management and uncertain political accountability at the local level.
- The magnitude of expenditure devolution required by the law would be overwhelming, especially considering the limited administrative capacities at the district level.
- Implementing the proposed oil and gas revenue sharing and a full 25 percent of domestic services for general allocations ahead of expenditure devolution, is likely to lead to a substantially larger consolidated fiscal deficit.
- If this process is not managed with prudence and skills, it could pose a threat to macroeconomic stability. Sharing of oil and gas revenue and moves toward a larger share of domestic revenues for the general allocation should be gradually phased in over a period of time.

Thus, decentralization needs to be carefully sequenced, based on a detailed expenditure devolution plan, and adequate own-source revenue to facilitate accountability.

Acknowledgments

This paper draws on joint work with Bert Hofman (World Bank), see Ahmad *et al.* (2000). Helpful comments from Ke Young Chu are gratefully acknowledged.

Notes

1 Laws 22/1999 and 25/1999, respectively.

2 Lower levels of government are known as regions. Provinces are allocated few decentralized responsibilities, and serve as a coordinating layer, but without authority over the tertiary tier, and as agents for the central government for "deconcentrated" central functions. The third tier is composed of districts (also known as regency regions) and municipalities, and will be the main decentralized level of government, with elected regents and mayors. Since provinces are

to function also as agents of the center, the appointment of provincial governors requires Presidential approval.

3 The law mandates exclusive authority for the central government over "the fields of international policies, defense and security, judicature, monetary and fiscal, religion, national planning, and macronational development control, financial balance fund, state administration and state economic institutional systems, human resources development, natural resources utilization as well as strategic high technology, conservation, and national standardization."

4 Ahmad *et al.* (2001) for a detailed assessment of the fiscal implications of Laws 22/99 and 25/99.

5 See Anwar Shah *et al.* (1994)

6 The General Allocation Fund (GAF) and special allocations.

7 This section is largely based on Ahmad and Krelove (2000).

8 In addition, Article 2 of the law allows local and provincial governments to introduce new taxes by local regulation, subject to approval by the MOHA, provided they meet a number of criteria.

9 This would depend on the number of nonproducing districts receiving transfers relative to the number of producing districts in a province.

10 This section draws on Ahmad *et al.* (2000).

11 The government's medium-term fiscal objective is to restore budgetary balance.

12 The amounts to be transferred are a function of the oil price, which has risen from US$10.5 per barrel (assumed in the 1999/2000 budget estimate) to over US$30 per barrel by mid-2000. A US$1 per barrel increase results in a 0.1 percent of GDP increase in revenue net of oil subsidies, most of which is transferred to the local governments.

13 Per capita GDP is sometimes used as a proxy of revenue capacity, or a partial indicator for social and development expenditure need.

14 The Law, however, does not specify the method for distributing the 6 percent oil revenue and 12 percent gas revenue to nonproducing districts.

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15 Decentralization in Africa

Giorgio Brosio

Introduction

Is Africa a convenient unit of analysis for decentralization? Possibly not, considering that countries in Africa are extremely diverse. They have, though, two features in common: poverty and fragile democratic institutions. Africa represents a challenge to the process of decentralization worth analyzing and following closely. Since the process started recently and evidence is scanty, drawing conclusions requires caution. This paper deals with two broad issues.

The first is how realistic are the rather ambitious goals for decentralization in Africa, in particular the eradication of poverty through specific interventions and growth-promoting policies. Proponents argue that where institutional capacity is weak, democratic institutions are fragile, and resources are scarce, caution is needed. Otherwise, vested interests and the non-poor may easily capture policies targeted to the poor. The interests of the poor are well provided for on a durable basis, when decentralization improves efficiency in the provision of basic local services and starts eliminating the huge disparities among the various areas of the same country. To reach these goals, the working of political institutions and the structure of decentralized government must meet several conditions.

The second set of issues focuses on these conditions, particularly on the setup of each territorial government, the assignment of responsibilities, and the financing of the newly created units. Evidence is also presented to show a number of weaknesses and critical points, as well as improvements, limited to the small number of countries where the process of decentralization is well underway.

Current trends: opportunities and risks

Decentralization is transforming the structure of governance in Africa. Since the middle of the 1980s most African countries have begun to transfer power, resources and responsibilities to their subnational governments. The pace of transformation is very uneven among countries. A few countries – namely, Ethiopia, South Africa and Uganda – are proceeding fast. A number of countries have just started the process and are presently creating new units and/or transferring responsibilities and revenues to those units. A large group has only adopted legal texts that engage the central government's process towards a more decentralized system. Finally, in a few countries decentralization is still at the stage of announcing the policy (see Tables 15.A1 and A2 at the end of this paper for a summary of the decentralization processes).

In almost every country, the re-introduction of decentralized government and/or its strengthening is taking place along with popular elections for local councils, mostly on a multiparty basis. As in other continents, the most important determinant of decentralization in Africa is the introduction of, or the return to, democracy.

Proponents of decentralization – who include most donors – have sought to achieve a number of different aims. At one end of the spectrum, "citizen-regarding" governments (and donor organizations) consider decentralization a practical way to (a) bring services to hitherto neglected peripheral areas, (b) obtain a more equitable distribution of public services, and (c) increase popular participation in policy choices. At the other end, "self-regarding" central governments consider decentralization mostly as a way of reducing the burden of unpopular structural adjustment programs on national politicians by offloading service responsibilities to subnational governments. To complete the picture, one also has to add the existence of a bandwagon effect. Decentralization is, nowadays, a popular process worldwide. National politicians may be tempted to experiment with it, hoping that its adoption will increase their popularity at home, even if they have to cede some power.

Africa shows an impressive institutional creativity. Two countries, Ethiopia and South Africa, have chosen a federal, or quasi-federal system. Nigeria, which used to be the only federal state in Africa, has adopted a new constitution that maintains the federal framework and gives more powers to its subnational governments. A number of countries in the east and the west of the continent have chosen a multilayer system. More specifically, an intermediate layer has been inserted between the central and the local governments. In other countries, decentralization means strengthening existing local government units in the urban areas and creating new units in the rural areas. This amounts to the revitalization of the two-tier system that prevailed in these countries in the immediate aftermath of independence. In general, rural areas are receiving priority over the urban ones in the current decentralizing trends in Africa.

Differences in institutional solutions are a response to different political pressures, both internal and external. In general, where strong ethnic rivalries are felt, as in Ethiopia, a federal system is considered an effective way of attenuating those rivalries and keeping the country together. In a number of countries, such as Mali, Madagascar, and Senegal, a new regional government – that is, the introduction of an intermediate layer between the central and the local government – is a response to the demand for more autonomy from some areas of the country, as well as for a more equitable distribution of national resources.

Previous centralized systems

It becomes easier to understand the popularity of decentralization in Africa when we return to the point of departure: the highly centralized model of territorial government prevailing in Africa before the late 1980s and early 1990s. More precisely, the system was based on several variants of hierarchical deconcentration, associated with an authoritarian/dictatorial political regime. This combination of administrative centralization with a nondemocratic political framework created, in most cases, an increasingly unaccountable and corrupt system. Basic infrastructure maintenance and service provision were neglected in the rural areas and the resources devolved to local government were concentrated in urban areas, particularly in the capital city.

Table 15.1 Relative weight of local government budget in selected West African countries 1992

	Benin	*Burkina Faso*	*Cameroon*	*Côte d'Ivoire*	*Senegal*
Share of GDP of central government	13	15	18	23	20
Share of GDP of local government	0.3	0.3	0.8	0.9	0.9
Local government as a share of central	2	2	5	4	5
Largest city (metro area):					
Share of total local expenditure	73	66	68	65	71
Share of national population	11	8	8	22	22
Second largest city:					
Share of total local expenditure	10	22	17	6	3
Share of national population	4	4	7	4	3

Source: Farvacque-Vitkovi and Godin (1998).

In the few cases where representative democracy survived, only the big cities maintained some sort of autonomously elected government. On the fiscal side, subnational governments had to rely on their own sources of revenues.

Table 15.1 refers to a select group of West African countries at the beginning of the 1990s. It shows both the paucity of subnational resources, amounting to generally less than 5 percent of central government expenditure, and their concentration in the capital city and other big cities. For example in Senegal, one of the very few countries that has maintained democratic traditions, subnational expenditure has amounted to no more than 5 percent of central government expenditure. Three-fourths of that 5 percent was spent on the two largest cities – Dakar and Tiès – which accounted for 25 percent of the total population of Senegal. In other words, levels of service provision were, *ceteris paribus*, nine times higher in these cities than in the rest of the country. It is also worth mentioning that per capita subnational expenditure amounted to approximately $10 per year in Senegal.

Decentralization and democracy: potential and risks

The relationship between democracy and decentralized government is multifaceted and fragile in Africa. The return to democracy and governments' commitment to it are still partial in a number of countries. Electoral competition and basic political rights are still restricted and effective political change has yet to come in many countries to allow their transformation into a workable decentralized system.

Secondly, even though there is widespread evidence that decentralization fosters democracy, we also have to take into account that, especially in poor, underdeveloped countries with little or no tradition of democratic practice, decentralization may work against democracy. This happens, for example, when control of the decentralized government is captured by corrupt nonaccountable elites.

Thirdly, using federalism or decentralization to alleviate ethnic rivalries and to satisfy demands for autonomy from the various areas of a country entails risk. Democratic elections at the regional level may catalyze the expression of divisive demands and exacerbate interregional and interethnic competition for central resources.[1] Problems may become more acute in countries with huge but regionally concentrated reserves of natural resources. A decentralized government institutionalizes and encourages regional demands. In the extreme, it can foster secessionist trends and may, ultimately, tear countries apart.

Finally, democracy may be endangered by wrong macroeconomic policies encouraged by the decentralization process (Tanzi, 1995) and by the creation of excessive expectations. Even with the most efficient decentralization process, the level of service provision will remain very low for a number of years. Most African countries with ambitious decentralization programs have very low levels of tax collection and large central government deficits.

Decentralization and poverty alleviation policies

Most governments in Africa and some proponents of decentralization in developing countries share the view that local government may be a major vehicle for specific poverty alleviation policies, such as the distribution of basic food to the poorest segments of the population or the implementation of growth-inducing policies, through the mobilization of local resources and increased participation.[2] Furthermore, the view is becoming increasingly popular, particularly among donors, that the responsibility for these policies should be assigned to very small local governments, or to informal communities, to avoid the risk, which is substantial where democratic institutions are fragile, of capture by vested interests.

The superiority of decentralized government over a centralized system derives, according to the supporters of this view, from superior information and increased participatory decision-making. Local information flows should make the identification of more effective ways of providing services easier and increase government awareness of local needs, while higher participation rates in local politics should give more voice to the poor in policy choices. In addition, local monitoring should help to ensure that officials perform diligently.

However, in purely analytical terms the greater effectiveness of poverty alleviation policies in a decentralized and democratic delivery mechanism over a centralized, but equally democratic, government is not granted. This is mainly because the poor are at a disadvantage *vis-à-vis* the two elements crucial in this respect: mobility and access to and use of information for their own purposes. As a consequence, local politics and policies may be captured by the non-poor.

Evidence, which is scanty for Africa, also suggests caution. While there are a number of cases in which we can observe both a decentralization process and more effective poverty alleviation policies, there is not necessarily a causality nexus between these two processes. In other words, the conditions of the poor may have improved simply as a result of the re-introduction of democracy and not as an effect of decentralization.[3]

The risk of political capture at the local government level

This problem should not be confused with the more traditional one of the assignment among levels of government of the redistribution branch. The assignment theory deals with preferences and mobility. According to mainstream theory (Brown and Oates, 1987), redistribution should be a central function because of mobility (rich self-interested people would move out of highly redistributing jurisdictions and poor people would move in). Pauly (1973) objected that it cannot be taken for granted that the rich object to redistribution, particularly in a local context in which they can see and enjoy the benefits of these policies.

Political capture does not deal with preferences and mobility. It concerns the ability of the poor to express their voice, that is, the differential risk of being captured by vested (rich) interests at the national or the local level. It may refer to any policy and not exclusively to redistribution. According to the Madisonian tradition (Federalist Papers no. 10), capture by vested interests ought to be greater at lower levels of government. At these levels, minorities and the poor in general would be less protected than in a centralized system. Moreover, at the central level there is more scope for political exchanges and divergent interests (this a common tenet of American history with regard to the abolition of slavery and discriminatory policies).

Recent literature (see e.g. Bardhan and Mookherjee, 1998, 2000) addresses the issue in more precisely analytical terms, but the results show that the extent of relative capture is context specific. Bardhan and Mookherjee analyze the differential impact of political capture by extending a typical model of electoral competition. Responsibility for a given policy – such as an irrigation scheme or the distribution of staple food to the needy – may be assigned to the national or the local level. The national government is constrained to provide the same policy across all districts (this assumption is not always valid, but it works in weak democratic contexts such as those in most developing countries). The country is divided into several districts. Voters are differentiated by income class (rich, poor, middle, etc.). Income status influences electoral behavior. More precisely, voters may be informed and hence determine their vote according to platforms offered by competing political parties, or else uninformed, in which case they are influenced by campaign spending. Information, or as the authors call it, political awareness, is thus a fundamental factor determining political capture. Awareness and capture are related – obviously in opposite ways – to poverty, illiteracy, and inequality.

Assuming a majority system of national elections, and identical districts in terms of the socio-economic distribution of their population, the amount of capture will depend on specific factors. For example, if voters are better informed at the national level, capture will be lower. This will also be the case if the poor can be more easily organized at the national level. Capture may also depend on the number of competing political parties. For example, if all parties compete at the national level but are specialized at the local level – that is, they do not compete in all districts – then capture may be greater at the local level, because pressure groups may target their political contributions more easily.

More interesting and realistic is the case in which districts vary in terms of equality: that is, the poor are concentrated in some districts. In general, capture will be greater in poor districts because there the spending of campaign funds is more effective. The differential of capture between national and local elections remains, however, context specific. It becomes crucial, for example, whether campaign funds have increasing or decreasing returns. When they have increasing returns, lobbies and parties will concentrate all the funds in poor districts and capture at national level will be equal to the highest level of capture across all local governments. Centralization will thus favor capture. If campaign spending has decreasing returns, parties will spend less in poor districts, and win fewer votes in these districts during national, as opposed to local, elections. The contrary holds for wealthier districts.

The relative advantages of very small jurisdictions

One of the Bardhan and Mookherjee study's main conclusions is that capture originates from inequality. Before dismissing the potential merits of a decentralized system, one has to consider how inequality in spatial contexts is related to the size of local jurisdictions. Evidence shows that the smaller the size of local jurisdictions, the more homogenous they tend to be, simply because people with similar backgrounds and interests tend to congregate together. The implication is that capture (of political power by vested interests) should be lower in small communities, or better in communities that are tiny enough to become homogenous. In fact, to alleviate poverty, many researchers and donor institutions favor outright decentralization of powers to small jurisdictions and to more or less formal communities within them.

There is some evidence (Wade, 1997; Bardhan, 1993; Baland and Platteau, 1996, 1999) of successful cooperation in the management of common property resources within local communities. This is because in small groups with similar needs, shared norms and patterns of reciprocity, monitoring is facilitated and sanctions are easier to implement. Thus, common resources that are vital for the poor may be better conserved and maintained by the devolution of power to these communities. Small autonomous communities show better results than central bureaucracies in the maintenance of crucial infrastructure, such as irrigation schemes.[4]

However, the small size-homogeneity argument does not have immediate implications for the design of a decentralized system and we should limit enthusiasm for small communities. Most of the advantages function best for small informal communities and not for local governments, that is, not for formal institutions. Small and informal, communities encourage participation by the poor (see, e.g. Binswanger and Deininger, 1997), and at the same time they do not arouse the interest of the non-poor, to whose benefit capture is engineered.

Very small size, however, also has the disadvantage of lost opportunity. Olson (1971) shows that size and inequality may promote collective efforts, in areas such as the provision of basic local infrastructure or the prevention of over exploitation of natural resources, to the advantage of the poor. In such cases, the rich may be interested in contributing even more than their share to a collective effort precisely because they have a larger stake in it.

Big cities provide an interesting example of the merits of large size. At the turn of the century, cities in industrialized countries witnessed an epoch of hefty investment in basic infrastructure, such as clean water abduction, sanitation and public transport, which clearly improved the lot of the poor (World Bank, 1999a). Given the unavailability of private solutions, the upper classes had a large stake in such projects and were eager to contribute to them by forming alliances with the poor. The urban technology of the time provided an opportunity to form a wide social partnership, because the wealthy could not escape the effects of unimproved urban living conditions. Possibly, the same favorable technological conditions work less effectively today,[5] but it is still worth trying to form broad social alliances for the provision of local public goods that benefit everyone.

To sum up, the advantages in terms of lesser capture of small and homogenous districts may be offset by smaller benefits from collective action.

Bureaucratic capture

Links between corruption and centralized or decentralized forms of government are a popular aspect of studies on corruption. There are, however, no clear results, partly because authors measure corruption in different ways. An example is the estimation of bribes taken on public contracts. Is corruption to be measured by the total amount of resources diverted in bribes, by the number of contracts tainted by corruption, or by the proportionate value of the bribes to the contracts? Clearly the choice of the measurement may lead to different conclusions about the impact of a centralized or a decentralized system. For example, if we measure the extent of corruption by the number of tainted contracts, a decentralized government will fare worse because there are more persons dealing with money and contracts.

Corruption may impact directly on the poor in many ways. It may impact on the sectorial allocation of public resources. For example, it can worsen income distribution by diverting resources from social sectors and infrastructure maintenance to defense and war expenditures. It can also impact geographically, that is, on inter-jurisdictional distribution, by diverting resources away from needy areas.

On a day-to-day basis, corruption can take a heavy toll on the poor by denying or making more expensive access to basic services, such as health or primary education. As we can see, in all these cases we are confronted with exactly the same problems of political capture. The key issue is to ascertain where – at the national or the local level – the poor have better prospects against corrupt practices (in this case, corrupt bureaucrats). As in the case of political capture, the results are context specific and difficult to generalize.

Take the case of a service, such as the delivery of subsidized food by a centrally, instead of by a locally appointed bureaucracy. According to the standard theory, more layers of bureaucracy in a centralized setting should produce more corruption, that is, higher costs of provision and imperfect targeting, especially in less developed countries, where information is harder to obtain. Although some might say that channeling resources through a centralized bureaucracy (instead of a local government) may end up with a greater diversion of resources, because central bureaucrats are more difficult to control (Bardhan and Mookherjee, 1998), we reach less conclusive results regarding the cost effectiveness of the two alternatives. More specifically, if targeting of the poor is less accurate at the local level because of political capture, the total cost of the operation in terms of its results may turn out to be higher in a decentralized than in a centralized system.

Changing priorities with decentralization: review of available evidence

Logically inherent in a decentralization process is a change of regional and sectorial priorities in the allocation of public resources. Evidence of this in Africa is very sparse and covers a very short time. The first issue is regional priorities. Previous centralized/authoritarian systems were generally characterized by a concentration of public resources in the capital city and the surrounding area, which is usually not poor.[6] Decentralization should thus redress this imbalance. Some evidence shows that the geographical redistribution of resources is on the way. For example, geographical redistribution of resources occurs in South Africa where educational expenditure (a provincial responsibility) has grown faster in the poorest and less endowed regions since the start of decentralization and of democratization (Department of Finance of South Africa, 1999a). A similar pattern is shown by Ethiopia, where centrally provided transfers increasingly benefit the poorest regions, whose shares have grown in the recent years (World Bank, l998).

A more poverty-oriented provision of services also requires a sectoral reorientation of public resources. Expenditure on general administration and defense needs to be reduced, while educational and health care need to be expanded. Furthermore, better-targeted intrasectoral interventions are needed. For example, administrative personnel costs should be reduced, while expenditure for textbooks, materials and equipment should be expanded.

Again, the little evidence that exists, on a small number of countries, finds limited improvements that are not exclusively attributable to decentralization. South Africa provides the most easily assessable case. Between 1995–96 and 1998–99, the two major social service programs – education and health care – grew at more than the rate of inflation and faster than total provincial expenditure. As a result, they captured an increasing share of provincial spending, crowding out expenditure on nonsocial services, such as provincial roads, tourism promotion, agricultural development, and economic affairs. Usually, expenditure with a more immediate welfare and distribution impact is preferred to expenditure with longer-term public benefits. However, expenditure data for South Africa show that teachers' salaries have absorbed a growing share of expenditure for education at the same time as expenditure on complementary items such as textbooks, materials, equipment, and teacher-support programs has been cut in real terms.

Table 15.2 shows the allocation of general government expenditure (both federal and regional) following the commencement of the decentralization process. Health and education again show slight increases in their relative shares. Roads seem to benefit most from decentralization. In fact, feeder roads in particular are needed at local level.[7]

Ethiopia shows a similar pattern in the sectoral allocation of public expenditure (see Table 15.3). National and regional money is channeled in Ethiopia, as in most other countries, to the local level where services are produced/provided. Thus, data on the sectoral allocation of general government expenditure give limited information, which has to be improved with information gathered at the local level and with data from appropriate surveys conducted on household (service) consumption. The first provisional data gathered by the World Bank for Ethiopian *woredas* show that salaries absorb a large share of local expenditure for health and education.

This situation is repeated in Uganda, where a survey for health services for 1996 (see Nsibambi, 1998) found the most common problem to be that drugs were not provided to patients. This was because most of the grants transferred to districts for health had been used for salaries. Obviously, local authorities can retort that financing is not sufficient and that money allocated to the central government exceeds what is needed for policy making, planning, inspection, and monitoring.

Table 15.2 South Africa – provincial expenditure by sector

	1995–96	*1998–99*
Social services	83.1	85.9
Education	41.2	41.6
Health	22.1	24.6
Welfare	19.8	19.7
Non-social services	16.9	14.1
Total	100.0	100.0

Source: Department of Finance of South Africa (1999a).

Table 15.3 Ethiopia – functional classification of general government expenditure 1993–94 and 1997–98

	1993–94	*1997–98*
General administration	9.7	10.7
Defence	9.4	7.4
Economic infrastructure	11.9	19.3
Roads	5.3	11.0
Economic services	22.3	19.7
Agriculture	8.0	7.4
Social services	25.7	25.1
Education	14.1	14.7
Health	5.3	6.5
Other	21.0	17.8
Total	100.0	100.0

Source: World Bank (1998a).

Another survey on the preferences of a sample of councilors, quoted by the same source (Nsibambi, 1998), shows that the two main priorities for districts in Uganda ranked as follows: (a) payment of salaries for district civil servants, and (b) payment of councilors' allowances. The same report noted that in many districts councilors were also employees of the district administration. (This is, unfortunately, a worldwide practice). However, the Local Government Act of 1997 of Uganda disallows employees of local administrations from becoming members of district councils. The clear introduction of this incompatibility rule ought to be considered by other countries as well.

Results from a similar survey of a small sample of local authorities (district assemblies) in Ghana show a great deal of disillusionment among citizens (Crook and Manor, 1999). Not only do citizens' preferences (roads rank again at the top) diverge from actual policy choices as shown by the breakdown of development infrastructure, but citizens also rate very poorly the actual performance of their newly elected local bodies. There are, as may be expected, many reasons for this, such as the insufficient skills of the newly elected councilors, the pretended or real lack of resources – district assemblies largely ignore central government pressure to intensify local revenue collection – and the precipitous transfer of too many responsibilities.

Coordination of donors' activities

In some countries, resources from donors cover a substantial share of subnational expenditure, especially in the social sector and in capital expenditure. While obviously welcome, these resources may create problems, unless they are properly managed. For example, in a number of countries one can witness a concentration of resources in a few selected areas, which are not necessarily the neediest, but which are easily accessible and/or have governments that are easier to deal with. Another problem is the insufficient coordination between donors' initiatives, central governments, and subnational recipients. More specifically, donor interventions are frequently focused on the building of facilities and they do not create mechanisms to manage the structures they build or rehabilitate. At the same time, subnational beneficiary governments do not have the recurrent revenue to run the facilities built with donors' funds. Thirdly, donors' priorities may not coincide with those of national and/or subnational governments. The same problems are frequently encountered in dealings with NGOs.

Some of those problems derive from insufficient reporting of donors' initiatives, and some from the direct links between donors and recipient subnational governments that bypass the central government. As decentralization proceeds, local governments increasingly claim that investment projects for local services should be their responsibility; thus, they demand the decentralization of the development budget, where donors' funds are usually included.

The easiest, albeit possibly partial, solution to most of these problems is to include donors' contributions, both in capital and recurrent expenditure terms, within the framework of each country's general-purpose/unconditional transfers system. This could be done, for example, by deducting a share – determined according to appropriate criteria – of donors' contributions (and possibly of the estimated value of services provided in the same jurisdiction by NGOs), from the transfer allocated to each subnational government. The second option is to begin allocating a small transfer for investment purposes to those subnational governments that do not benefit much from the present distribution of donor funds.

In either case, there is a need for subnational jurisdictions to record donors' expenditure. Once this has been done and inequalities identified, the central government could seek to direct future donor activity into jurisdictions that have not benefited significantly in the past. Ultimately, it may be desirable to conduct a similar process with regard to NGO flows.

Structures of territorial systems of government and assignment of responsibilities

Most of the benefits and drawbacks of a decentralized system derive from the specific territorial structure of government. For example, if too many layers of government are created, political and administrative costs will soar. This is a problem many African countries are likely to experience. Space constraints allow the analysis of only a few cases.

Multi-layered systems

While not a federal state, South Africa (Figure 15.1) provides one of the best-structured models, based on three distinct layers, or "spheres" as they are referred to in the constitution: the central government, provinces, and municipalities. As in most modern federations, there is no subordination of municipalities to provinces, while the national government has co-ordinating powers over both subnational levels.

South Africa provides, with a few exceptions, a well thought out model of expenditure assignment.[8] The provinces are, on average, big enough to provide efficiently the major services they are responsible for, health and education. Provision of welfare, specifically of typical social security services such as pensions, represents the exception. This is in fact a typical central government responsibility and should be removed from provincial responsibilities, although South African provinces act in this field mainly as agents of the central government, with the latter determining eligibility and individual payments as well as providing the financing.

An important process of consolidation of municipalities has taken place. Their number has halved. Their responsibilities are well separated from those of the provincial governments. More precisely, local governments have to provide typical urban infrastructure and its running (water, sanitation, traffic, refuse collection etc.) and have no responsibility in the field of social services, which are reserved for provinces. Compared to the size of the country, the small number of both provincial and municipal units avoids the absorption of a large part of subnational budgets by political costs.

The Ethiopian federal system (Figures 15.2 and 15.3) is formally a two-layered one, based on the national government and the regional governments as in classical federations. Local governments are hierarchically and financially subordinated to regional governments, more precisely, below regional governments are zones, that are, in all but

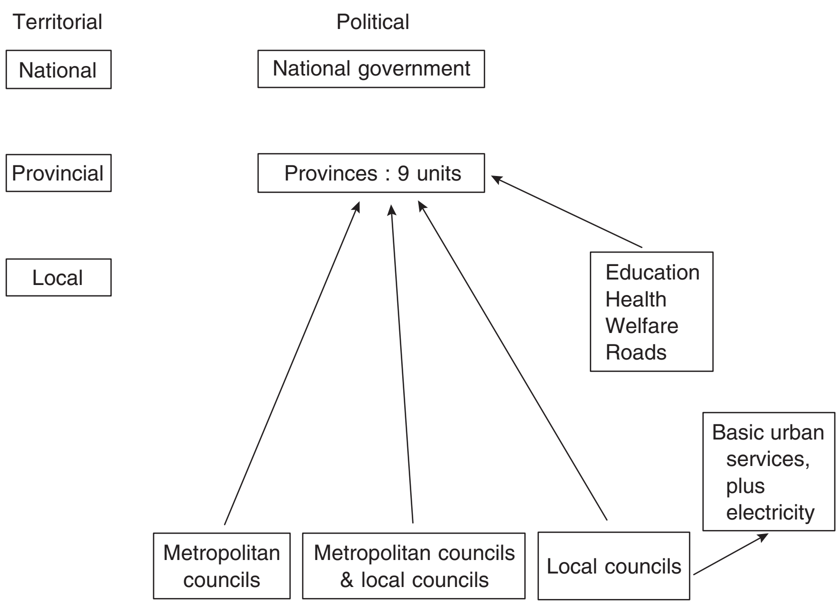

Figure 15.1 South Africa: government structure.

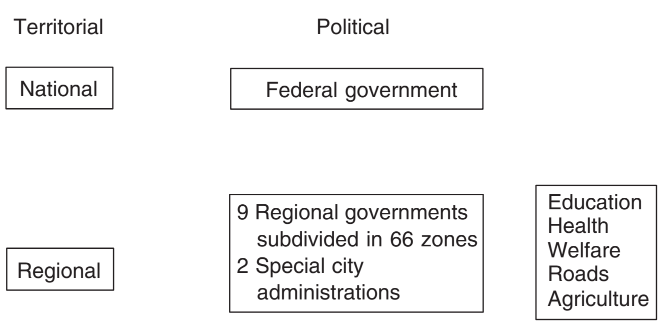

Figure 15.2 Ethiopia: government structure.

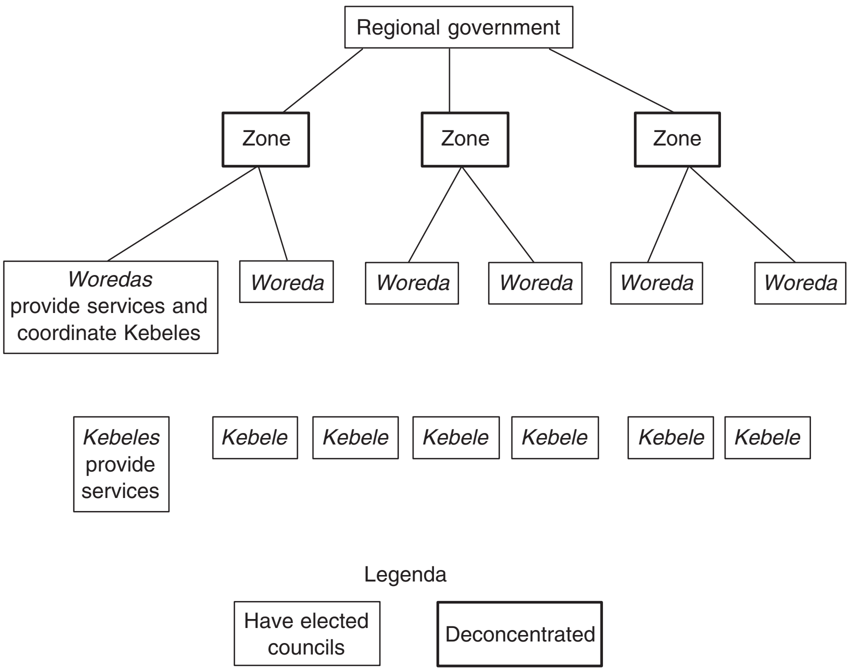

Figure 15.3 The structure of subregional government in Ethiopia.

one region, deconcentrated units. They have no elected councils and depend on regional governments. Zones coordinate and fund *woredas*, a decentralized layer of government responsible for the provision of most subnational services. In turn, *woredas* coordinate *kebeles*, another layer of subnational government. Municipalities constitute a separate system and are not regulated by the constitution. All together they form a rather complex system, which is clearly quite expensive and cumbersome, given the lengthy command channel.

Quite distinct, if not opposite, reasons have influenced the choice of the federal structure in the two countries. In Ethiopia the demarcation of regional governments follows clear ethnic lines, and the federal system has been introduced to satisfy strong demands for autonomy by the major ethnic groups. The South African federal system is basically a checks and balances mechanism. Provinces were not drawn along ethnic lines, but were instead created to dilute the power of the central government. The closer link between states and local governments in the Ethiopian system may, *ceteris paribus*, make secession easier than in the South African system, where separation between provinces and local governments gives less political weight to the former (and to their secessionist tendencies, if any). Local authorities may even oppose secessionist tendencies if preferences regarding this issue diverge.

Regional systems

When important responsibilities, such as education and health, have to be decentralized, then the creation of a regional layer of government becomes almost a necessity

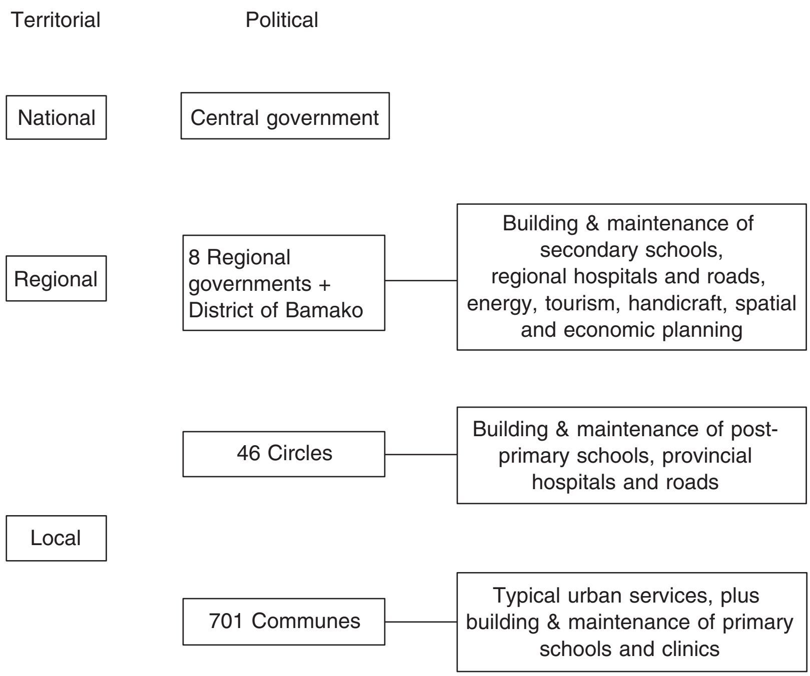

Figure 15.4 Mali: government structure.

to internalize spatial spillovers. On the other hand, the creation of the regional layer of government serves no purpose if the regional units have only marginal responsibilities.

The decentralized system envisaged in the constitution of Mali (see Figure 15.4) does not follow these considerations. It is a four-layer system, reminiscent of the French and Italian systems. It is based, in addition to the central government, on regions, departments, and municipalities. In Mali, besides the central government and 701 municipalities, there are eight regional governments and forty-six circles. All have elected councils.[9] Given the low GDP of the country and the large number of decentralized units, the political and administrative costs of local governments alone absorb an important share of total revenues, leaving meager resources for effective service provision. These costs may not be justified by the limited range of functions that are devolved to regions, and more specifically to circles. In fact, the assignment of responsibilities for education and health in Mali follows the traditional continental European pattern, where only buildings and the maintenance of premises are assigned to subnational governments, while the effective provision of services is left to the central government.[10]

The limited devolution of responsibility is partly a compromise between two contrasting pressures. On one hand, there are the demands for more autonomy from the northern regions of Mali. On the other hand, there is the central government's fear of losing too much power and/or its worry about the lack of capacity in the newly created government units. The compromise is thus to devolve equal but few responsibilities nationwide. One should, however, consider the merits of asymmetric devolution.[11]

Two-layer systems

The Côte d'Ivoire has the typical two-layer system based on central government and municipalities (see Figure 15.5). A deconcentrated layer, made up of departments and subdepartments, occupies the middle ground between the central government and the municipalities.

The Côte d'Ivoire model, still common in West Africa, is close to the French pre-1970 system. The responsibilities of municipalities encompass typical small-area urban services. In addition, the Côte d'Ivoire utilizes the horizontal separation model for education and health. More specifically, municipalities are responsible for the construction and maintenance of schools and health facilities, while the central government is responsible for running them – that is, for the effective provision of services. This peculiar apportionment of responsibilities is frequently a source of problems, especially in countries with rapidly changing demographic trends. Especially in peripheral areas, schools may be built by municipalities without the necessary number of teachers, while at the same time, especially in urban areas, other schools have an overabundance of teachers, unwilling to be transferred to rural areas.

The Côte d'Ivoire approach to decentralization seems to be based on gradualism, with an eye to capacity building. The number of municipalities increased in recent years with the aim of starting or improving the provision of services in the previously neglected rural areas. The territorial system of government still reserves a fundamental role for the central government, in terms both of responsibilities and of the monitoring and control of local authorities. The number of deconcentrated units still exceeds that of decentralized units (283 against 197): an infrequent peculiarity in a decentralization process.

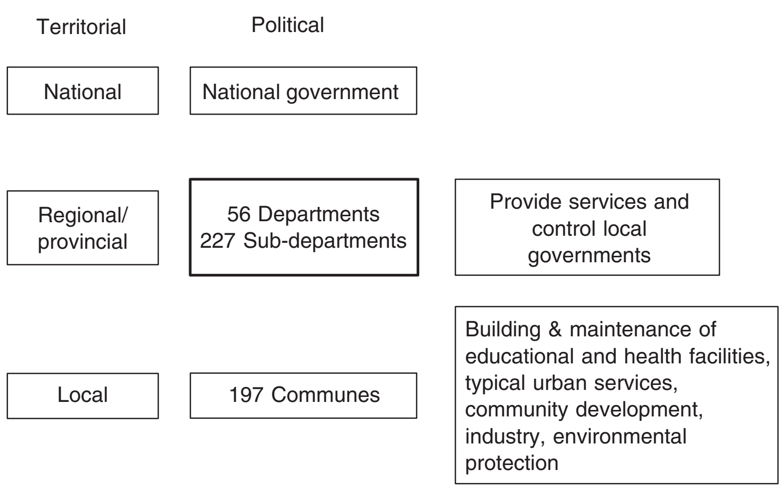

Figure 15.5 Côte d'Ivoire: government structure.

Table 15.4 Average dimension of governments in selected African countries 1998

	National (millions)	*Regional*	*Sub-regional*	*Local*
Benin	6.04		503,333	78,442
Burkina Faso	10.68		1,068,000	98,889
Côte d'Ivoire	14.29			72,538
Ethiopia	59.88	5,443,636		777,662
Madagascar	15.6	2,600,000		141,818
Ghana	19.16			174,182
Mali	10.69	1,336,250	232,391	15,250
Nigeria	106.41	2,955,833		137,481
Senegal	9.28	928,000		154,667
South Africa	42.13	4,681,111		138,586
Uganda	21.03		489,070	140,200
Zimbabwe	12.68			222,456

Source: Population is taken from UN Statistical Bulletin.

Number of subnational units and political costs

The average size of regional (subnational) government units ranges from almost one million inhabitants in Senegal to 5.4 million in Ethiopia (see Table 15.4). Average local government size ranges from 78,000 to 777,000 inhabitants. While the size of regions is comparable to the industrialized world, the size of local governments is clearly larger. One has to take into account, however, that in many cases, other sublocal layers of governments have been created, such as *kebeles* in Ethiopia, and counties, subcounties, parishes, and villages in Uganda. The number of these small units is usually very large.

The multiple layers of government, and the many distinct units within those layers, mean high political costs for countries with extremely low levels of gross domestic product. Some of these costs derive from the lack of coordination and are thus hard to quantify. Some of the costs are directly related to elections, fees, and allowances paid to political personnel and for the working of assemblies. A tentative but interesting estimate of direct political costs connected to the intended decentralization process in Madagascar has been made by the World Bank (1998). This analysis shows that the creation of 6 regions and 111 local governments – quite a modest number given the size of the country in terms of area and population – would absorb between 9 percent and 19 percent of central government's total present transfers to subnational governments. The creation of 28 regions and 111 local governments would increase these shares to 11 percent and 25 percent, respectively.

Tax revenues

Finding taxes for subnational governments

Most African countries have unproductive tax systems that rely heavily on taxes on foreign trade. Tax effort – that is the share of taxes on GDP – is generally low. This is true also for countries that have embarked upon an ambitious decentralization process, such as Ethiopia, Madagascar, Mali, and Uganda. Moreover, tax administration is rather weak in most African countries.

The only tax sources for subnational governments meeting all the stringent requirements imposed by the theory of fiscal federalism are user charges and the property tax.[12] However, property taxes are costly to administer well, especially in a developing country. Moreover, these taxes are widely resisted by taxpayers, because of the frequently crowded conditions and poor quality of housing and the frequent lack of basic services, such as water, sanitation, and electricity. To avoid unpopularity, local governments frequently concentrate taxation on nonresidential properties, thus encouraging tax exporting.

International evidence shows that, when well administrated and complemented with the revenue from user charges and fees, only in the richest areas can the property tax finance the provision of local services, that is, the services usually provided by municipalities and other small-area jurisdictions. This is the case, for example, in rich urban areas in South Africa, where local governments are responsible for the provision of typical urban services aside from education, health care, and social assistance.

When major social expenditure is decentralized – meaning, as we have seen in Africa, the creation of a new, large layer of government – property taxes and user charges become totally insufficient. They have to be complemented with other tax revenues. Good candidates in developing countries are vehicle-related taxes, payroll and personal income taxes, and to a lesser extent, retail sales taxes.

The present tax assignments are largely unsatisfactory. Ethiopia, South Africa, and Uganda provide three distinct but rather unsatisfactory examples of the financing of wide-area governments.

Ethiopia is characterized by a high vertical fiscal imbalance. In the 1997–98 fiscal year, the federal government collected 82 percent of the aggregate tax revenue and 83 percent of the aggregate nontax revenue (World Bank, 1999). Regional governments' own revenues are almost negligible and include fees from usufructuary use of land and for the use of forest resources. These are supplemented by centrally provided transfers and (revenue) shared taxes. Shared revenues, albeit widely used across the world, induce inefficient behavior. This is easy to understand. When shared revenues exceed expenditure needs, subnational beneficiary governments cannot reduce tax rates and have to spend the revenue for low-priority sectors, thus possibly indulging in waste (as the experience of the Italian special statute regions clearly shows). When, on the other hand, revenue is lower than needs, governments do not have the power to increase the rates.

The constitution of Ethiopia is silent about the assignment of important sources of revenues, such as sales taxes and automobile related taxes. The introduction of a VAT is presently under consideration, as is its partial assignment to regions.

Despite the generous constitutional provisions in terms of revenue,[13] South African provinces have been denied access to their own sources of revenue and have had to rely almost entirely on centrally provided grants. This reflects a high vertical imbalance in South Africa. Fees for hospital services, motor vehicle licenses and gambling taxes represent the only own provincial revenues. They account for only 4 percent of the total revenue.

Own provincial revenues have declined by about 20 percent over recent years, partly reflecting a health policy decision to provide free care. In part, this reduction also reflects reluctance by provinces to use their own revenue instruments when massive grants are provided by the center. A proposal to increase the tax autonomy of provinces substantially by allowing them to introduce a flat rate surcharge on the personal income tax base was forwarded by the Financial and Fiscal Commission (an advisory body responsible for making recommendations to Parliament concerning all financing issues). The surcharge has, however, been rejected by the central government with the argument that the personal income tax base is still too small and unequally distributed across provinces, and that administrative costs would be quite high despite the small number of taxpayers. More generally, the central government (Department of Finance of South Africa, l999b) has argued that this solution is not adequate for a developing country such as South Africa. The central government's present orientation is to leave the range of taxes devolved to provincial governments as small as possible, forcing reliance on transfers from the central purse. This reluctance to extend provincial tax powers is partly due to the macroeconomic strategy of South Africa, which includes maintaining tax revenue at 25 percent of the GDP so as to promote investments both national and foreign.

Uganda provides an interesting case of the difficulty of financing important subnational expenditure responsibilities in a nonfederal setting. Local tax assignments include the property tax, market dues, and business license fees, plus a potentially broadly based tax, the *graduated tax*, which is an unusual mix of poll tax, income tax, and wealth tax. However, according to a sample of twenty-nine Districts (out of the thirty-nine existing that year), in FY 1995–96 local taxes and fees represented only 19 percent of total local government revenues, the largest share of which were foreign donors' contributions. Local tax rates and fees are determined freely by local governments, with the advice of the Local Government Finance Commission, an advisory body on all matters relating to subnational sources of revenue, including transfers.

Property taxes

The administration of property taxes in Africa is largely deficient (see World Bank, 1996; Farvacque–Vitkoviand Godin, 1998). The property tax base is inelastic, despite growth in the physical size or value of property, because old valuations are not updated and new properties not identified. The administration is costly and inefficient. In most cases, the system has been inherited from the colonial era and is poorly suited to present conditions. For example, cadastral systems work in areas with regular street patterns, named streets and numbered houses. In the absence of street addresses, tax bills are not deliverable, and penalties are unenforceable. Problems are compounded by the lack of skilled technical staff. Collection is often poor and many bills go unpaid, because taxpayers are not identified, or they resist payment because their housing conditions are too poor or urban basic services are not provided to their areas. Thus administration is the crucial problem of property taxation.

Expert opinion diverges on how to improve property taxation in developing countries (a good summary of the problems is provided by Dillinger, 1992). Some experts blame the excessive centralization of property tax policy, which disallows setting higher tax rates. Others blame what they consider the total anarchy deriving from local government freedom in this field. There is also dispute over tax administration. West African French-speaking countries rely on the traditional French model, in which the property tax is administered and collected by the central government, whereas East African countries rely on local administration. This local collection is usually recommended in the literature stressing that taxes should be administered by the government entitled to their revenue. Both cases in Africa produce mixed results. Local administrations may produce acceptable results in large urban areas, but are unlikely to produce good results in the small, rural places. Here, possibly, a central administration could be used, and remunerated with fees to encourage adequate efforts.

It is extremely difficult to make valid general recommendations for a number of countries. Foreign donors have been involved in a number of cases, but with mixed results.[14] Clearly, property tax has to be simplified to adapt it to the reality of developing countries. Ambitious cadastral projects were undertaken in the 1980s, but many of them failed or were abandoned halfway (as in Cameroon, Mali, and Senegal). Perhaps the use of very simple parametric methods for the evaluation of property values is advisable. Parameters including the number of rooms, the quality of the materials and the area of the city are transparent and easy to apply. These methods have been used in a number of countries (included industrialized ones) with satisfactory results. Administration could be left local, but the legal framework should be centrally provided.

Too many local tax instruments

A common characteristic of local government revenue systems in Africa is their large number of revenue instruments. This derives, in some countries, from the broad autonomy local governments have in revenue matters. In most cases, the central government has assigned to itself all the broadly based and buoyant taxes, allowing local governments – as a way of compensation – the total freedom to set up their own taxes. The result has been a multiplication of small unproductive taxes that complicate local tax systems and make them completely nontransparent.

A Tanzanian local council studied by Fjeldstad and Semboja (1998) has more than 60 taxes and fees. This is due to the large tax autonomy of local authorities that may pass bylaws without prior approval of the ministry concerned. Basic economic criteria are frequently left out, as in the case of the Kibaha district, which has imposed a tax on the production of cashewnuts, an export crop.

The costs of administrating a complicated tax structure are obviously high. In the Kibaha district, the administrative costs of tax collection in some wards are higher than the tax revenues remitted to the council. This is because, among other things, a badly conceived structure lowers voluntary compliance.

Local tax fragmentation is only slightly lower in West African French-speaking countries, where tax policy and administration are traditionally much more centralized. For example, a recent law on decentralization in Benin lists 17 different taxes for local governments. Happily for the latter, the list includes all the major traditional local taxes (such as those on property and on business). A common pattern in this part of the African continent is to leave the administration of the more productive local taxes to the central government, while small "nuisance" taxes are left to local administration. An unfortunate result of this policy is that the central government – as in the case of the Côte d'Ivoire – may appropriate most of the property tax, leaving very little for local government use.

Natural resources revenue for subnational governments

In many developing countries, subnational governments pressure their central governments to receive a greater share of natural resource revenues.[15] Nigeria is the most relevant case in Africa. According to some estimates, 8 percent of the *Federation Account* goes to the oil-producing areas. Furthermore, the new constitution mandates "that the principle of derivation shall be constantly reflected in any approved formula, as being not less that 13 percent of the revenue accruing to the *Federation Account* directly from any natural resources." Although there is no clear understanding of what the mandate really means, it appears that the share of natural resource revenues going to subnational governments is destined to increase in the near future. The Nigerian model may possibly have followers in countries that are decentralizing their government structure and/or in those, such as Congo and Angola, that have endowments of natural resources, or favorable prospects of future discoveries.

Taxes on natural resources are not ideal candidates for subnational revenue, even under a tax-sharing arrangement.[16] However, political economy realities might dictate that some form of regional taxation, or tax sharing, on natural resources is inevitable, if there is distrust that the center will provide sufficient revenues for regional expenditures.

If subnational governments provide significant amounts of service and infrastructure for the exploitation of the natural resources, an adequate share of natural resource revenue could be returned to the regional governments under the benefit-tax principle as a compensation for the associated costs, and for environmental damage.[17]

Quite often regional demands for additional oil and gas revenue have to be interpreted as a request for greater revenue sources at the subnational level. For the sake of efficiency and equity, this demand should be met by a comprehensive tax package and the redesign of the equalization transfer system.

Transfers to subnational governments

Systems of transfers to local governments are badly needed in most African countries. Only a few large urban governments located in rich areas are able to finance a substantial share of their total expenditure with their own revenues. This share is almost insignificant for regional governments and approaches zero in the local governments of rural and peripheral areas. Like most developing countries, African countries are characterized by huge fiscal disparities.

General/unconditional grants

African countries use a variety of systems to determine the total amount to be distributed to local governments. Ghana uses a potentially inefficient system, the *Common Fund*. The 1992 constitution (Article 252) provides for allocation of no less than 5 percent of the total central government revenue to the *Common Fund*. This system is potentially inefficient because there is no necessary connection between this share and the cost of devolved expenditure.

Nigeria has a similar, but much less transparent system, for determining the total amount of unconditional transfers to states and local governments. Receipts from crude oil exports, domestic petroleum revenue, corporate income tax, custom duties, excises, and fees accrue to the *Federation Account*. After deductions for some important expenditures of national interest, such as external debt servicing, national priority projects, and Nigerian National Petroleum Corporation projects (as we can see, apart from debt servicing, the other items are highly discretionary and nontransparent), the proceeds are allocated in different proportions to states, local governments, federal government and, finally, special funds.

In Uganda, general purpose transfers are determined annually with reference to the reassignment of tasks between the national and subnational governments. According to the constitution (Article 193, Clause 2), the total amount is calculated according to a formula that takes into account the total of the unconditional grant of the previous year, corrected by the increase in the general price level, plus the net change in the budgeted costs of running newly devolved or subtracted services. In other words, the formula takes into account the actual devolution of functions and their budgetary implications.

South Africa uses a complex bargaining process among distinct layers of government to determine the total amount of centrally provided unconditional transfers. A fundamental principle of the new constitution is that an *equitable share* of national resources has to be allocated to each layer of government. Interpretation of the principle has been widely debated, and a broad agreement has been reached recognizing that distribution has to be based on national standards and costing factors.

Ethiopia follows a complex, but not transparent, determination system. It starts with estimates of total resources available from tax and nontax revenue and counterpart funds, but excludes direct foreign assistance to regions. After negotiations with the regions, the federal government allocates the total pool among itself and the regional governments.

With regard to distribution, African countries are shifting from totally discretionary methods[18] to formula-based systems of allocation. The main problems at present would appear to be (a) frequent changes in the formula for allocation without provisions for compensating those subnational governments whose allocation decreases in absolute terms as a result of the change, (b) variation in discretionary policy choices made by the recipient governments, (c) little attention paid to equalization, and (d) few incentives to increase subnational governments' own revenue.

Ethiopia is a good example of frequent changes in the formula. From the inception of the system in 1992–93 to 1994–95, the transfers were determined by the federal government according to its own discretionary criteria. Since 1995–96, a formula has been introduced; that, however, has changed every year.

Uganda provides an illustration of the second problem, the variation in discretionary policy choices at the local level. The main component of the transfer system of Uganda is a grant for the payment of salaries of teachers and health personnel. (Until the 1996–97 fiscal year, administrative staff salaries were also paid with this transfer.) This salary grant presently benefits those local governments which, before decentralization, were privileged in the allocation of facilities and staff, and/or those which have increased their payrolls the most rapidly in the initial stage of decentralization, particularly in the field of education. In addition, a grant based on salaries discourages careful scrutiny of expenditure, as clearly shown by Uganda's experience. With the implementation of the Universal Primary Education Program, districts were encouraged to hire a substantial number of new teachers, seemingly on the basis of a tacit understanding that the central government would cover their cost. No precise guidelines concerning appropriate staffing based on standardized pupil–teacher ratios were given and large arrears were accumulated for teachers' salaries.

However, Uganda's transfer system is gradually improving, now that salary transfers are allocated according to a formula based on (a) population, with a relative weight of

85 percent; and (b) area, with a weight of 15 percent; and supplemented by a lump sum grant ($70 million per district).

In a very few countries, unconditional transfers address the problem of the reduction of disparities in poverty levels among areas. However, in some cases as in Uganda, unconditional transfers perpetuate such disparities, because the dominant transfer for salaries is distributed to fund existing levels of service provision.[19]

The South African system deserves further attention, since it has made an important improvement in terms of transparency and efficiency in the allocation of unconditional transfers to provinces and municipalities. Starting with the former, transfers were provided until 1998 by the central government in an absolutely discretionary way; that is, according to Ministry of Finance estimates of the needs of each distinct province. Each province was thus at the mercy of the central government.

Since fiscal year 1998–99 a formula-based system of allocation has been introduced.[20] This system, is in fact a collection of seven separate transfers, some of which – like those for education and health – are in fact conditional: the recipient governments have the obligation to spend these grants entirely in the targeted sectors. Most of the transfers are based on very simple indicators of needs, such as population, age structure, and population eligible for social security grants. A share of 3 percent of the total is allocated according to backlogs in the provision of infrastructure, while the last component of the system – the so-called economic activity grant, with a share of 8 percent – is allocated on the basis of total wage remuneration in the provinces. The introduction of a revenue capacity equalization component is not an urgent task for South African provinces, because, as mentioned before, they have almost no revenue autonomy.

Specific purpose grants

Specific purpose or conditional grants are used for correcting interjurisdictional spillovers and/or for funding activities that have a high priority from the point of view of the national government (but which, in the absence of such transfers, might be given a low priority by local governments), such as the promotion of environmental protection, or the prevention of epidemics (see Ahmad, 1997).

Specific purpose grants are seldom used in Africa;[21] this seems reasonable given the present availability of finance and administration skills. As to the correction of externalities, one partial exception is South Africa. To correct some of the problems deriving from the current assignment of responsibilities in the health sector, this country started a specific grant program that funds medical research conducted by general hospitals run by provinces. However, correcting grant externalities requires sophistication in terms of design and is not an easy process. This difficulty explains, at least partly, why South Africa has postponed the starting of this grant.

Some countries, such as Uganda, use conditional transfers for funding supplies for education and health care. The idea behind these conditional grants is to force the effective production of services by recipient governments, which could otherwise spend grants for salaries and/or councilors' fees. The use of these conditional grants may reduce the risk of misuse or waste.

As we have seen, African countries tend to promote national priorities by attaching strings to general purpose transfers, rather than using specific transfers. Promotion of national priorities is obviously a valuable goal, but if pushed too far it may be contradictory in the present stage of decentralization in Africa. A sounder policy may be the introduction of ceilings on the use of transfers for purely administrative or political costs to avoid waste and mismanagement.

Conclusion

Decentralization offers many opportunities. However, to work properly, a decentralized system needs well-defined, strictly enforced rules. Otherwise, decentralization becomes a risky venture, particularly in developing countries, such as most of Africa, where democratic institutions are fragile, and capacity is weak.

The risk of overburdening the newly created institutions is substantial. This risk also applies to the implementation of specific poverty-alleviating policies, a crucial goal of decentralized government. While neither theory nor evidence shows conclusively that political and bureaucratic capture are greater at the local than at the national level – they are rather context specific – governments and proponents of decentralization should not place too many demands on newly created local governments.

The interests of the poor are well served when decentralization improves efficiency in the provision of basic local services and starts eliminating disparities in their provision among the various areas of the same country. To reach this goal, decentralization has to satisfy many demanding conditions. It should be gradual and closely monitored.

African countries are choosing a wide variety of institutional arrangements. Frequently, too many layers have been created, particularly in view of the political and administrative costs of the newly created units. Furthermore, central governments have decentralized to satisfy demands for more autonomy, but are still quite reluctant to cede power. The assignment of limited responsibilities may be a signal of the intention to proceed gradually, but this interpretation is often inconsistent with the excessive number of layers of government created.

African governments are also uniformly reluctant to devolve taxing powers, reducing accountability at the local level. The property tax is generally used for financing small-area governments (i.e. municipalities), but it is very inefficiently collected. Wide-area governments, such as regions, have no revenue sources of their own and are forced to rely on transfers from the central government.

Finding appropriate tax sources for regional governments is one of the most urgent and challenging tasks for African decentralization processes. Although the system of grants has been improved in a number of countries recently through the introduction of formula-based systems of allocation, fiscal responsibility is still quite weak, because of – among other factors, such as too frequent changes of formula and criteria – the dominant importance of grants in the revenue system of decentralized governments.

Acknowledgments

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Appendix

Table 15.A1 Decentralization in Africa – selected institutional and political issues

Countries	*Institutional reform*	*Political reform*
Ethiopia	Introduced federal system (Proclamations of 1992–93 and Constitution of 1994)	Introduces elections of regional councils (last in 1995)
Uganda	Substituted (1993) deconcentrated system with a decentralized one. Districts (43). Counties (150) and sub-counties	Introduces local elections (last in 1996)
Côte d'Ivoire	Substitutes deconcentrated system with a decentralized (two-layer) system. New municipalities are added to the list. New total is 197	Introduces elections of councils (last in 1996)
Ghana	Replaced (1989) deconcentrated system with a decentralized one: districts (110). Regions (10) are still deconcentrated	Introduces elections of districts (since 1988)
Senegal	Introduced (1996) a three-layer system: regions (10). Municipalities (60). Creates rural municipalities	Introduces elections of regional and municipal councils.
Mali	Introduced a multi-layer system: regions (8); District de Bamako; circles (46); municipalities (701). Created 682 new municipalities (1996)	Introduces elections of municipal councils. These councils appoint councilors of regions and circles
Madagascar	Constitution of 1998, introduced a multilayer system: provinces (6); municipalities (110)	Introduces elections of municipal and provincial councils (late 2000)
South Africa	Constitution of 1996 introduced a quasi-federal system: provinces (9); local governments (800–300)	Introduces elections of municipal and provincial councils (1994 and 1999)
Burkina Faso	Introduced (law of 1989) a multiplayer system: provinces (10); municipalities (their number has been increased to 108)	Introduces elections of councils (last for municipalities in 1995)
Nigeria	Has a federal system. States have been increased to 36. 774 municipalities. Federal capital territory: Abuja	Introduces elections of state and local councils
Zimbabwe	Has a deconcentrated system with 8 provinces and a decentralized one based on urban and rural districts (57 have been created by amalgamation in 1987)	Holds local elections regularly
Benin	Law of 1998 reforms deconcentrated government (6 new departments with a total of 12); creates 77 municipalities	Intends to introduce elections of municipal councils (scheduled for 2000)
Sierra Leone	Intended to proceed to a reform of its decentralized system but increased civil war put an end to reform plans	Intended to introduce elections of district councils, but …
Gambia	Has recently returned to democracy with multiparty elections	
Namibia	Regions (13); local authorities	Holds elections for regional councils and local authorities

(Continued)

Table 15.A1 (Continued)

Countries	*Institutional reform*	*Political reform*
Botswana	Districts (9); town councils (5)	Holds local elections
Central African Republic	No decentralization process on the way	n.a.
Congo Democratic Republic	Centralized system	
Republic of Congo	Introduced decentralization in 1973	Holds local elections. Last in 1992
Gabon	Introduced (1993) multiplayer system; regions, provinces and municipalities	Introduces communal elections (last in 1995)
Mozambique	Introduced (law of 1994) decentralized system. Established (Law of 1997) 33 municipalities	Introduces local elections (last 1998). Very low participation rate
Rwanda	Centralized system	Elections for submunicipalities held March 1999
Malawi	Introduced (law of 1998) decentralized system based on districts, cities, towns and municipal assemblies	Intends to introduce elections of assemblies after September 2000
Kenya	Has a highly centralized system. No decentralization process is on the agenda	
Tanzania	Reinstated in 1984 a two-layer system based on urban and rural authorities. Intends strengthening local government (Government Reform Agenda 1996–2000)	Holds local elections since 1983

Table 15.A2 Fiscal assignments

Countries	*Functional responsibilities*	*Revenue*	*Decentralization (% of subnational on total public expenditure)*	*Implementation stage*
Ethiopia	Education, health, roads; transferred to regions	Introduced revenue sharing	45% (1995–96)	Well on the way
Uganda	Education, health, roads and basic urban services to districts	Introduced unconditional and equalization grants	Substantial	Well on the way
Côte d'Ivoire	Typical urban services, local roads, construction and maintenance of schools and primary health care facilities	35% of property tax; 65% of business (license) tax, charges and fees	5% (1992)	Stalling

(Continued)

Table 15.A2 (Continued)

Countries	*Functional responsibilities*	*Revenue*	*Decentralization (% of subnational on total public expenditure)*	*Implementation stage*
Ghana	Regions coordinate districts. Districts have typical urban services, local roads, primary education and health	Property tax, minor taxes, fees. Central government transfers. District Assembly Common Fund (at least 5% of domestic tax revenue)	Approximately 10%	On the way
Senegal	Municipalities have typical urban services regions have health and education	Municipalities have property, business and other minor taxes. Introduces capital grant to municipalities (FECL)	6% (1994–95)	Stalling
Mali	Municipalities have typical urban services. Circles and regions build and maintain infrastructure	Assigns business tax and other minor taxes to municipalities	2–3%	Just started
Mada-gascar	Typical urban services to municipalities; no detailed assignments for provinces	Business tax to provinces' Property and minor taxes to municipalities; introduces unconditional grant for municipalities	7% (1998)	Just started
South Africa	Education, health and welfare to provinces. Typical urban services to municipalities	No major taxes to provinces, unconditional grant for provinces; property and business taxes to municipalities	50% (1998–99)	Well on the way
Burkina Faso	No detailed assign-ments for provinces. Urban services to municipalities	No tax assignments for provinces. Property and business taxes to municipalities	5% (early 1990s)	Just started and possibly stalled
Nigeria	Education, health and welfare to states. Typical urban services to municipalities	Revenue sharing: 24% of federation revenue to states; 20% to local. VAT: 50/50 to states and LG	States: 12.6% (1998), Local govts: 3.9% (1998)	
Zimbabwe	Typical urban services, plus health care services to districts	Property tax, vehicle tax, pool tax, fees account for most of revenue (similar to South Africa)	20% (early 1990s)	No major changes in view
Benin	Typical urban services to municipalities, including infrastruc-ture for primary schools and primary health care services	Business tax, property tax, other minor taxes to municipalities. Capital grant from central government	2% (1992)	Slow

(Continued)

Table 15.A2 (Continued)

Countries	*Functional responsibilities*	*Revenue*	*Decentralization (% of subnational on total public expenditure)*	*Implementation stage*
Namibia	Typical local services, local roads, electricity distribution	Share of property taxes, electricity and water fees, central transfers	13.6% (1993–94)	?
Botswana	Primary education, urban services, rural roads, minor development projects	Local government tax (personal income tax), school fees, and grants (7% of central government exp. in 1990)	n.a.	
Gabon	Municipalities have typical urban services		n.a.	Stalling
Mozambique	No clear assignment. Functions correlated to available revenues	Poll tax, property tax, business tax, payroll tax, fees, plus central government grants amounting to 1.3–1.5 of national tax revenue allocated with annual formula	2–3%	Stalling
Malawi	LG have typical urban services, plus primary Schools, health, development and physical planning	Property taxes, fees, ceded revenues, block grants of no less than 5% of national revenue, distributed on selected criteria	n.a.	Process should start by July 2000
Tanzania	LG have typical urban services, plus primary Schools, health, development and physical planning	Property, business, fuel and other minor taxes	n.a.	

Notes

1 We also have to consider that the protection of minorities dispersed in many areas may be more difficult in a decentralized system. In other words, decentralized/federal systems protect minorities that are geographically concentrated.

2 See World Bank (1999) particularly Chapter 6, for a presentation of some of those views.

3 For example, with the return to democracy, rural areas should receive a greater share of public funds, simply because politicians need farmers' votes. Bates (1988) shows that this is, in fact, the case in Africa, where agricultural policies based on staple food subsidies and taxes on exports are used to favor urban settlers at the expense of farmers.

4 In a frequently quoted example, Wade (1997) shows the contrast between the inefficient mode of operation of Indian central bureaucracy in the maintenance of canal systems with the more successful example of Korea, where maintenance was delegated to farmland associations.

5 This is because technological progress provides the rich with wide opportunities to produce similar services, such as water filtering systems or transport by helicopter, on a individual basis without having to contribute to the collective effort. Baland and Platteau (1999) provide another example of the uncertainty about the results of collective action. The example refers to communal control of grazing lands in India. When, before independence, these lands were of common ownership, big landlords took upon themselves the task of deciding and implementing conservation measures to preserve them. After independence, following a land reform that resulted in the privatization of a large part of grazing areas, collective maintenance of the common land was discontinued.

6 For example, it has been estimated (World Bank, l998) that in Madagascar 40 percent of all civil servants are concentrated in the capital city of Antananarivo.

7 The results of two surveys conducted by Crook and Manor (1999) for a sample of municipalities in the Côte d'Ivoire and Ghana reveal, for the first country, "an overwhelming popular concern with the issue of travel and communication between their local communities and the rest of the country. Not only were 'better roads' the most frequently mentioned need overall; they also featured as the first or second preference in all four Municipalities" (p. 188) and for the second, "that a clear majority of respondents, of both sexes and in both districts, saw improving the roads as the main "need" of the area" (p. 257).

8 Namibia has introduced a similar model.

9 The councilors of circles and regions are designated by municipals councils.

10 The European model refers specifically to education. Health services are organized in different ways in different European countries.

11 Burkina Faso has adopted this solution. The number of municipalities was increased from 10 to 108 after 1982, but 31 of these have "full powers" the remaining 75 still have "limited powers," that is, fewer responsibilities.

12 More specifically, only the component taxing residential properties meets all requirements. This is because the property tax on industrial and commercial activities may be easily exported to other jurisdictions.

13 The South African constitution stipulates, as a general principle, that (a) nationally raised revenue must be distributed equitably among national, provincial and local government following the recommendations of the Financial and Fiscal Commission, and (b) the provincial share must be divided equitably among the nine provinces. Moreover, the constitution [Section 228(1)] allows provinces to impose taxes, levies and duties other than income tax, VAT, sales tax, rates on property, and customs duties. Provinces may also levy a flat rate surcharge on the tax bases of any tax, levy, or duty imposed by national legislation, except for corporate income tax, VAT, rates on property, and customs duties. Such taxes must be regulated in terms of national legislation.

14 According to the study "… donors and central governments are equally active in the field… The detailed evidence suggests that the interventions have had relatively limited impact on revenues" (Dillinger, 1992).

15 A notable present day case is Indonesia. See Ahmad and Krelove (2000).

16 The major problems are (1) the resource rents are unevenly distributed geographically and impinge on equity, (2) the revenues are subject to the vagaries of the market, and (3) they are not a buoyant long-term source of revenue. The first and best solution would be to tax natural resources centrally, and ensure that the general allocation transfer system provides adequate financing for subnational government expenditure.

17 For example, a charge on oil and gas could be interpreted as a payment for services provided in the production of the resources. In this case, it is likely that the appropriate local share will be limited to a proportion of the rents (royalties) generated by the resource, and a combination of severance taxes and production excises to compensate for environmental damage caused by the oil/gas extraction.

18 A typical discretionary system is that used for the allocation of FECAL (*Fonds d'Equipement des collectivités locales*) in Senegal. Its annual amount and allocation per municipality are decided

by the ministry in charge of decentralization on the basis of unclear criteria, after a multiplicity of procedural steps whereby a number of bodies make their evaluations of the requests presented by each distinct municipality. The complexity of the mechanism allows political interference and is time-consuming. When all steps are completed funds may no longer be available.

19 However, the introduction of an explicit equalization grant, prescribed by the constitution, is presently under consideration. The Local Government Finance Commission has recently proposed the introduction of this grant, based on revenue capacity and expenditure needs.

20 Department of Finance of South Africa (l999a).

21 This statement assumes that salary grants are not considered as specific or conditional grants. This assumption seems reasonable, since they are used for funding salaries in all sectors of expenditure and there are no strings attached to them. If beneficiary governments could use these grants for non-salary expenditure, the central government would be unlikely to object. This use would, however, reduce the grant in the next allocation.

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16 Fiscal decentralization in South Africa

A practitioner's perspective

Ismail Momoniat

Introduction

This paper focuses on South Africa's implementation of a decentralized fiscal system since 1994, when South Africa's democratic government replaced the previous Apartheid administration.

As a developing country, the experience of South Africa promises to be relevant for other developing countries. Many papers on fiscal decentralization focus on the conventional arguments for, or against fiscal decentralization. Such analyses, while potentially appropriate for more developed countries, ignore the critical factors and choices facing developing countries. Incorrect and unsustainable strategies are, therefore, frequently attempted and when problems occur it is easy to blame poor capacity, lack of information or flawed implementation.

Building capacity and improving information are part of the daily requirements facing practitioners in developing countries, particularly in Africa. Developing countries do not enjoy the luxury of carefully sequencing the devolution of fiscal powers to subnational governments. Governments in developing countries are often forced to undertake critical political and economic reforms without sufficient capacity or information. Developing and implementing policy in this environment represents a major challenge made more difficult in the light of the ever-present pressure to deliver services to poor communities.

This paper provides an insight into the South African experience, and concludes with the general lessons learned in the implementation of a fiscally decentralized system in South Africa. The experience of the country's two spheres of subnational government (provincial and local) differs markedly. However, both emphasize the extent to which conventional economic arguments for or against fiscal decentralization pale into insignificance compared to problems caused by lack of sufficient capacity and absence of more modern budgeting and financial systems. The foremost lesson is that, irrespective of the degree of centralization or decentralization, basic budget and financial management reforms are critical elements for successful implementation of any system. While decentralization does have potential benefits, the selection of functions to decentralize is not obvious. Determining the correct balance of fiscal decentralization is more difficult, and does not automatically lead to more fiscal responsibility or better outcomes.

Background on decentralization[1]

The coming into power of the new democratic government led by Nelson Mandela in 1994 marked the end of Apartheid and, consequently, the policies of racial discrimination that denied the 88 percent black majority political rights, citizenship and economic benefits. Previously, white-ruled South Africa was divided into four provincial administrations (appointed by the national government) and local governments. Black South Africans were confined to live in "homelands" established in rural areas away from the main centers. Although supposedly independent, "homelands" were fiscally dependent on the Apartheid government, and their "governments" operated in effect as appointees of the Apartheid regime. The many black people living in urban townships in white South Africa were regarded as temporary residents, to be removed to the homelands once their labor was not required in white South Africa.

The budget of the Apartheid government focused spending on white residents, with very little expenditure directed towards education, health, housing and other basic needs of black residents. Poverty and unemployment were characteristic of life for most black South Africans.

The population of South Africa is over 43 million and is comprised of 33 million Africans, 4.5 million whites and 4.7 million Coloreds and Indians. South Africa is a middle-income country with a projected GDP of R876 billion ($110 billion) in 2000, a per capita income around $2,500 and inflation projected at 5.3 percent. What makes South Africa different from most middle-income countries is the extent of income inequality, which is also mirrored along racial lines. A poverty study in 1998 found that the poorest 40 percent of the population earn only 11 percent of income, while the wealthiest 10 percent of population earned 40 percent of income. The Gini-coefficient is 0.52.[2]

Political decentralization

South Africa has a unitary but decentralized system of government. It is not a federal system. The 1994 post-Apartheid system created three tiers ("spheres") of government: national, provincial and local.

Nine provinces replaced the previous four white provinces and nine black homelands, while the local governments largely integrated adjoining racially segregated black and white local areas. The new provinces were created in April 1994, only four months after their conception at the negotiation table and new integrated municipalities took effect in November 1995. There are 284 local municipalities.[3]

The national Parliament comprises two houses: a national assembly, and a national council of provinces representing provincial legislatures and organized local government. Provinces are accountable to provincial legislatures, and local governments to their councils.[4] The system of election at the national and provincial level is one of proportional representation, while the local level is a mix of directly elected and proportional representation.

Political imperatives to end Apartheid and prevent further civil strife dominated the 1993–94 transition. Fiscal decentralization to the provincial level was a political compromise between the main parties, part of the deal that allowed for a negotiated transition to democracy. Economic and fiscal considerations were secondary concerns to the political imperatives driving the negotiations. Decentralization to the local level was merely a continuation of the historical situation. The features of the new intergovernmental system, therefore, emanate from political, historical and constitutional factors, rather than fiscal considerations.

Powers and responsibilities

The Constitution assigns functions to the three spheres of government.[5] National and provincial governments are concurrently responsible for functions like school education, health, welfare and housing. In practice this means that the national government determines the policy, and provincial governments are responsible for implementation. Exclusive functions for provinces are not significant in budgetary terms, with the notable exception of provincial roads.

While the division of powers changed for national and provincial governments after 1994, the local government sphere was left with similar powers and functions as the previous white local authorities. Approximately two-thirds of local functions (in budgetary terms) involve user fee services like electricity, water and sanitation, while the remaining one-third involves the provision of public goods such as municipal and household infrastructure, streets, streetlights and garbage collection.

The South African constitution entrenches the important principle of *cooperative governance*. This obliges the three spheres of government to cooperate, and legally enforces negotiation, rather than litigation, to resolve political (and budgeting) problems between them. Numerous intergovernmental forums have been established as a result, including the Budget Council[6] and Budget Forum, which facilitate cooperation and consultation in the budget process.

Two aspects of decentralization in South Africa must be noted: First, the one million public servants employed by national and provincial governments comprise *one single public service* (with similar remuneration for similar rankings, irrespective of function[7]). Provinces employ the majority of public servants, at around 759,000. Municipal employees are not part of this public service, nor any uniform municipal service, but employees of their respective municipalities only. Second, there is a high level of unionization and collective bargaining. This reinforces the uniform nature of the public service, not only at the national and provincial level, but it also drives municipalities to converge towards similar conditions of service and salary structures.[8]

Fiscal decentralization in South Africa

Fiscal division of powers

As demonstrated in Table 16.1, South Africa's fiscal system is based on a *revenue-sharing* model, with provinces totally dependent on transfers from the national government, while municipalities are only marginally dependent.

The total national government budget in 2000 was R235 billion, comprising R213.4 billion in revenue (mainly corporate and personal income tax, VAT, fuel and excise levies), and borrowing amounting to R21.7 billion for a 2.4 percent deficit. The largest portion (R108 billion) is transferred to provinces, and about R6.8 billion to local governments (including grants-in-kind).

The actual spending budget of the national government is R73.7 billion, after excluding debt service and grants-in-kind to local government. The national government's main spending responsibilities are the criminal justice system (police, justice and prisons) and defence, which make up around 55 percent of its expenditure; higher education transfers (universities and technikons) 10 percent; transport including roads, rail, bus and other subsidies and public works, 5 percent each; revenue services (3 percent); and trade and

Table 16.1 Total budget and revenue sources of the three spheres of government in fiscal year 2000[a]

	Revenue generated (R bn)	*Borrowing (R bn)*	*Transfers from national (R bn)*	*Total budget (as appropriated)*	*Actual spending budget (excluding debt-servicing)(R bn)*
National	213.4	21.7	−112.2	122.9	73.7[b]
Provincial	3.6	0	108.4	112	112
Local[c]	55	8	3.8	66.8	69.8[d]
Total	272.0	29.7	0	301.7	255.6

Notes

a The fiscal year 2000 for national and provincial governments refers to the period 1 April 2000 to 31 March 2001. The municipal fiscal year is different, covering the period 1 July 2000 to 30 June 2001.

b The national government budget of R122.9 billion includes debt-servicing costs of R46.2 billion, and about R3 billion in grants-in-kind to local government.

c Local government figures are generally budget estimates, rather than actual expenditure. Actual expenditure figures will differ markedly from the budgeted estimates, given poor budgeting and financial management systems, and the exclusion of conditional grants and grants-in-kind in municipal budgets. If all grants and grants-in-kind are included, the local budget may increase to between R65 and R70 billion.

d Includes about R3 billion in grants-in-kind spent by national departments.

industry (3 percent). Smaller but significant budgets include water affairs (excluding all grants-in-kind), foreign affairs and home affairs (identity documents and passports). National education, health, welfare and housing departments focus on policy-making and monitoring rather than implementation, and so have small budgets, once grants to provinces and transfers to universities or technikons are excluded. The national government also has an oversight role oversight over public entities and government business enterprises.

Provincial governments are responsible for the implementation of the most important social services, including school education, health (including quarternary, academic and regional hospitals, as well as primary health care), welfare grants and services, housing and provincial roads (See table 16.2). Provincial budgets total R112 billion, comprising R108.4 billion of transfers from national, and R3.6 billion own revenue. Under the South African system, the R108 billion of transfers comprises an unconditional "equitable share"[9] of R96 billion, and R12 billion of conditional grants. The most significant own revenue sources are motor car license fees, casino and horseracing taxes and hospital fees.

Local governments are responsible for the provision of public goods and user services. The public goods comprise municipal infrastructure like access roads, streets, streetlights, garbage collection, sanitation and town planning. The key user-pay services are water and electricity. Local governments have taxation powers (property, regional levies), and generate income from the provision of services. Local governments raise R12.4 billion from these sources, and together with transfers of R6.8 billion from the national government, are estimated to jointly have budgets of R70 billion (if grants-in-kind are taken into account). The unconditional equitable share is just under R2 billion, while conditional grants and grants-in-kind comprise R5 billion.

In terms of actual spending of the R256 billion spent by the three spheres of government, the provinces spend the largest share (44 percent), national (29 percent) and the local sphere (27 percent).

Table 16.2 Expenditure functions of different spheres of government

	Major spending functions
National (R73.7 bn)	Protection services (R40.9 bn) • Criminal justice (police, prisons, justice) (R25.7 bn) • Defence and intelligence (R15.2 bn) Higher education (R7.1 bn) Transport (R4.1 bn) • National roads (R700 mn) • Bus subsidies (R1.5 bn) Public works (R3.8 bn) Water affairs (R2.9 bn) SA revenue services (R2.4 bn) Trade and industry (R2.2 bn) Labor (R2.1 bn) Foreign affairs (R1.3 bn) Home affairs (R1.3 bn) Other functions under R1 bn (R4.3 bn) • Arts, culture, science and technology • Agriculture (R719 mn) • Environment/Tourism • Land affairs • Minerals and energy • Communications Policy functions • Education (R476 mn) • Health (R478 mn) • Welfare (R348 mn) • Housing (R400 mn)
Provincial (R112 bn)	School education (R43.6 bn) Health (academic, hospitals, primary) (R26.4 bn) Welfare (social grants, services) (R21.5 bn) Housing (R3 bn) Provincial roads
Local (R69.8 bn)	Electricity reticulation (R14.5 bn) Water reticulation (R6.6 bn) Sanitation and wastewater (R1 bn) Garbage collection Municipal infrastructure (streets) Firefighting Municipal infrastructure

Taxation powers

Provinces cannot impose corporate income tax, VAT, excise levies or property taxes. Though they cannot impose a personal income tax, they may impose a surcharge on personal income tax and on the fuel levy. However, in terms of the Constitution, the right to impose a tax or surcharge is subject to national legislation and national economic policy objectives. To date, no province has exercised its taxation or surcharge powers.

As required under the Constitution, the forthcoming legislation[10] will establish a process to regulate the imposition of new provincial taxes. Under this regulatory process, national government will review each proposed provincial tax for consistency with the national economic and fiscal policy and ensure that it does not have adverse economic consequences for other provinces. If national government approves a provincial tax option, the tax would become part of an "allowed list" of taxes that any province could then impose once enacted by its provincial legislature. The approval process requires the national government to consult with the provinces (through the Budget Council) and with the constitutionally independent fiscal commission (the Financial and Fiscal Commission (FFC)). The allowed list will be in the form of legislation adopted by the national Parliament.

In general, provinces have accepted that the surcharge on the personal income tax is not feasible for the foreseeable future. Currently, options considered include a surcharge on the fuel levy and some smaller taxes. The introduction of any new taxes to provinces may require an adjustment in the revenue-sharing formula, to prevent poor provinces from losing out to richer provinces.

Provincial revenue has declined in both real and nominal terms since 1995–96. Therefore, the imposition of any new taxes is dependent on provinces improving their revenue collection from current tax sources (motor car licenses, gambling and hospital fees).

Further, given the success of the central revenue collection agency (South African Revenue Services), there is strong pressure for any significant taxes to be collected by this agency, rather than setting up new revenue services in provinces.

Local government has significantly more fiscal capacity than the provinces. Municipalities can raise property tax and turnover/payroll regional levies on businesses, as well as user charges (and a surcharge) on the provision of electricity and water (see Table 16.3). All of this revenue is collected by municipalities directly through their own collection agencies. However, local governments generally do not collect a significant portion of revenue due, resulting in deficits at the end of the financial year (as they budget on the expectation of collecting all their revenue). No additional taxes (except possibly for local betterment taxes) are planned for local government; the focus is on reforming the current design of local taxes and modernizing collection and billing systems. The budgeting system is also being modernized, and will be based on more realistic revenue projections.

Borrowing powers

The South African Constitution allows provincial and local governments to borrow for capital and bridging purposes only. Being new, provinces have not borrowed for capital, restricting their borrowing to bridging loans, largely in the form of overdrafts. They are expected to start borrowing for capital from 2002. Local governments have traditionally borrowed for capital investment. However, given the poor state of local government finances, and the uncertainty generated by the many policy changes since 1994, long-term borrowing has largely dried up. This is also because the previous system of national government guarantees was abandoned in 1994, and subnational governments were forced to borrow on their own merits.

Proposed legislation[11] to facilitate long-term borrowing for municipalities reinforces the approach of not providing central guarantees for subnational borrowing. This

Table 16.3 Taxation and user-charge revenue powers of the three spheres of government[a]

	Current taxes	*Current user charges*	*Potential taxes*
National[b]	Income tax (personal) (R86.4 bn) Income tax (corporate) (R26 bn) VAT (R54 bn) Fuel levy (R14.9 bn) Excise (R9.7 bn)		
Provincial	Gambling (R468 mn) Other (R540 mn)	Motor car licence fees (1.6 bn) Hospital fees (R395 mn)	Surcharge on personal income tax Surcharge on fuel levy Small taxes
Local	Property Tax (R10.1 bn) Regional levies (R3.9 bn)	Electricity/Water (R23,9 bn)[c]	Small betterment taxes

Notes

a The figures are indicative, to enable the reader to gauge the fiscal capacity of the three spheres. The figures for national are the most accurate, while that of local government the least accurate, being a guesstimate.

b Total tax revenue collected by the national government is estimated to be R208.4 bn in 2000. If total local and provincial tax is estimated at R13.4 bn, the total tax-to-GDP for the three spheres is estimated at around 25.3 percent, with subnational tax comprising around 6 percent of the total tax take of the three spheres.

c Note that this represents the budgeted gross income from the provision of electricity and water. The bulk purchase of electricity and water around R14 bn. If salaries/wages and administrative costs are taken into account, the net "surplus" from these services is significantly smaller, probably less than R1 billion.

legislation allows for a form of judicial intervention in the event of defaults, clarifying the rights of lenders.

To summarize, provinces and local governments have different fiscal capacities. Local governments have significantly more revenue-raising powers than provincial governments, raising over 90 percent of their own revenue, while provinces raise only 4 percent of their own revenue. Local governments have traditionally been allowed to borrow for both capital and bridging purposes, while provinces only borrow for bridging purposes. Provinces are, therefore, totally dependent on transfers, receiving R108.4 billion or 96.8 percent of their revenue, while local governments are less dependent, receiving R7 billion or around 10 percent of their total revenue.

Intergovernmental transfer system

Vertical division of revenue

Under the South African revenue-sharing system, nationally raised revenue is divided among the three spheres after national debt-servicing needs and a contingency reserve for emergencies are taken into account. This means that after deducting the R46.2 billion for debt-servicing in 2000, non-interest expenditure of R189 billion is available to be divided between the three spheres. Allocations are made for three years under the multi-year budgeting system in South Africa.

The Constitution requires ten factors be taken into account to help determine this division. This includes fiscal capacity and expenditure efficiency of the provincial and local spheres, their developmental needs and backlogs, and provision for emergency funding. Before proposing its final allocations to Parliament, the national Cabinet discusses its proposals with provinces and local government at the appropriate intergovernmental forums, the Budget Council and the Budget Forum.[12] It also takes into account any recommendations from the FFC. In addition, provincial premiers are invited to the Cabinet meeting where the final allocations between the three spheres is decided.

The consultations use as their starting point a *baseline allocation* (which includes the implicit percentage shares allocated to each of the three spheres) that reflects the three-year allocations from the last budget. As a result, it is only the additional resources that have to be allocated. This division between the three spheres reflects priorities determined by the national Cabinet after the above consultations. It is a *political judgment*, and depending on the program or sector prioritized, more resources are made available to the implementing sphere. Thus, if school education is identified as a new or higher priority, the provincial share increases over the baseline allocation from the current three-year allocation; if policing is a priority, the national government share is increased.

Given the high demands facing a developing country like South Africa and the need to prioritize, it is unlikely a formula-driven approach can be utilized to improve on this process for the vertical division among the three spheres. The political judgment approach does not make the budget process *ad-hoc*, given the baseline allocations (and the implicit baseline percentage share) of each sphere. The provincial and local spheres are (implicitly) guaranteed their baseline three-year allocations. Furthermore, Parliament (and particularly the second house, the National Council of Provinces) subjects such allocations and shares to rigorous scrutiny, where the FFC (and provincial and local) comments are also taken into account.

The political judgment, thus only involves allocations on the margin, and the additional allocations indicate the new priorities determined by the national executive. It is also not an unfettered political judgment, as the baseline percentage share between the three spheres is an important factor when such new priorities are taken into account. It would be incorrect, as well as unrealistic, to make the resource allocation process a mechanistic one determined by a formula. A formula-approach for the vertical division is not necessarily any more certain or less *ad-hoc*. For instance, a formula will be subject to annual changes as policy priorities change or better information becomes available.

In a developing country like South Africa, any formula is dependent on the information available, and will be subject to change as information is revised or improved. For example, in South Africa, given the number of informal settlements and high levels of illiteracy and poverty, census information is subject to changes from data corrections or new migrancy patterns. More complicated formulae attempting to capture the costs of providing basic services are more difficult to implement, not only because they require more sophisticated information, but also because they still require political judgment on the minimum *levels of service* to be prioritized. The higher the level of service, the higher the costs. Those functions with relatively high levels of service will in effect squeeze out those functions with lower levels of service. For this reason, the South African government has not accepted the proposed costed-norms approach of the FFC.[13]

It is the process to make these divisions that must be open and transparent, and allocations should be on three-year basis. Any sudden or major changes in allocations should be phased-in, reducing uncertainty and stabilizing the budget process.

Table 16.4 Division of revenue between the spheres of government[a]

Rand million	*2000/01 Budget*	*Revised estimates*	*2001/02 Budget*	*2002/03*	*2003/04*
				Medium-term estimate	
National allocation	75,212	74,414	84,287	89,955	95,432
Provincial allocation	106,037	108,736	117,386	126,563	135,221
Equitable share	*94,408*	*96,186*	*104,136*	*112,560*	*120,215*
Conditional grants	*11,629*	*12,551*	*13,250*	*14,003*	*15,006*
Local government allocation	3,713	5,712	6,506	7,155	7,849
Equitable share	*2,330*	*2,330*	*2,618*	*3,002*	*3,551*
Conditional grants	*1,383*	*3,382*	*3,888*	*4,153*	*4,298*
Allocated expenditure	184,962	188,863	208,179	223,672	238,502
Plus:					
Debt service costs	46,490	46,186	48,138	49,651	51,022
Contingency reserve	2,000		2,000	4,000	8,000
Total expenditure	233,453	235,048	258,318	277,323	297,524
Percentage of shared total	100	100	100	100	100
National allocation (%)	*40.7*	*39.4*	*40.5*	*40.2*	*40.0*
Provincial allocation (%)	*57.3*	*57.6*	*56.4*	*56.6*	*56.7*
Local government allocation (%)	*2.0*	*3.0*	*3.1*	*3.2*	*3.3*

Note
a Table 7.1 in Budget Review 2001.

Horizontal distribution

The *equitable share* is an unconditional grant to enable provinces and local governments to provide basic services and to perform any functions assigned to them (see Table 16.4). These allocations are not appropriated in the national budget, but only in the provincial/municipal budget, as they are regarded as a direct charge, legislated in the annual Division of Revenue Act.[14]

Once the provincial and local equitable share allocations are determined, a formula is used to effect the division between municipalities.

The *provincial formula*[15] utilizes seven factors. The heaviest weighting measures the need for education, health and welfare needs. In addition, the formula contains backlog and economic activity components. It favors the poorer provinces. Directed at basic services, the local formula[16] targets households at the lowest income level (less than R800 per month). This formula supports the more rural and very poor municipalities.

In addition to equitable share allocations, provinces and local governments also receive conditional grants from the national share. These grants are targeted first at the allocated functions (e.g. academic/highly specialized hospitals which provide services to residents of all provinces). They also support national priorities like housing, municipal infrastructure for poor households, and capital grants to address backlogs. Conditional grants are appropriated in both the national and provincial/municipal budgets, and are legislated in the annual Division of Revenue Act.

While the equitable share allocations have worked smoothly, there have been problems with conditional grants. Many of these lack a clear purpose and measurable objectives and are poorly designed. They tend to undermine the budget reform process and fragment the budget process. They undermine co-ordination between policy and budgeting, are not transparent, may lead to budget game-playing and create confusion about accountability. Some national departments regard them as a lever to force changes and/or attempt to micro-control such grants. Delays in decisions, including a failure to make three-year allocations for many such grants, results in non-transfers and under spending of some conditional grants.

A comprehensive budget process for determining all allocations is best suited to incorporating policy priorities. The challenge facing the budgeting process in South Africa is to ensure that the process to determine conditional grant allocations is part of a comprehensive budget process.

Experience and lessons from fiscal decentralization

Provincial experience

The new provincial administrations had little or no time to prepare for their establishment in 1994. Their initial years were difficult, as the new provinces struggled to merge fourteen different administrations into nine new ones. Since there was a centralized budget process before 1994, as provinces were mere administrations then, provinces had to develop the capacity to budget as the new, more decentralized, budget system began to be implemented.

Most provinces struggled initially, given the lack of expertise and information on spending prior to 1994. The implementation of new national policies to correct past injustices added further pressure. Policies to redress previous neglect and deprivation in education and health in black areas resulted in significant increases in the number of teachers and health personnel. The nationally negotiated wage agreement, together with the equalization of salaries between white and black officials at the higher "white" levels, dramatically increased the share of personnel expenditure.

Provincial treasuries, having been established in 1994, were initially not in a position to monitor or check the expenditure of departments from 1994 to 1997. The treasuries were dependent on the one-year input-driven budgeting system used at that time, and they lacked any in-year management system. There were long delays before financial statements were completed and in some cases, the books from previous years were simply never closed. As a result, the nature and extent of budget problems were not well understood.

Overspending, particularly in departments like education, health and welfare, was identified only late in 1997, during preparations for the 1998 budget. Such overspending did not lead to deficits in 1995 and 1996, as it was funded from unspent transfers meant for other priority programs (the Reconstruction and Development Programme (RDP)). During this time, the heads of departments frequently ignored their budgets, and provincial treasuries proved unable to curb spending. Provincial treasuries were forced to run large overdrafts in some cases, but generally failed to alert the national treasury about the severity and extent of their problems. The seriousness of the situation became clear only when banks were no longer willing to extend additional overdraft facilities to provinces, in particular the Eastern Cape and KwaZulu-Natal. Provinces ran an aggregate deficit of R5.5 billion in 1997, or about 5.8 percent of actual spending.

All provinces experienced similar over-spending, in large part due to implementing nationally determined policies. This included the nationally-negotiated salary agreement and new policies in the education, health and welfare sectors. Much of this problem was due to the lack of co-ordination between policy-making and budgeting, and the rapid creation of a decentralized system compounded this problem. The implementation of nationally agreed policies was not necessarily an unfunded mandate, however. Such policies (in education, health and welfare) were implemented with the full support of provincial line function departments who were also involved in developing the policies.

Sectoral collusion to secure more funds for a sector proved to be a far stronger factor in overspending than unfunded mandates. Intergovernmental forums[17] in education, health and welfare developed national policy without taking into account budgetary resources. Many departments adopted an aggressive policy to address backlogs in deprived black areas. The outcome in the welfare sector was successful in reducing poverty, as social pensions were extended to cover poor black pensioners. However, the policy was less successful in education and health, where the effect was to increase the cost of inputs (personnel expenditure) rather than improve outputs like better quality education or health services. For instance, differences in teacher–pupil ratios were reduced between black and white schools. But this did not always have the desired result of improving the quality of education in black schools. The increase in personnel expenditure squeezed out expenditure in non-personnel inputs like textbooks, undermining the attainment of the desired outputs. Similar problems existed in health where large pay increases made it impossible to buy needed medical equipment and drugs.

National government was forced to intervene, and impose stringent measures in provinces, such as spending controls, freezing employment, and cutbacks in non-social security expenditure. Provincial treasuries helped to implement such measures. A monthly reporting system was created and the national treasury assisted provinces in drawing up more realistic budgets for the financial year 1998.

The problem of a lack of co-ordination was resolved by the creation of joint intergovernmental forums, between the treasuries and that function. For example, a joint Minmec comprising the national Ministers of Finance and Education, together with their counterparts in provinces met at least twice a year to co-ordinate policy-making, budgeting and implementation. These structures are supported by a range of large and small technical forums of officials from national and provincial treasuries and line function departments.[18] These forums ensure that budgets and national policy are aligned, and that provincial departments adhere to their budgets. It also reduced the budget games played by such sectors.

The implementation of these simple but critical measures helped to turn around provincial finances dramatically, as they ran a R500 million surplus in 1998–99 compared to the R5.5 billion deficit a year earlier. Provinces stabilized their personnel expenditure and began shifting funds towards non-personnel budgets and payment of debts. The implementation of a multi-year budget from 1998 onwards, also helped provinces to prepare more realistic budgets. Provinces have run surpluses every year since 1998 to pay off their debt by the end of the financial year 2000. This has put them in a strong position to focus on the micro reforms necessary to improve the quality of spending in education and health and on increasing their budgets for infrastructure.

The importance of best practices and peer learning, as well as benchmarking, have also played a significant role in the turn-around of provincial finances. Following the best practices established in more innovative provinces proved to be invaluable in the

South African experience. The province of Gauteng, for example, focused on modernizing its approach to budgeting and financial management, providing a best practice for both provincial and national departments. Once the Gauteng provincial treasury had set up its three-year budgeting process and its financial systems, its officials were inundated by requests from other provincial treasuries to help implement reforms in their provinces. The Budget Council (and its technical meetings) provided a further forum to demonstrate such best practices to all provinces. Provincial treasuries worked closely together, and the role of peer learning has been a major factor in improving the performance of all provincial treasuries. This is a real benefit of fiscal decentralization, as it clearly allows for greater variety and innovation.

A further impetus for reform emerged through *benchmarking*. The publication by national government of the first *Intergovernmental Fiscal Review* in 1999 marked the culmination of attempts to benchmark the various provincial budgets, especially for the education, health and welfare sectors. The production of comparable statistics is dependent on the successful implementation of a uniform classification system (e.g. the new GFS, budget formats and a chart of accounts). Comparisons between provinces not only identified cost-drivers, but emphasized the need for further reforms in lagging provinces.

While the implementation of fiscal decentralization in provinces appears to be successful after initial problems, there are areas where progress has been slow or non-existent. Provincial governments so far have not succeeded in improving their revenue collection or to increase their revenue potential from current sources, neither have they take effective measures in dealing with excess staff. This can be attributed largely to the lack of agreement with the trade unions on a mechanism to retrench excess staff. The responsibility to secure such an agreement resides with the national government. The slow progress in these areas tended to undermine provincial budgets, as all projected revenue was not collected, or savings from staff reductions did not materialize.

Local government experience

It is harder to assess the progress (or the lack of it) in the state of local government finances. One reason for this is the archaic line-item (telephone directory type) budgeting system inherited in 1994, which did not promote in-year management of budgets. Budgets were not adhered to, making the budget information base inconsistent, lacking uniformity and of poor quality. Delays in preparation and submission of financial statements (as was the case with provinces) exacerbated this problem.

Though the fiscal capacity of the local sphere (in aggregate) is much stronger than that of the provincial sphere, there is great variance between municipalities. The major urban municipalities have strong revenue-generating powers, and are only marginally dependent on transfers from the national government. Many rural and smaller urban municipalities, however, have very weak fiscal capacity, and are strongly dependent on transfers from the national government. Many of the smaller municipalities were not financially viable, and have therefore been phased out under the new demarcation system implemented in November 2000. This new system created 284 new municipalities, with all the rural municipalities now consolidated with neighboring urban municipalities. Most of these municipalities are, however, very small in budgetary terms with budgets under R100 million. The twenty biggest municipalities make up about 80 percent of the aggregated local government budget, with the six metropolitan municipalities making up at least 50 percent.

The financial problems of municipalities can be largely attributed to poor budgeting systems and the failure to collect revenue. Apart from the poor design of municipal budgets, the budget process often lacks depth (it had no buy-in from politicians, as officials drove the process as a technical exercise) and fails to close the gap between ambitious plans and actual financial resources. The budgets also often over-estimate revenue (using an accrual system of estimating revenue), resulting in deficits, and poor accounting systems do not reveal how reserves are used to finance such deficits. Finally, municipalities have often not focused on revenue collection, instead attempting to secure more funds from the national government.

The challenge facing South Africa is to stabilize the finances of the new municipalities, as they will be carrying the burden accumulated from the previous unviable municipalities. They also inherited the poor budgeting and financial management system and mindset of officials steeped in such systems. But the biggest challenge facing municipalities is that of modernizing their organizational structures. Few municipalities run key services on a commercial basis or as distinct cost centers, resulting in poor management systems with great inefficiencies.

Although the bigger municipalities are in a better financial state, this has in some instances only come about after a major financial crisis. The largest municipality, Johannesburg, experienced a serious financial crisis in 1997, on a scale comparable with the New York City crisis of the mid-1970s. After national and provincial government intervention, Johannesburg put in place tough restructuring proposals[19] in an attempt to turnaround its finances. In the process, the municipality is piloting a modernization program, including the creation of utilities to run its services on a more business-like basis, privatizing non-core functions, introducing a multi-year budgeting system and a management-oriented financial reporting system to reflect information in a more transparent manner.

Reforms in local government budgeting and financing will be phased in over the next five to ten years. Such reforms will be accompanied by a modernization program in the way municipalities provide services like electricity and water. The national treasury is piloting many budgeting and financial management reforms (similar to those implemented in provinces) with seven of the larger municipalities. Once these are successfully implemented over the next two years, the reforms will be rolled-out to all other municipalities. The pilot approach is the only feasible way to roll out reform to so many municipalities. While it is supported by donor support, there is much potential to increase the scale of such support.

Devolution of functions

While some functions may be performed in any sphere of government, the South African experience indicates that some functions are difficult to perform in the national sphere. While defence, foreign affairs and higher education are clearly national functions, it is less clear where academic hospitals and welfare grants, currently in provinces, would be better performed. It is also not clear whether school education or health clinics are better performed at the provincial level rather than at the local level. Much depends on where such functions have traditionally been assigned and where implementing skills exist.

In the limited South African experience since 1994, some lessons are beginning to emerge, particularly for household and municipal infrastructure. Unlike many countries, the local sphere in South Africa is autonomous, and not under the control of the provincial or national government. But national departments have been able to intervene directly in municipal affairs through the use of grants-in-aid for the delivery of services to the poor. For example, water and sanitation services and infrastructure have been provided to rural areas by the national department responsible for water affairs. In addition, national government manages a conditional grant for municipal infrastructure. All these grants fund specific projects.

Although such measures were necessary in 1994 in order to ensure speedy delivery, national departments are too far removed from local areas to take account of local demand for services. The project-based approach resulted in a lack of attention to sustainability considerations (e.g. who is responsible for maintaining infrastructure and the collection of user fees for such services). It has also led to locational decisions that were not well coordinated with spatial and delivery plans of provincial or local governments (e.g. for the provision of schools, clinics or municipal infrastructure). Further, since such projects were not on the budgets of a municipality, no provision was made for the complementary services required to make the project successful. National government has shifted away from this approach, and will henceforth shift funds for such services to the responsible sphere of government. The municipal infrastructure fund is being consolidated with similar national programs (water infrastructure), and allocated between municipalities on a formula basis for a three-year period. The poor co-ordination between these infrastructure programs and the housing program is also to be addressed. It is likely that well capacitated local governments, like the six metros with good capacity, will be given more responsibility for the housing programs that are currently supervised by national and provincial government.

Poverty alleviation

Poverty alleviation is an important objective in developing countries. In South Africa, poverty-alleviation programmes like welfare grants, the provision of free basic water and electricity for poor households are implemented through the equitable share and conditional grant allocations to provinces and local government.

There has been much confusion amongst policy-makers in South Africa about the extent to which subnational governments are expected to redistribute from rich to poor households (or from urban to rural) from their own revenue raised. The approach adopted in South Africa suggests that while subnational governments must take some responsibility for redistribution, using their own taxes and tariff charges (where rich households should pay to subsidize poor households), this capacity is limited. The national tax system is far more effective in funding redistribution and poverty-alleviation, and the equitable share allocations should be adjusted as such programs are prioritized by the national government.

Financial management

A critical element in laying the basis for the modernization of the financial management system was the passage of the 1999 Public Finance Management Act. This Act clarified the division of responsibilities between the political head (Cabinet Minister) and head of department. The political head is responsible for policy and outcomes, while the head of department is responsible for implementation, and hence is also made the accounting-officer responsible for the spending of the department's budget.

The Act also spells out the responsibilities of the accounting-officer, and the deadlines for the submission of financial statements and annual reports. It also obligates the accounting officer to submit (and use!) monthly reports to the treasury and political head.

The underlying philosophy of the Act is to enable managers to manage, but to hold them more accountable. It requires the accounting officer to collect management information on a monthly basis and use such information.

This Act applies to national and provincial governments. Similar legislation has been tabled for local governments.

Why conventional arguments are not critical to analyzing fiscal decentralization in South Africa

The debate on decentralization must not be cast in extreme terms: that is, whether all powers and functions must be centralized or decentralized. No country fully fits into either of the two extremes. Though South Africa is not a federal country, it is characterized by a high degree of decentralization of powers and functions. Such decentralization is the result of historical factors and political negotiations during 1993 and 1994.

The evidence in South Africa suggests that appropriate decentralization does lead to better outcomes (or that inappropriate centralization leads to sub-optimal outcomes). However, determining the optimal assignment of functions between spheres is a complex process with no easy options. More difficult is determining whether, and when, to decentralize fiscal powers.

Decentralization should be ideally carefully phased in, taking into account capacity, but this is not always possible. In a developing country context, such capacity is often not immediately available. It cannot, therefore, be assumed that when it is available, it is at the national government level – an implicit assumption assumed by many when recommending a slow and ordered sequence of devolution.

It is, therefore, much too simple to attribute any problems in fiscal decentralization in South Africa to the poor design or lack of clarity in assignment of functions, or mismatch between revenue powers and expenditure responsibilities or to the rate or sequencing of the devolution of functions. It is too easy to blame problems on the lack of capacity or poor information. These are the everyday realities of a developing country, affecting every sphere of government, irrespective of the degree of fiscal decentralization.

An important lesson in South Africa is that decentralization is more likely to be successful if all allocations to perform such functions are properly budgeted for in subnational budgets. A problem with grants-in-kind is that they are often budgeted for at the national level, but are not taken into account in subnational budgets. This can undermine accountability and transparency at the subnational level, as it bypasses the subnational budget process and confuses accountability arrangements. This is particularly true where the subnational government is expected to take over the maintenance and operating costs of any asset built though a grant-in-kind.

It also does not automatically follow that shifting more revenue powers to match devolved expenditure functions will lead to more fiscal responsibility or better outcomes. In South Africa, the local government sphere has far more significant revenue-generating powers than the provincial sphere, yet municipalities appear more inclined to run deficits, often due to a continual failure to collect all revenue due.

Decentralization (or centralization) will not work if problems of capacity, budgeting, financial management, reporting, information and transparency are not addressed simultaneously. These are the fundamental building blocks of good and effective government. They are probably more critical in a decentralized context, because if these areas are not addressed, the problems surrounding assignment of functions and sequencing cannot be solved anyway.

Assignment of revenue and expenditure powers

The South African Constitution is detailed and the division of powers and functions is clearly defined. In terms of actual operation, the revenue-raising powers of each sphere are unambiguous, as is the case with expenditure powers.

There are, however, many dimensions to any function. Even where this is clearly defined in terms of practice, there are many areas where cooperation across spheres is necessary on a regular basis. For such sharing – for example, policymaking and implementation – some details always have to be worked out at the implementation stage. Though the South African system sounds easy to understand on paper – national departments make policy to ensure certain standards across the country, while provinces and municipalities implement to ensure local needs are met – it still proves difficult to implement, since it not only involves coordinating policy and budgets, but has also to take account of varying capacity in the different spheres.

The optimal assignment of functions and sequencing of devolution constantly evolves in a decentralized system. These relationships change and evolve even in developed countries (e.g. in the United States, the balance of power between the federal government and the states has shifted over time). To make matters worse, even where there is clarity on the division of powers and functions, regulatory powers of national governments or their agencies can impose additional (cost) burdens on subnational governments. Changes in sectoral policy (if determined nationally) may also introduce significant shocks to subnational governments.[20]

The South African system is clearly defined compared to most other countries. A lack of clear assignment can therefore not be a significant factor when analyzing fiscal decentralization in South Africa.

Matching of revenue and expenditure powers

The South African experience does not suggest that increasing the revenue capacity of subnational governments (by shifting the fiscal powers from the central government) will necessarily lead to more fiscal responsibility or a better outcome.

In terms of fiscal powers, the lesson in South Africa is that better fiscal matching by itself is no guarantee for better outcomes in terms of fiscal responsibility. The revenue-raising powers of provinces and local government differ, with local government having significantly more powers. In some instances (like the major metros) such revenue powers almost match expenditure responsibilities. But local governments are not more fiscally responsible than provincial governments.

It is not automatic that subnational governments with taxation and revenue-raising powers use such powers effectively. Subnational governments have proved to be more prone to spending than collecting revenue, and less inclined to avoiding deficits than national government, which is more sensitive to its credit-rating and international image. Until pressured by national government, provincial governments did not adjust fees for services on an annual basis, and continued to collect less revenue even in nominal terms. Subnational governments also do not generally adjust their budgets downward during the financial year to account for lower-than-budgeted revenues.

Comparisons between the province of Gauteng and its capital city Johannesburg are a case in point. One has revenues to match expenditure, the other does not; yet it is Gauteng that was better managed before the budget crisis affected Johannesburg in 1997. Both have large budgets, with Gauteng having a budget of R18 billion in 2000 and Johannesburg about R8 billion. When salaries and pension grants are excluded, Johannesburg and Gauteng have similar size discretionary budgets. Given their revenue powers, Johannesburg is not dependent on national transfers. It raised almost all its own revenue, while Gauteng province is totally dependent (94 percent of its budget) on national transfers. Yet Johannesburg proved to be fiscally irresponsible during 1994–97, not collecting a significant portion of its revenue, raiding all its reserves, and not curtailing its expenditure. National and provincial government intervened, and forced the city to acknowledge that it was in the midst of a serious financial crisis, and that it should not expect to be bailed-out by the national or provincial government. It took a further two years before the city took full ownership of its crisis, developing its own restructuring proposals to turn the city's finances around. The city is now proving to be a model for the reform of other municipalities in the country.

In contrast, the Gauteng province prided itself as a modernizer, and as a fiscally responsible government, from its creation in 1994. It helped demonstrate to national government, the adverse consequences of some of the new sectoral policies, including the impact of the first wage agreements. Although dependent on national transfers, it resisted the temptation to be bailed-out by national government, and instead focused on bringing overspending departments into line. National government did not have to persuade the provincial government to take tough measures to make its budget more credible, and improve its quality of financial management. The province took responsibility for its problems, and led other provinces in reforming its finances.

The risks associated with moral hazard can be contained if government adopts a strict no-bail-out approach, backed by a policy of not guaranteeing any subnational loans or deficits. However, this is easier said than done, and national government should have an intervention policy in place where tough sanctions apply against both political and departmental heads. Such intervention should occur only if all else has failed, and no co-operative process to address the problem is possible. A cooperative intervention is far more likely to succeed.[21]

It is important for revenue powers to be phased in carefully. Developing countries are under extreme pressure to limit their tax-to-GDP ratio if they want to attract investors.

Given the higher risk attributed to developing (or emerging) countries, they have to go much further than developed countries to demonstrate the credibility of their macroeconomic policies, and to prove that they can use their fiscal powers prudently. This calls for caution and a gradual approach in shifting taxation powers to subnational governments.

The initial lessons from South Africa indicate that subnational governments require both capacity and the political will to collect revenue due. It is also important when the tax base is small because of inequity in income, to ensure subnational governments resist the temptation to be selective in the collection of revenue (e.g. by concentrating only those paying their fees or taxes, and ignoring or forgiving those not paying).

Subnational governments have not demonstrated significant improvements in collecting all revenue due, or in increasing their revenue potential from current sources.

The approach adopted in South Africa is to ensure that rudimentary expenditure controls are in place before revenue powers can be expanded to any subnational government; it is difficult to know how much revenue to raise without knowing the amounts and objectives of funds spent. Secondly, it is important that such subnational governments are collecting their revenue from current sources.

Poor skills and capacity

In a developing country like South Africa, capacity and information are limited. An argument for sequencing of functions often assumes that national departments have such capacity in the first place. Where capacity is poor, it may be poor at both the local/provincial and national levels. Such capacity may exist, but not be properly distributed in terms of where it is required (e.g. urban areas are more likely to have skilled personnel than rural areas).

Certainly, there is more capacity in South Africa than in many other developing countries – but the capacity or skills are not always appropriate to the task at hand. Similarly, available capacity is hampered by lack of tools (e.g. information) or lack of clear policy direction.

The type of capacity that may exist in government may also not be appropriate for other reasons. In South Africa, many public servants were trained to deliver in developed (formerly white) areas, and are not skilled or be easily re-deployed to poor and deprived (black) areas, where the problems may be fundamentally different. The capacity to deal with poor and deprived (black) areas has had to be built up from almost nothing, making the challenge of immediate delivery a near-impossible task for any government.

Building the appropriate capacity must also be seen as part of a dynamic process, part of a development strategy. Appropriate capacity is unlikely to arise in a vacuum, but will develop only when and where there is a demand for it – in other words, when a function is assigned to the national or subnational government, it starts to develop capacity.

A major problem for developing countries is the migration of highly developed skills to developed countries (e.g. doctors, nurses, IT, chartered accountants, managers and professionals). Where skilled staff leave the public sector, they do not necessarily do so for the domestic private sector, but to emigrate out of the country. Constant changes in top management is a further problem – for example, one education department has had five heads of department in as many years – this is a sure recipe for failure. Attracting and retaining skills is critical to building sustainable capacity in the public sector.

Decentralization strategy must take capacity into account, but it may not be a critical factor in deciding whether to decentralize or not in the short-term. In any case, government can reduce disruption if it has a clear view of existing capacity when taking steps to devolve functions. There are trade-offs; government needs to address short-term problems with capacity at hand, but then make sure more appropriate capacity is being developed for long-term challenges. This requires pragmatic assessment of existing capacity and to focus on what is possible, in a phased and asymmetric manner. A peer-learning and mentorship approach can complement any approach in building capacity in subnational governments.

Information

Similar problems exist with information. In a developing country, even basic statistics may not be available. Population figures, even where they exist and are reliable, may not be available by region or locality. The challenge facing policy-makers in such a changing or dynamic environment is to construct policy (and formulae), and to improve information at the same time. As information improves, policies must be adjusted and fine-tuned. One cannot wait to improve information, and then set out to construct policy. The poorer an area, the more likely that information on such an area is inadequate. This makes it difficult to cost the needs of such communities.

Poor information is not only the product of poor capacity, but also the result of non-existent or poor management in the public sector. Reforms to introduce and improve management in government departments will go hand-in-hand with the process to improve public sector management and other information. By ensuring that managers use available information, the quality of information will come under closer scrutiny and would likely improve. An initial lesson in implementing financial management and reporting reforms indicates that monthly reporting is more effective than quarterly (or irregular) reporting, as monthly reporting is more likely to become a routine activity (together with the closing of monthly accounts) for managers.

The issue of poor information, and improving such information is particularly applicable to the budget process. The budget process has to proceed, irrespective of the quality of information. Budget and financial information may not be reliable for a number of reasons, especially where audits on financial statements are not available when required – this may be due to the fact that there is no auditing, poor audit capacity, poor quality of financial statements or long delays in the completion of financial statements. Where actual expenditure and revenue is not being monitored on a monthly basis, and such information is not available in time to inform the next budget, the quality of information will tend to be poor and unreliable, making budget decision-making even harder.

The issue of poor information must be factored in when analyzing fiscal decentralization in a developing country. It is all to easy to blame poor information for any weaknesses in fiscal decentralization. Instituting reforms to improve information must go hand-in-hand with other budget reforms.

Political factors

The type of political system, or the stage of its development, is a critical factor to consider when assessing why conventional economic theory may not be applicable to developing countries.

The South African system consists of elected national, provincial and local governments, an independent judiciary, and a critical and independent media. While the electoral process is sensitive to public opinion, the level of literacy may determine the speed of such political response. Left to themselves, subnational governments can bleed for a long time before the democratic or political process can respond to correct the problem. The response is slowest in the local sphere, as national departments are, almost always, much more in the public eye. Most media are national or regional, and are generally not particularly interested in local news. In a developing country, with a high degree of illiteracy, and with a high level of conflict or division, the political process may take even longer to respond to events at the local level. Transparency without effective accountability undermines fiscal decentralization, particularly where the political process is too slow to respond to negative actions.

The quality of audits by the office of the Auditor-General, and its ability to focus the legislature on material issues (rather than technical violations), is important for the accountability mechanisms to be effective. The capacity of the legislature to focus on such material issues, and to monitor the implementation of any corrective measures, and to apply sanctions over non-complying accounting officers, is a major challenge. Many of the parliamentary committees which oversee departmental activities tend to shy away from financial monitoring (leaving this to the public accounts committee).

The problem is even greater in provincial legislatures, where capacity is a bigger problem. The informed media adds to public confusion by ignoring the local governance arrangements, and expecting national intervention for every problem at the subnational level. Building the capacity of the various stakeholders in the political process is important for ensuring that the local political process functions effectively.

Conclusion and way forward

Fiscal decentralization does offer benefits to developing countries, because many functions like housing, municipal infrastructure, school education and primary health are better situated at the regional or local level. There are sufficient examples in South Africa to indicate why it is problematic for national departments, and more appropriate for provincial/regional or local government, to co-ordinate or organize these functions. However, determining which functions to decentralize may be less clear-cut. While obvious for some functions, it is more difficult with complex functions like highly specialized/academic hospitals, welfare grants and major roads.

The South African experience indicates that no system, whether centralized or decentralized, will work well if basic budget and financial reforms (together with good governance measures to promote transparency and accountability) are not in place. South Africa has benefited greatly from the implementation of a multi-year budget framework, where budgets are set at realistic levels and they are supported by effective monitoring and auditing systems, including in-year management. To be effective, the financial statements must be submitted on time, with audit opinion and financial statements submitted to the legislature within a specified period (say six months) after the end of the financial year.

A fiscally decentralized system is probably riskier than a centralized one if such budget and good governance mechanisms are not in place. The national government (or its treasury) must ensure that no subnational government ignores these basic budgeting and financial management principles.

Decentralization is far less likely to work if these basic elements are not in place or fail to be addressed as decentralization is implemented. In determining the extent of fiscal decentralization, and the sequencing of such fiscal powers, the South African experience indicates that it is important to ensure that basic expenditure controls are in place before devolving further functions. Furthermore, the revenue potential of existing revenue sources must be maximized, with additional taxation powers devolved only after significant progress has been made with regard to expenditure controls and the collection of revenue. South Africa shows that increasing revenue capacity (by shifting the fiscal powers from the central government) will not necessarily lead to more fiscal responsibility or a better outcome.

The process of aligning expenditure and revenue-raising powers at subnational levels (so-called "fiscal matching") must therefore be phased in, but imbalances may never be totally eliminated. While moral hazard is clearly a risk in the case of such a mismatch, this risk can be contained if government adopts a strict no-bail-out approach, backed by a policy of not guaranteeing any subnational loans or deficits. The fiscal system also requires a workable intervention mechanism in the event that subnational governments ignore good fiscal practices.

Institutionalizing a comprehensive budget process is important, not only to promote more transparency and accountability, but to facilitate more participation in the budget process. This is even more important in a fiscally decentralized environment, where the provincial and local spheres are dependent on grants from nationally raised revenue. It is critical that the process of dividing nationally raised revenue is effected through a transparent and participatory process. Having one comprehensive budget process is critical in this respect. A separate process to determine some grants (e.g. conditional grants) can fragment the budget process, undermine the underlying policy-prioritization process, introduce uncertainty and confuse lines of accountability.

Contrary to the approach frequently espoused, the South African experience indicates that it is more important to ensure that the process of dividing nationally raised revenue between the spheres is an objective one, rather than a formula-driven one. The three-year budgeting process in South Africa offers subnational governments a certain degree of certainty about their allocations, allowing for proper planning to take plan, and focuses the annual budget discussions on the *additional* resources to be allocated. This approach takes into account that budgets should be determined in terms of a policy-prioritization process. In contrast, the horizontal division of the provincial and local equitable share allocation can and should utilize a formula to ensure fairness in allocating funds between provinces and municipalities.

The budget process must integrate policy, planning and budgeting. In South Africa, the creation of joint forums between the treasury and line functions across the spheres has helped to reduce budget-games through sectoral collusion, without undermining subnational autonomy.

Some of these lessons seem to go against conventional wisdom. But from the perspective of a practitioner, the real lesson is that a country cannot enjoy the benefits of decentralization without simultaneously reforming its budget process. It has to address the problems of capacity, information and financial management simultaneously, and ensure that the political system is responsive at subnational levels. These elements cannot be viewed in isolation from the implementation of a decentralized system, and need to be seen as part of a dynamic process where they improve as implementation takes place. It is often not possible to carefully phase in fiscal decentralization after bringing capacity and information up to a minimum standard.

Indeed, the process of improving capacity and information is part of a broader developmental strategy, and must be addressed as part of a general process to modernize and improve the public sector. In determining when to decentralize, national government should consider an asymmetric approach, choosing those subnational governments that have demonstrated their capacity (or shown the potential) to perform. In South Africa, a peer learning or mentorship approach, together with benchmarking, has proved to be an effective and invaluable approach in improving the quality of budgeting and financial management in subnational governments. Improving budget formats, introducing the new GFS classifications, improving the accounting standards and reforming the chart of accounts are essential elements for reforming the financial management system, and improving information for the purpose of benchmarking.

Donor agencies can and should do much more to assist in the area of building capacity and developing budget and financial management systems. Such a program could include the development of training institutions for public officials, as well as a major program to deploy experienced budgeting staff from developed countries (on for e.g. two-year secondments). The South African experience demonstrates that, with a few exceptions, donor agencies have not made this type of assistance program a major priority. The benefits of any such a program, however, can and will significantly improve the service delivery capacity of governments in developing countries.

To conclude, when assessing the success of the South African government in fiscal decentralization, the provincial experience is particularly instructive. In implementing a decentralized system in the post-Apartheid era, the South African government has faced challenges that are typical of many developing countries. Although the specific solutions to problems may have been tailored to South Africa's unique situation, these techniques can easily be adapted to suit the circumstances in other developing countries. At the heart of the South African approach, however, has been a dedication to proper budgeting and financial management. These have proven to be essential ingredients in the promotion of an effective decentralized system.

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Appendix: type of reforms to be prioritized in developing countries

The following measures have been critical to lay the basis for success in the provincial sphere of government:

- a Ensuring provinces have credible budgets;
- b Introducing mechanisms to close the budget and policy gaps;
- c Deepening the budget preparation process, with the involvement of the elected political executive at key points in the process;
- d Ensuring provinces manage and stick to their budgets in-year;
- e Publishing "state of the budget" reports on a monthly or quarterly basis;
- f Introducing consistent and comparable budget formats, classifications and chart of accounts;
- g Benchmarking provincial budgets through the publication of the intergovernmental fiscal review.

General budget and financial management reforms

Whatever the political system (centralized or decentralized), some necessary reforms to modernize the public sector are necessary. These reforms should be implemented as the very first steps, and will be part of the process to improve capacity and the quality of information. Many of these measures may be obvious in a developed country, but should not be taken for granted in a developing country. Sticking to the deadlines, and the underlying processes, is a major challenge for any government, and requires building the capacity of the various players (e.g. financial accountants, treasury officials, auditors and legislators). A lax attitude by any of the players (e.g. legislators or auditors in accepting delays in the submission of financial statements) not only entrenches bad practices, but results in poor management and information systems, and undermines the accountability chain. New legislation in South Africa (the Public Finance Management Act) introduces harsh penalties and sanctions if these deadlines are not met. Much technical assistance will however be required to improve the current situation, but simple enforcement will result in significant improvements in the short-term.

The critical reforms can be broken down into three phases: budget preparation, implementation, post-implementation.

Budget preparation

- implementation of a three-year budgeting system;
- coordinating the budgeting, policy-making and planning processes;
- ensuring that the budgets are credible and realistic;
- deepening the budget process to include political executives to ensure that budgets reflect political priorities and have greater buy-in;
- simplifying the formats of budgets (away from line-item telephone directory type) budgets; and
- ensuring that the chart of accounts are adjusted to reflect management and other statutory information once the budget is implemented.

Budget implementation

- ensuring that once budgets are adopted by the legislature, all officials and the political executive enforce such budgets, and do not illegally stray from the budget;
- most importantly, ensuring a monthly reporting system, whereby heads of departments responsible for specific departments close their monthly accounts, and issue to the treasury a monthly report no later than twenty days after the end of the month;
- having a formal process to adjust budgets (only once) in-year should this be necessary (such a process must only focus on very limited cases, for unforeseen and unavoidable adjustments); and
- the treasury, to actively monitor monthly reports on actual revenue and expenditure, and to publish such information for public scrutiny.

Post-budget implementation (after financial year ends)

- ensure that financial statements are completed and submitted for audit no later than two months after the end of the financial year;

- ensure that the financial statements are audited no later than five months after the end of the financial year, and that an annual report containing the financial statements is tabled a month later;
- ensure that an independent audit office prepares high-quality audits, and focuses on material transgressions rather than small technical issues; and
- ensure that the legislature insists on receiving the annual report no later than six months after the financial year, and is empowered to deliberate on the report.

Notes

1 All the documents referred to in this paper are available on the treasury or other websites. Key documents referred to in this paper include the two *Intergovernmental Fiscal Reviews* (1999, 2000), *Budget Review* (2000, 2001), *The Constitution* (especially Chapter 13), Division of Revenue Acts (2000, 2001), *Public Finance Management Act* and various guidebooks to implement this Act. These are all available on the national treasury website *www.treasury.gov.za*.

2 J. May (ed.), 1998, Using a household income of R800 per month, Stats SA, 2000 estimates the percentage of the poor at 28.4 percent using imputed expenditure.

3 Local government has undergone a two-phase transformation. The initial transformation in 1995 created 843 *transitional* municipalities, combining adjoining white and black areas. The second phase in December 2000, significantly changed boundaries by incorporating urban and rural areas, and reduced this number to 284. The new system consists of six one-tiered urban metropolitan governments or metros (Johannesburg, Cape Town, Durban, Pretoria, East Rand and Port Elizabeth) and 232 two-tiered *primary* municipalities falling under forty six *district* municipalities.

4 South Africa is a multi-party democracy. While the biggest party, the African National Congress (ANC) controls the national government, seven of the nine provinces, and five of the metros, opposition parties control two provinces and one metro.

5 Schedules 4 and 5 of the Constitution divides functions on a concurrent and exclusive basis between the three spheres.

6 The Budget Council comprises the national and provincial Ministers of Finance, while the Budget Forum consists of the members of the Budget Council and the national and provincial chairpersons of local government associations in each province.

7 New public service policies will allow some differentiation in salaries.

8 Municipalities (and most public entities) tend to have higher levels of remuneration for staff.

9 Section 214 of the Constitution determines a revenue-sharing arrangement for South Africa. The provincial and local spheres of government are entitled to an unconditional equitable share to enable them to provide basic services and perform the functions assigned to them. Sections 228–230 of the Constitution also spell out the taxation and borrowing powers of the two spheres.

10 The Provincial Tax Regulation Bill is available on the treasury website.

11 The Municipal Finance Management Bill is available on the treasury website. In addition to financial management arrangements, the bill also deals with borrowing and judicial management issues.

12 The Intergovernmental Relations Act (no. 97 of 1997) gives effect to Chapter 13 of the Constitution which requires the national executive (Cabinet) to consult with the key role players (provinces) and organized local government (South African Local Government Association (SALGA)) when determining budget allocations between the spheres.

13 The FFC's Project 2001 proposals are available on its website *www.ffc.co.za*. The response of the national government is outlined in Annexure E of the *Budget Review 2001*, tabled on Budget Day, 21 February 2001. This document is also available on www.treasury.gov.za.

14 See for example the Division of Revenue Bill, 2001 available on *www.treasury.gov.za*.

15 Refer to Annexure E in the *Budget Review* 2000 (or 2001) or Annexure A in the Intergovernmental Review 2000.
16 Refer to National Treasury , 21 April 1998.
17 Minmecs, or meetings between the national Minister and the nine provincial ministers (MECs) for that function (education, health or welfare), was created to discuss policy and implementation. These are advisory institutions, making recommendations to the national executive (if it is to adopt national policy), or to provincial executives (if it is to implement national policy).
18 These forums, referred to as a "4 × 4" comprises officials from the national treasury and the national department, as well as officials from three provincial treasuries and three provincial departments.
19 Johannesburg's restructuring plan, called Igoli 2002 and now Igoli 2010, are available on its website *www.igoli.gov.za*. Their restructuring agreement with the national treasury is available on the treasury website.
20 Shocks to the system are an ever-present risk. This is particularly the case in the local sphere in South Africa, as the recent new demarcation of local government demonstrates. Some of these problems are restricted within the two tiers of local government, in terms of the division of functions between them. National restructuring of the electricity sector is another potential shock. A significant cost here to consider is foregone investment/expansion due the paralysis resulting from uncertainty.
21 Refer to the Section 100 interventions in two provinces in the *Budget Review* 1999 (p. 94), available on the treasury website.

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