Chapter 4

Organizational Structure of Subnational and Local Government[1]

"Responsibilities in government organization have to be well defined and the spheres of action delineated."

—Ali Pasha 1871

SUBNATIONAL GOVERNMENT UNITS AND DEGREES OF AUTONOMY

Structure of Subnational Government

Below the central government in all countries are the subnational government entities with varying legal and administrative powers and resources to discharge them. These entities comprise the provinces and regions at the upper intermediate level; the counties, districts, and municipalities at the lower intermediate level; and the village councils and territorial committees in small towns at the lowest level. Subnational government can receive its mandate through the country's constitution or through central government legislation. Clearly, in the former case the authority and powers of subnational government enjoy greater protection.

The term "local government" generally denotes the units of government that provide direct services to citizens at the lower intermediate and lowest levels. In a number of countries (as in Italy with its city-states and in many other European countries), the local government units were autonomous long before the country in its present form was constituted, and did not require authority to be devolved from higher government level. The developing countries, on the other hand, started with strong central governments after being decolonized, and the habit of local governance is usually not well rooted.

The structure of subnational government varies according to the nature of the political system. Federal constitutions confer sovereign powers on the states in certain functions, and list specific financial sources for the states to exploit. Generally, local government units are the constitutional creation and responsibility of the provinces, although some countries (e.g., Mexico, Philippines and Thailand) provide for independent national capital regions. The federal government does not normally have direct control over local governments, although, as in the United States (US), it can choose to administer programs through them.[2]

In some unitary systems of government, subnational entities exercise their powers by virtue of the *ultra vires* (beyond the powers) principle: their powers are specifically delegated to them by the central government, which can override their decisions.[3] In other unitary systems, local governments operate under the *general competence* principle, and are in principle entitled to exercise all powers that are not reserved to the central government.

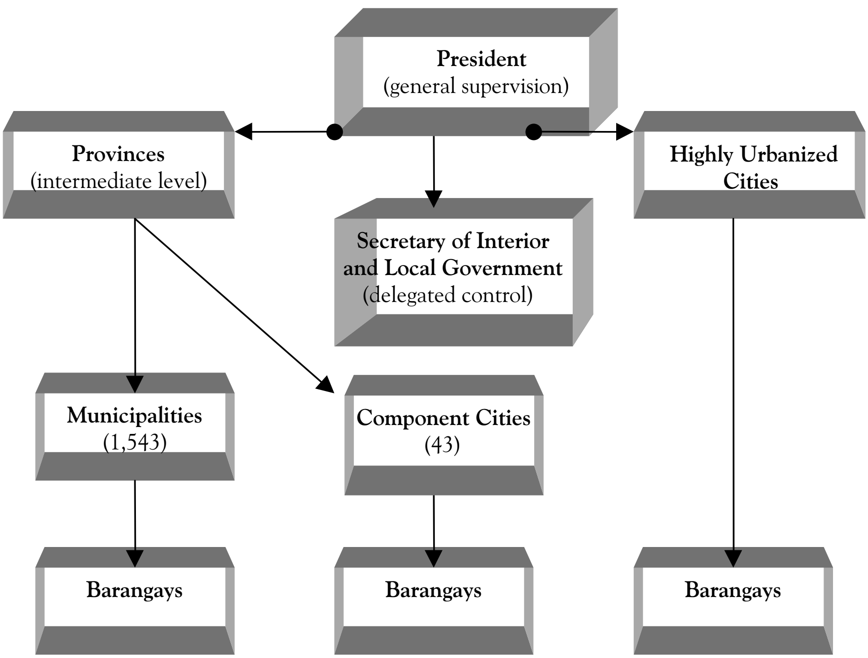
The organization and hierarchy of subnational units show considerable variety, depending on colonial traditions, customary forms of local administration, and postindependence decentralization movements. Most unitary governments have divided the country into provinces or regions, under a governor who is directly elected by the people or appointed by the head of state. The village administrations in developing countries, through elected councils or customary organizations, often survived colonial domination for centuries. Indeed, in many countries, they were essential to selective colonial control through the principle of "indirect rule."

Subnational units vary greatly in size across countries in the same country group, and there are significant differences as well between local governments in the various countries. For instance, in Indonesia, regional government encompasses the provincial government (the first-level autonomous regions) and second-level autonomous regions. In the Philippines, however, the provinces are closer in size to the Indonesian districts. The municipalities are the basic units of government in the Philippines, and the *barangays* (villages) are the submunicipal units at the city and village levels. While the provinces have certain supervisory responsibilities over the municipalities, and the municipalities over the barangays, each level of local government performs basic services within its area of competence (see Figure 4.1).

Autonomy of Subnational Units

The degree of independence of subnational government units varies from country to country. At one end of the spectrum are autonomously functioning subnational governments, controlled by locally elected representatives. At the other end are subnational units that are mere creatures of the central government, which appoints and dismisses mayors. (In reality, subnational governments in unitary countries can never be totally independent of the national government.)

Figure 4.1
Structure of Subnational Government in the Philippines



The governor or provincial head is often a political appointee of the central government, and plays a dual role as head of the provincial administration and agent of the central government. In a number of countries, the provincial administration, composed of the field personnel of central ministries and agencies, merely channels funds from central ministries to lower entities, which it monitors. Countries display contrasting trends in political regionalization (some countries with federal constitutions or unitary systems, such as Indonesia and the United Kingdom, grant autonomy to some regions), and administrative regionalization (such as that seen in France and Japan). In Italy, although all regions have considerable autonomy, a few have special status on linguistic and ethnic grounds.

In the transitional economies of eastern Europe and the former Soviet Union, the services to be performed through decentralized units of government are still unclear, owing to the tradition of strong centralization. The laws establishing local government in eastern Europe place heavy emphasis on characteristics that distinguish the new system from the old centrally dominated system.[4] Attitudes to provincial or regional administration remain ambivalent. On the one hand, regional government is suspected of being an agent of central control by the central government, and thus a threat to the newfound autonomy of local government. On the other hand, it is recognized that the small size of the basic municipal units makes it difficult to devolve all local functions to them, especially for those services that have a lager catchment area.

There is thus a felt need in transitional economies for an elected authority at the provincial/regional level, to bring regional administration and some of the regulatory authority within the sphere of local accountability. However, this has not materialized because of disputes over territorial boundaries, and the concern of local governments with vesting appellate powers in an elected authority that could have a different political affiliation. In most countries, the vacuum has been filled by deconcentrated units of central administration—regional governors in Bulgaria, district offices in the Czech Republic, *voivods* in Poland, regional and district administration in Slovakia, etc.

LOCAL GOVERNMENT ADMINISTRATION

Overview

While local government is understood to comprise the administrative units that provide services directly to the people, such units are not uniformly positioned in the subnational structure in all countries. The Philippines considers all subnational levels as “local” government, while Indonesia, like a majority of countries, denotes as local government only those administrative levels below the provincial. In the two-tier system in North America and many European countries, the counties occupy the upper end, while the municipalities or communes and villages take up the lower end of territorial administration. Japan, on the other hand, follows the system of single-tier local government beneath the province or region. The two-tier system appears to have positive advantages in terms of effective administration of settlements lying outside municipal limits, and coordinated planning of infrastructure.

India, following the colonial tradition, has nearly 600 administrative districts, each reporting to the province in which it is located. These districts vary tremendously in size, from a few tens of thousands to several million people. The central and state governments have the authority to vary the territorial boundaries of districts and their subunits, and to merge the units in different ways. Generally, the subdistrict has no autonomous role although, as already noted, the villages have traditionally enjoyed autonomy.

Depending on their size and character, the municipalities could report directly to the government at the center or to the province, or could form part of the district/county administration. The submunicipal bodies, such as neighborhood committees and community councils, constitute the final links in the chain between the government and the citizens.

Administrative systems for rural areas are typically different, and are strongly influenced by cultural factors and traditions. Village organizations were identified as the building blocks of local government in many Asian and African countries, and were later built into the administrative structure for the district (a large collection of contiguous villages). At the same time, in a number of countries, a representative of central or provincial government was placed in charge of administering and coordinating the workings of agencies (in the manner of the French prefect). In a number of Asian countries, democratic decentralization, in the form of elected councils at the district and subdistrict levels, was grafted onto this model.

Establishing local government has posed special problems for countries in Africa and the Pacific, which followed customary modes even during colonial rule. Customary systems persist in many African countries, although customary traditions have been retained alongside formal systems in developed countries like the New Zealand and US, and some developing countries like India. In Africa, Uganda has made the most serious attempt to democratize native authority through local councils that cross sectarian boundaries.[5] Tanzania has succeeded both in devolving authority to local levels and in building a national consciousness beyond tribal and local confines, one of a handful of such cases in Africa.

Constitution making in the Pacific brought out two issues: decentralization and the role of customary systems and leaders. The dispersed islands and the social makeup of the new states made decentralization and power sharing more acceptable to the people. However, the traditional role of customary leaders, which is integral to the way they are chosen, is different from their assigned role within the legislative framework for local government. In the process of induction into local government, the chiefs lose some of their traditional accountability and authority. As Hughes (1998) perceptively put it, custom codified ceases to be custom, as it loses its inherent capacity to adapt to the changed circumstances and aspirations of the community.

Rural Administration

Rural administration is important to the quality of life of millions of citizens and, for this reason, is not treated simply as a residual of provincial government in most countries. Especially in countries with vastly dispersed settlements, as well as those undertaking large poverty reduction and social services programs, administration by remote decisions and unrepresentative agencies is not conducive to efficiency or credibility. The need for effective organizational structures for rural administration reaching down to villages has been recognized in most developing countries.

The emerging model of self-government for rural areas in many Asian countries is that of a village council at the base, a second-tier subdistrict to represent a block of villages, and the top tier at the district level with indirectly elected members. This formal structure is modified by customary norms and self-governing organizations.

In India, where the system of district administration has been given constitutional backing, the district councils also prepare (together with urban representatives) the development plan for the entire district. The 1999 law on decentralization in Indonesia envisages a similar role for the elected district government. Zimbabwe amalgamated rural and district councils into 57 rural district councils in 1993. Similar efforts were seen in South Africa after the fall of apartheid, as well as in a number of African countries. In most countries, there are also examples of local communities coexisting with the formal bodies and managing schools, health services, irrigation systems, etc.

In some countries, parastatal organizations such as development agencies also function as local authorities for their clients. Townships built around large manufacturing plants have, in some cases, been allowed to provide social services. Some of these nonmunicipal local authorities are also permitted to levy taxes and service charges to defray the costs of operation.

Management of Cities

Although all countries have experienced urbanization, the rate, magnitude, and character of urban concentration have differed significantly across countries. Worldwide, there are now over 300 cities with more than a million inhabitants, and 200 of these are in developing countries. In the year 2000, of the 20 largest urban agglomerations ("megacities") with more than 10 million inhabitants, 17 are in developing countries, including 12 in Asia alone. By the year 2025, it is estimated that there will be 20 megacities in Asia, with a combined population of almost 400 million.

However, while a substantial proportion of the urban population lives in the bigger cities, the smaller urban settlements still dominate the urban scene in almost all countries. For example, more than 90 percent of the municipal and township governments in the US serve fewer than 10,000 residents, and 28,000 of France's 36,000 communes have less than 1,000 inhabitants. Municipalization is due largely to the natural extension of city limits. It is also due to the granting of new municipal charters by governments in countries where the citizens have the right to form themselves into new urban units (as in the US and many countries of eastern Europe). Many countries, such as Japan and the United Kingdom, have deliberately amalgamated smaller municipalities to achieve a viable urban settlement structure. Recognizing the importance of secondary cities with populations of less than 300,000 and redressing their relative neglect over the years, developing countries like India and Indonesia have undertaken comprehensive infrastructure development programs in these small and medium towns.

Urban government

What urban government does, who does it, and with what resources vary from country to country, and from town to town.[6] Generally, however, urban public services in most countries comprise

- garbage collection/waste management;
- water supply/sewerage;
- environmental services, streetlight maintenance, parks and recreation;
- primary health care and education (in some countries only, usually to complement central government services);
- some social welfare (e.g., shelters for the homeless);
- internal transport;
- urban planning and regulatory enforcement;
- local public works and housing;
- firefighting and other emergency services;
- traffic regulation;

The responsibility for police and prisons is usually not entrusted to municipal bodies, except in some countries of the Organisation for Economics Co-operation and Development (OECD) (e.g., the US). In many Asian countries the urban areas have suffered from the predominantly rural bias of political leaders, which led to the diversion of resources to nonviable rural development projects. On the other hand, fears of city services being overwhelmed by the flood of rural migrants have made urban authorities determined to stem migration to the cities, even by denying basic services to slum dwellers. The predominance of rural voters continues to nourish the bias against essential investment in municipal infrastructure in many countries, while populist policies operate against self-financing urban services.

It is useful to look at different ways in which urban functions evolved. Countries following the British tradition of local government tend to look at municipalities as service delivery agencies, and to specify functions and finances, boundaries, and central control in relation to this role. Countries in the European tradition tend instead to proceed from allocation of different functions to central and subnational government, thus allowing for wide variations in municipality size and capacity to deliver services. This difference accounts for the much smaller size of urban jurisdictions in many countries on the European continent, compared with those in the UK or countries influenced by the British tradition. Countries in the French tradition have thus been able to let deconcentration ensure state and local coordination in the performance of functions such as law enforcement. Unlike the countries in the British tradition, countries in continental Europe (as well as Japan) grant "general competence" powers to urban governments: the municipality can do anything that benefits the local residents and is not reserved to central government. In the dual-function model, which prevails in most developing countries and eastern European nations, the municipalities, while locally self-governing, are obliged instead to discharge functions delegated to them by the provincial and central governments (the so-called agency or deconcentrated role).

Municipal systems

"Urban" is different from "municipal." A municipal agency is an administrative entity, while urban services could be, and often are, performed by a variety of nonmunicipal agencies. Nevertheless, urban government has historically been treated as synonymous with municipal administration in many countries.

The status of municipalities in different countries varies between the statutory and the permissive. Urban government has no constitutional status in countries like the UK and the US, but has been granted such status in most Asian, African, eastern European, and Latin American countries, and in continental Europe. At the same time, there are varying traditions of local administration within many countries with dispersed settlements and disparate cultures. The issue that arises, therefore, is whether the municipalities in a country should have a uniform structure, or whether the structure should be modified to suit local traditions.

Some countries provide for the powers and resources of urban local bodies in the constitution itself, while others leave these details to be decided by the provincial or national government in the executive orders and regulations it issues. The laws often envisage different structures for large and small municipalities, and sometimes enable the formation of associations of municipalities and of district councils composed of urban and local representatives for comprehensive planning. (Separate laws are often passed for metropolitan cities.) In a revival of local self-government, Hungary reinstalled the traditional two-tier local structure with the counties (*megyjk*) as the upper level, and the municipalities (settlements) as the pivotal lower layer. It is useful to have the legal and regulatory system recognize significant differences in the management capacities of municipalities of different sizes, through a classification of local government into different levels.

Elected municipalities are not as widespread as may be imagined. A significant proportion of municipalities are governed by bodies nominated by the central or provincial government. The reluctance to accept elected and autonomous local bodies as the principal organ for local management is a major obstacle to responsive city management.

Within elected municipal governments, executive authority can reside in (i) an executive mayor elected directly by the people (as in central and eastern Europe, Japan, and most cities of North and South America); (ii) council committees (as in the British-based systems in Asia and Africa); (iii) council committees along with administrators appointed by the government or the council itself (as in South Asia); (iv) a mayor selected by a council, which is itself elected by the people (as in several western European countries and some Asian cities); or (v) a mayor-in-council system, whereby a group of councilors is elected along with a person to head the council.[7]

The pattern of executive leadership through a mayor or a mayor-in-council is becoming increasingly common. This is partly an answer to the fragmentation of authority within the municipal administration. Such leadership is more effective, in turn, when supported by a senior professional administrator such as a "city manager".[8] This arrangement is particularly advantageous in a functionally fragmented situation because of the ability of the elected mayor to represent local interests before other public agencies and levels of government, to link political leadership to the administration, and to make collaborative bargains for resource mobilization and program implementation.

The experience of countries in Asia shows that the capacity of a mayor to exercise strong leadership depends on the manner of election, the length of tenure, and on whether the mayor functions in an individual or a collegial capacity. It also depends on the extent to which the higher government eschews day-to-day control over the operations of the municipal council. In the Japan, US, and a number of developing countries in Asia, Eastern Europe, and Latin America, the mayor is directly elected by the people. Executive authority is concentrated in the mayor, subject only to the supervision of the elected council in the approval of budgets, new positions, senior appointments, and major policies. The mayor cannot be removed by the council (although countries like India provide for the mayor's removal by the provincial government, after due process). Many instances of mayors showing innovative leadership, eradicating corruption, augmenting city infrastructure, and forging partnerships with civil society have been documented. (For example, the mayor of Colombo, Sri Lanka, was able to move the municipal system to a more people-friendly system based on partnerships with business and civil society, and involving the citizens in planning and decision making.) The mayor of La Paz, Bolivia, in the early 1990s turned a corrupt and bankrupt city into a reasonably efficient and financially stable entity.

The model of the mayor elected indirectly by the city council, which is apparently symmetrical with that of the prime minister in a parliamentary system, is followed in Asian and African countries in the British tradition, among others. This model has the advantage of avoiding conflicts between the mayor and the elected council, but makes the mayor more vulnerable to party maneuvers and the mayor's authority dependent on his or her position in the hierarchy of the ruling political party. In a number of countries in the British tradition, executive authority is often split between the standing committee and subject committees of councilors. Inherent in the committee system, even in countries like the UK, is the potential for delay and manipulative politics in local government.

A variant of the model of an indirectly elected mayor is the mayor-in-council system adopted in a number of cities such as Calcutta, India. The majority party elects a group of councilors along with a person to head the council. Each councilor is responsible for a particular department, but functions as a member of a collective executive under the leadership of the mayor. This system gives greater attention to administrative detail, and guidance to the department heads. Its success, however, depends on the ability of the mayor to deal with overlaps and conflicts. The institution is subject to the same risks as a cabinet government system, including the personal agenda of the members of the council. The Calcutta system functions effectively because the vertically controlled hierarchy of the political party dominates both the provincial and city governments, and there is less risk of internal dissension undermining collective work.

Where, as in a number of Asian and African countries, the mayors are not elected but appointed by the political executive of the national government, their authority depends on the extent to which they are allowed to function independently and carry influence with the city administration.

In any case, political authority must be supported by a strong administrative executive (city commissioner, city manager, town clerk, or whatever title). This chief executive of municipalities is appointed differently in different countries. In the British model, the chief executive is appointed by the mayor with the approval of the council and is thus answerable to both. (Such appointments are increasingly made under renewable contracts for specified periods.) In countries in the US tradition, the strong mayor is empowered to select the chief executive, who is usually endorsed by the council. In the continental European tradition and Japan, the chief administrator can be seconded from the national bureaucracy, or appointed by the mayor under a renewable contract with the approval of the council, after a process of competitive recruitment.

In a number of developing countries that follow the British tradition of local government, the chief administrator in large cities is appointed by the provincial or national government from the generalist cadres of the civil service. Often, there is little or no consultation with the mayor and the council, and the chief administrator can be removed only by the government. If this person comes from the senior executive service, the posting in the city government is treated as a rank-related posting for which no special skills are deemed necessary. Some countries like India have started constituting specialized cadres of municipal chief executives and other senior managers for smaller councils but not for the bigger cities. The practice of the central or state government appointing the chief administrator for large cities creates divided loyalties among municipal personnel and dilutes local political control. The practice is inherited, in fact, from the deep-rooted colonial mistrust of local native administrations and the resulting wish to install a colonial functionary to guard against the possible misuse of power and wasteful expenditure. Accordingly, most mayors in Asian countries see the practice as undermining the principle of local democracy and empowered urban bodies. Provided transparency and credible selection systems are ensured, the model of the locally appointed chief administrator offers advantages because of the scope for selecting competent professionals with experience in diverse aspects of city government.

But, irrespective of the manner in which policies and operational norms are set in the different models, the appointed chief administrator needs the power and status to exercise clear managerial control, especially over department heads; agreement by political leaders to refrain from intruding into managerial functions; and reasonably long tenure. Recent studies have brought out many examples of local innovation and leadership by chief executives, who worked closely with both the political leadership and citizen groups.

Concerning other local personnel (Chapter 10), the personnel systems in urban government in developing countries follow three broad patterns:

- separate, meaning that each urban authority or municipality appoints and controls its own staff (sometimes with the help of central civil service commissions);
- unified, in the sense that the senior management posts are filled from a central cadre of service for local authorities; and
- integrated, meaning that the staff of central and local government agencies form a common cadre, and are exchanged freely between levels of government and localities according to central posting policies.[9]

Submunicipal Organizations

Establishing submunicipal organizations in a number of developed and developing countries answers the need for more responsive community services, and has significant implications for partnerships with different organizations in civil society. For most urban dwellers, the quality of life is determined by what happens in their immediate neighborhood. Submunicipal organizations contribute to four main functions: coordination of urban services, community participation in prioritizing and delivering services, community representation (voice) in city agencies, and mobilization of community resources and skills.

Examples are the community councils in the Netherlands, the barangays in the Philippines, and the ward committees provided for in recent Indian legislation. In countries such as Brazil and India, communities are consulted in setting budget priorities and new programs, and participate in formulating development plans. Of equal importance is the movement for citizens' charters (or service charters) in some countries, and the publication of performance indicators for municipalities and other public service providers. Meaningful participation of citizens requires a legal system that provides for full, timely, and easily accessible public disclosure of decisions related to resource allocation and budgets, and institutionalized channels for participation and monitoring. (These and related issues are discussed at length in Part III.)

In the 1960s and 1970s, national and provincial governments became more closely involved in urban services either directly or through parastatal agencies. This move was partly inspired by municipal incapacity to tackle major capital investments. The other major development was the failure to adjust municipal boundaries to accommodate urban growth. This created problems of peripheral settlements, and the unregulated development of areas abutting large cities in all developing countries. The issue of establishing local government units of an appropriately larger size has serious political overtones, and boundary changes run up against entrenched political interests. Consequently, urban administration all over the world is characterized by varying degrees of fragmentation:

- *geographical fragmentation*, where an urban area and its periphery are divided among several jurisdictions (e.g., Calcutta with 107 local government agencies, or Metro Manila with a dozen contiguous cities forming a single unplanned conglomeration);
- *functional fragmentation*, where responsibility for urban government is divided among several agencies, including ministries, public corporations, and municipalities. This is especially problematic for functions that link together, such as water supply, sewerage, waste disposal, roads and traffic management, environmental management, etc.[10]

In eastern Europe, very small municipalities resulted from the virtual freedom granted to settlements to govern themselves. These countries have from 3,000 to 6,200 municipalities, with an average population of between 1,800 and 7,600.[11] The majority are too small to employ professional staff or operate even basic services independently. The financial costs of fragmentation are high. Since intermediate subnational units have not emerged (for the political reasons noted earlier), executive capacity can be coordinated and augmented only through cooperation between municipalities, but this is not always easy to achieve in practice.

MEGACITIES AND METROPOLITAN AREAS[12]

The metropolitan cities and national capitals have been the subject of different experiments in governance, ranging from a separate governmental structure to a regional authority supervising local councils. The growth of megacities, i.e. urban agglomerations with more than 10 million population, is the most striking feature of late 20th century urbanization. As mentioned, Asia by the year 2025 is forecast to have 20 megacities with a combined population of nearly 400 million. Megacities have grown because of the natural increase in population and migration, and are expanding to Extended Metropolitan Regions (EMRs), which often cover areas 50 to 100 kilometers from the city core.

Megacities comprise a built-up area at the city core, a metropolitan ring, and an EMR. Some EMRs,[13] such as the JABOTABEK (Jakarta region), the Bangkok metropolitan region, and the Metro Manila region, have a formal administrative status. Such megacity regions form a significant proportion of the national urban population—Jakarta, 20 percent; Bangkok, 50 percent; Seoul, Dhaka, and Metro Manila, 33 percent.[14] These and other megacities are reaching the physical limits of growth, need strategic guidance in better and integrated planning to divert future growth into areas with lower development and ecological costs, and for better and more accountable governance. The alternative is human and ecological disaster.

Metropolitan areas and megacities are economically larger than most of the counties in their respective regions, and their contribution to Gross National Product (GNP) is substantial (36 percent of gross domestic product [GDP] for Bangkok, 24 percent for Manila, and 36 percent for Tokyo). Also, these cities are increasingly forming part of a global network of knowledge, commerce and industry, and cultural exchange. Unfortunately, equally striking are the problems of urban poverty, disease, slums and squatter settlements, deprivation of basic services, lack of transport, environmental pollution, and crime and violence.

Megacities are in special need of good governance. The sheer number of people involved and the importance of these cities in the national economy argue for urgent interventions to address their governance weaknesses. The weaknesses include unclear development policies and coordination, ineffective regulations, violations of land-use rules, unresponsive and unrepresentative administration, and near-complete disregard of marginal groups.

Because a metropolitan area includes the larger urbanized area surrounding a core city, a number of municipalities and rural bodies are within its ambit (1,250 local governments and authorities in Chicago, Illinois, in the US, for example). Metropolitan governance, then, implies multiple organizational jurisdictions and responsibilities. The national capital region of Delhi in India encompasses cities and districts from three surrounding states besides the state of Delhi proper, and is governed by special legislation. Provincial status has been given to Beijing, Jakarta, Shanghai, and Tianjin; a two-tier system (a metropolitan authority and city governance) applies in Manila and Tokyo; a combination of local government and metropolitan authorities is found in Karachi, Mumbai, and New Delhi; and multimunicipal arrangements exist in the Calcutta area.

Clearly, therefore, the conventional single-municipality model has great limitations for metropolitan cities, although there are many instances of a single municipality or authority governing the entire city (as in the case of Toronto in recent times). Metropolitan regions typically contain various municipalities of different sizes. Urban growth cannot be contained within prescriptive municipal boundaries, neither can people be forced to reside within the metropolitan area. Consequently, the responsibility for services is badly fragmented, not only among municipalities, but also among functional agencies of central and state governments and privatized delivery arrangements. Some specialization is possible, however. Responsibilities like sanitation may be local in scale, while others (like transit) may involve higher levels of government.

Necessarily, then, the central and provincial governments must play a significant role in the delivery of services in metropolitan regions all over the world, as national policies on immigration and economic reform generate significant financial and organizational demands on metropolitan government. Developing countries have generally been encouraged by donor agencies to set up metropolitan-level sector authorities for water supply and sewerage, housing, transport, and area development, often patterned after similar agencies in developed countries. The local bodies were, naturally, expected to meet the maintenance responsibilities after the aid-supported schemes were completed. With very little resources from the national government and limited ability to levy user charges, the assets rapidly deteriorated.

Other solutions have focused on interagency coordination through physical and investment planning and through negotiation. The "capital folio" experiment in Manila helped ensure coherently planned investments by subjecting competing agency demands to collective decisions on the basis of agreed criteria. Curitiba in Brazil is a model city for structuring the metropolitan network around the transport system. Singapore demonstrates the huge payoff from effective traffic management, in contrast to the glaring failures in transport planning and rising volumes of vehicular pollution in other Asian megacities (Manila having now far surpassed Bangkok in scale and severity of traffic and pollution problems).

Box 4.1
Dealing with Car Ownership and Traffic Congestion: The Way of Singapore and Hong Kong, China

Dealing with traffic congestion and excessive delays in the movement of goods and passengers in big cities calls for demand management and differential pricing. One important means of enhancing the efficient use of road space is the use of fiscal and regulatory measures to restrain private auto ownership and use. To be politically and popularly accepted, such measures must also provide a good alternative to private car use in the form of safe and affordable public transportation.

Hong Kong, China, used a combination of a high purchase tax and high annual vehicle license fees since 1974 to reduce the number of private cars and motorcycles on the road. This was supplemented by electronic road pricing in the 1990s (as was also introduced in Singapore in 1998) to charge road users for the external effects of vehicular traffic at a given time and location.

Singapore provides an interesting example of the application of an overt policy of containing road traffic congestion through the clear assignment of property rights (to the government) and the use of market mechanisms to re-allocate those rights to the car owners.

User charges in Singapore are complemented by motor vehicle ownership policies. From May 1990, the owner of a new vehicle must acquire a certificate of entitlement (COE) before the vehicle can be registered. The COE is valid for a 10 year period and can be obtained at a monthly closed auction held by the Land Transport Authority. Bids are submitted electronically via automated teller machines. The price of a COE fluctuates accordingly to supply and demand. For a medium-sized car (1,001 to 1,600 cubic centimeters) in October 1998 it was Singapore dollar (S$)25,102. In addition to the COE, the owner of a new motor vehicle is required to pay an import tax that is 41 percent of the market value of the vehicle, a 3 percent goods and services tax, a registration fee of S$140, an additional registration fee that is 140 percent of the market value of the vehicle, and annual road taxes that vary with the engine capacity of the vehicle. The motor vehicle quota system allows the motor vehicle population to grow at a fixed predetermined annual rate. In the US, where income levels are comparable with those in Singapore, nine out of 10 of all central city households owned at least one vehicle in 1990, compared with only one in four resident households in Singapore. (Car ownership is much higher in other East Asian countries.)

continued on next page

Box 4.1 (cont'd.)

Singapore's area licensing scheme, the foremost example of intelligent road pricing in the world since 1975, requires private cars and motorcycles entering the restricted zone in the central business district during the hours of operation to display a color-coded area license on their windshields, and to pay differential monthly or daily charges for peak and nonpeak hours. The scheme is enforced by traffic wardens eyeballing the traffic past the gantries. These measures help reduce pollution concentration levels during peak hours.

Besides regulating car ownership, both Singapore and Hong Kong, China, have restrained traffic by enforcing controls over parking supply, and imposing high parking charges and road pricing. Most parking in these cities is under public control. By controlling on-street parking, providing of new spaces off-street, and charging for public parking, government can restrain inefficient road use, to the benefit of the great majority. Steps to promote and subsidize public transport supplement these measures, and public transport in both Singapore and Hong Kong, China, is easily accessible and of high standard.

It should be emphasized that such measures, taken in compact city-states, are not easily transferable to other countries. Nevertheless, there is much in these practices that is worth considering in other large cities in Asia and elsewhere.

Source: Phang, Sock-Yong. 2000. Paper on Urban Transportation and Land Regulation. Singapore.

Governments have also come up with multisectoral responses in the form of planning and development authorities with regionwide jurisdiction. Examples of such authorities are to be found in Bombay, Calcutta, Colombo, Delhi, Karachi and Metro Manila. Tokyo provides the alternative response of metropolitan governments with special provincial status. The Tokyo metropolitan government exercises the authority of both city and prefecture over 17 cities, 12 towns, and other areas in the region. It controls and supervises sector authorities, with avenues for public participation. However, in general, development efforts have suffered from lack of responsiveness to local needs, and the failure to take full advantage of representative structures. Metro Manila is still searching for the right answer to balance the needs of local government and regional coordination (Box 4.2).

Box 4.2
Metropolitanization: The Metro Manila Experience

The evolution of 17 local governments into what is now known as Metropolitan Manila occurred in three different time frames. The first took place during the Marcos regime from 1975 to 1986; the second during the term of President Aquino from 1986 to 1992; and the third during the regime of President Ramos from 1992 to 1998.

Metro Manila was created in 1975 during the Marcos regime as a geopolitical entity, and it was governed by a national agency called the Metropolitan Manila Commission headed by Marcos' wife Imelda. The lawmaking powers of the 17 local governments in the metro region were concentrated in the new commission. All legislative and executive powers were vested in a single governing board with five members. The commission was responsible for all the metropolitan services, the levy of taxes and charges, and comprehensive planning. However, it acted in practice as a rent-seeking device for the regime.

After the fall of the Marcos regime, the commission went into limbo. Legislative councils were elected for the local governments. The governing board of the commission consisted of an interim council of 17 mayors from local governments. The commission enjoyed no taxing powers, and its planning and coordination authority was very limited. The bigger municipal units demanded a breakaway from the commission.

In 1995, the Congress passed a law setting up the Metro Manila Development Authority, and designating Metro Manila as a special development and administrative region. Decision-making and policy-making powers were vested in an expanded Metro Manila Council, consisting of mayors, government officials, and the chief of police. The commission was given the powers of development planning, transport and traffic management, solid waste disposal and management, urban renewal, zoning and land use planning, health and sanitation, pollution control, and public safety. The commission could pass ordinances in matters covered by these functions, but this authority conflicted with the legal powers of the municipal councils.

Although the citizens recognize the need for a coordinating body to deal with regional issues, which transcend municipal boundaries, the government has not been able to find the right institutional mix to balance the competing demands of coordination and the autonomy of municipal councils.

Source: Bunye (1999).

Megacity management problems include

- inability to augment public expenditure, particularly capital expenditure, at rates commensurate with the rising need for facilities;
- inadequate skills and manpower to deal with the vast job of managing a rapidly growing and complex city;
- absence of a supportive legal framework and facilitating mechanisms from higher government to ensure the cooperative working of all service and regulatory agencies;
- inadequate time frame for urban planning, budgeting, financing, and decision making;
- lack of sound and well-enforced policies for land use and management;
- deficient political procedures through which metropolitan institutions can secure public access and the people can participate and get information at the neighborhood level;
- unclear institutional responsibilities; and
- tendency of metropolitan authorities to wander into project execution and land development, instead of attending to their main role of metropolitan-level advocacy, information systems, regional planning, and institutional coordination.[15]

The electoral constituencies of large cities are often so large that a single councilor is unable to represent the views of diverse groups, and needs the help of submunicipal structures reaching down to small neighborhoods. Metropolitan governments, to a greater extent, need to develop democratic interaction with the informal sector and the marginal groups, excluded from access to services, or entry into economic activities, or meaningful political participation. In some cities (e.g., Mumbai), however, one begins to see a growing web of business, local communities, environmental management, and other interests.

Globalization, information and communication technology, and environmental concerns have major effects on the spatial spread and management of megacities. To enhance their competitiveness, megacities need to build and improve transportation and communication facilities, and facilities to attract foreign investors. However, those competitiveness needs must be balanced with the social priorities of the poor and environmental sustainability.

While some new towns in developing countries have succeeded, governments generally cannot shift populations and activities to low-density enclaves. Attention should be focused, therefore, on the strategic selection of activities and on intrametropolitan cooperation. Such cooperation is particularly needed in crime control, transportation, waste disposal, pollution control, water resources, and similar network systems. Interdependence has made collaborative leadership the watchword for metropolitan governance.

As grave and complex as the problems of megacities are, solutions do exist and have been found. Unfortunately, it is far easier to apply them with foresight at the start of the problem (as Curitiba, Singapore, and, to some extent, Seoul have done) than to remedy a disastrous situation after it has been allowed to worsen for decades (as in Jakarta or Manila). Once again, the crucial importance of good governance comes to the fore.

KEY POINTS AND DIRECTIONS OF IMPROVEMENT

Key Points

Every country has levels of government below the central national government. Subnational government entities have different powers, resources, and organizational structure, depending on whether the country has a unitary or federal political system, as well as its colonial experience, persistence of customary forms of local administration, and the character of the independence movements. Generally, however, subnational government is subdivided between an intermediate level ("regions," "provinces," or "districts") and local government (at the municipal and village level). In some administrative systems, subnational entities have only the powers specifically delegated to them by the central government; in other systems, they operate on the "general competence" principle, by which they can exercise all powers not expressly reserved to central government.

In many countries, the rights and powers of local government are explicit in the constitution or in national legislation; in other countries, they remain unspecified, and hence are generally dependent on the attitude of the central government of the day. Moreover, in most developing countries, the functioning in practice of local administrative systems is strongly influenced by cultural norms and customs. Especially in Africa and the Pacific, formal structures have been grafted onto traditional modes of local administration. Therefore, when assessing possible improvements in the effectiveness of local government administration (including those suggested below), it is important to look beyond these formal structures to the role of customary systems and traditional leaders.

There are major differences between local administration in rural areas, in cities, and in "megacities" with over 10 million inhabitants. In rural areas, the frequent structure of government in developing countries is that of a village council with elected members at the base, a second-tier level of government to represent a group of villages, and a top tier of government at district level with indirectly elected members. In cities, the organization of municipal government is largely a function of the services it provides.

City government is normally organized to deliver services (such as waste disposal, water supply, internal transport, firefighting, parks, and similar services) for the direct benefit of the local population. In a minority of cases, municipal governments are appointed by central or provincial authorities—a system that in developing countries partly reflects a central distrust of local authority inherited from the former colonial administration. In appointed municipal governments, management is typically much less responsive and personnel loyalties are divided. Within elected municipal governments, the more frequent problem is fragmentation of authority, especially when the executive head (the mayor) is elected by and from among the members of the municipal council. The main alternatives are separate direct election of both the mayor and the council, and the mayor-in-council model, whereby the majority party elects a slate of councilors along with a person to head the group. In the direct election model (resembling the presidential political system), the mayor has the strongest degree of authority, derived from the personal electoral mandate. In the mayor-in-council model (resembling the cabinet system described in Chapter 2), councilors are responsible for their departments but also function as members of a collective executive under the leadership of the mayor. Whatever the manner of election of the mayor, the local political authority can benefit from the support of a strong administrative executive (city manager or similar role).

The expansion of megacities (urban agglomerations with more than 10 million people) is the most striking feature of late 20th century urbanization. By 2025, megacities such as Jakarta, Bangkok, Manila, Seoul, and Calcutta will account for some 400 million people in Asia alone. A megacity typically comprises a core area, a metropolitan ring, and an extended metropolitan region. Therefore, the conventional single-municipality model is clearly inadequate, as responsibility for services in megacities is badly fragmented and cannot be associated with specific municipal boundaries. Megacities are in special need of good governance and strong coordination and planning, to deal with environmental degradation and extreme human poverty. Interagency coordination is essential and the central and intermediate levels of government must necessarily play a major role.

Directions of Improvement

Because a first requirement for accountability is a clear assignment of responsibility, it is advisable to specify by law the powers of each level of subnational government, in those cases where they remain ambiguous. It is highly inadvisable, however, to codify administrative customs or other informal modes of behavior, as custom when codified loses its natural capacity to adapt to change.

Weak capacity of subnational government to exercise certain functions should be an indication of the need to strengthen such capacity, and not an excuse for withholding legal sanction for the responsibilities it is expected to exercise. Central and intermediate levels of government can strengthen both the powers and the capacity of local government by

- entrusting to elected local bodies the government of urban and rural areas, with clear functions and commensurate resources;
- avoiding the central appointment of local leaders and resisting the temptation to intervene except when local governance is violated or at risk;
- fostering the creation of mechanisms for accountability and responsiveness of local government to the citizens and for appropriate public participation;
- enabling local governments to appoint qualified staff and providing such technical and managerial assistance as local government may require to function effectively; and
- assuring the effective audit of local government activity and an appeals channel for the redress of citizens' grievances.

Considering the growing importance of large urban centers and megacities, and especially the large numbers of marginal and poor people residing in those agglomerations in developing countries, central and provincial governments have a special responsibility to

- help devise integrated region-wide solutions for land-use, transport, and environmental problems, as well as for the provision of a

minimum level of services to the poorer groups, primarily shelter, clean water, and waste disposal;
- assure that megacity governance responds to the same basic requirements as good governance in general—particularly participation;
- prevent particularistic interests of individual municipalities or of privileged groups from exploiting the unplanned expansion of megacities to their own advantage; and
- help address the issues of internal migration, along with measures to assist the recovery of impoverished inner cities.

It is much easier to anticipate and prevent the problems of megacities (as was done in Seoul) than to remedy them after they have surfaced in their most severe form (as in Jakarta and Manila). Nevertheless, improvements in megacity governance and resolute action by all levels of government are essential to prevent those problems from becoming worse still, and can succeed if they are well coordinated and sustained.

NOTES

1 This section draws heavily on OECD (1997a); ADB (1995, 1998b, and 1999b); Davey (1993); Fesler and Kettl (1991); Commonwealth Secretariat (1995a); and Hyden (1999).

2 The US offers a striking example of the variety and profusion of local authorities, all delivering local services. In 1987, there were 83,186 local government units—3,042 counties, 19,200 municipalities, 19,200 townships, 14,721 school districts, and 29,532 special districts.

3 New Zealand has organized its local authorities into three categories: regional, territorial, and special-purpose or ad hoc authorities. The regional councils set the regulatory environment for managing the natural resources, while the territorial councils provide local services within the regulatory framework defined for them.

4 Davey (1993).

5 Hyden (1999).

6 This section has been drawn largely from Davey (1993); Dillinger (1994); ADB (1998b and 1999b); Svara (1994); and Campbell (1997).

7 A variation, popular in some cities like Calcutta, is the mayor-in-council, similar to the cabinet system. The mayor is elected from the members of the majority party in the council.

8 Svara (1994).

9 Davey (1993).

10 Oakerson, in Perry (1989); Davey (1993).

[11] Davey (1993).
[12] This section has drawn on Sivaramakrishnan and Green (1986); UN (1993); ADB (1995a and 1998b); and Bunye (1999).
[13] The extended metroregions have few clear boundaries between urban and rural settlements, agricultural activities focused on the urban market, dispersed manufacturing plants, and some commercial functions, as well as a haphazard pattern of new formal housing developments and individual construction.
[14] ADB (1999b).
[15] Sivaramakrishnan and Green (1986).

Chapter 5

Decentralization: What, When, and How

▪ With Helena Ireen Vista-Baylon

Unity to be real must stand strain without breaking.
—Mahatma Gandhi

DECENTRALIZATION: DIMENSIONS AND DEGREES

Decentralization of central power and authority to subnational entities can be important for political stability, effective service delivery, poverty reduction, and equity. When ill-conceived or inapplicable to country circumstances, however, decentralization can also carry serious risks. The trend toward decentralization has been especially strong in Europe and Latin America, but a variety of initiatives in that direction have also been taken in many developing countries. The dictionary definition of *decentralization* is "the removal of certain centralized powers or control to various areas, usually the area where operations take place." (Webster 1995). However, semantic confusion arises because of the wide range of meanings with which the concept is associated in different country practices. Accordingly, this chapter begins with a definition of the basic concepts all associated with the word *decentralization*. Dimensions of decentralization include the geographic, functional, political/administrative, and fiscal. Degrees of decentralization include deconcentration, delegation, and devolution.

Dimensions of Decentralization

Geographic decentralization

Geographic decentralization entails dividing the territory of a state into smaller areas and assigning jurisdictional powers among them. The geographic division depends on the relevant criterion used: it should be based on settlement patterns if the criterion is to minister to the needs of the population; on language and tradition, if the criterion is to recognize different ethnic groups and cultures; and on scale economies, if the criterion is efficiency. Constituent areas of federations correspond to the divisions made by unitary states for urban and rural jurisdictions. Examples are the provinces and districts of Zambia; the departments and communes of France; counties and districts of England; the regions and districts of Scotland; and the provinces, autonomous regions, counties, people's communes, and production brigades of the People's Republic of China.

Functional decentralization

Functional decentralization is the distribution of state's authority and responsibility among different functional entities of government. It involves determining the type, amount, and mix of government services and creating the entities to dispense them. Accordingly, subnational government entities may be regional offices of the central ministries, service districts, autonomous agencies, or local units of government. The geographic and functional dimensions of decentralization are, in practice, intertwined.

Political and administrative decentralization

The degree of administrative decentralization is closely related to the political structure of the state. However, a distinction is still useful, as certain functions may be exercised centrally even in a federal system, and locally even in a centralized system.

Political decentralization shifts decision-making powers to lower levels of government, encouraging citizens and their elected representatives to participate in decision-making processes. In a fully decentralized structure, lower levels of government formulate and implement policies independently, without intervention from higher levels of government.

A federal constitution is by definition a more decentralized arrangement than a unitary one. However, as mentioned earlier, it is possible for a unitary state to shift substantial powers to provincial governments so that a quasifederal arrangement exists, as in Papua New Guinea. Conversely, a number of federal constitutions exercise significant powers over subnational governments, and the two levels of government in federal states have become increasingly interdependent. In Canada and Switzerland, for example, the federal government may disallow provincial law, or the local courts must judge the validity of federal laws. The Canadian central government appoints lieutenants-governor and important officials of the state judiciary. In India, extensive powers are conferred on the federal government. The growth in spending on federal grant-aided programs in the US means that state- and local-level governments are required to implement them under close federal supervision, and thus lose some de facto autonomy.

Administrative decentralization involves mainly the design of organizational roles, the identification of specific administrative tasks needed to fulfill those roles, and the assigning of actors to perform the tasks. Some generic administrative roles are executive leadership, policy innovation, planning, financial management, operational management, and regulation and oversight. Naturally, the distinction between political and administrative decentralization is blurred in practice.

The amount of administrative tasks performed by subnational governments depends on the variety of service delivery functions assigned to them. Service delivery can be segmented into parts. In public education, for example, subnational governments may perform any one or more of the following services: curriculum design and teaching methods, textbook production and distribution, teacher recruitment and promotion, school building construction and maintenance, and payment of teachers' salaries. Normally, standard setting is reserved to the national government entity.

Fiscal decentralization[1]

Fiscal decentralization (sometimes called fiscal federalism) involves transferring expenditure and revenue responsibilities from the central government to subnational governments. Fiscal decentralization takes a number of forms: (i) self-financing or cost recovery through user charges; (ii) cofinancing or coproduction with the private sector; (iii) expanding local tax and nontax revenues; (iv) intergovernmental transfers; and (v) local borrowing. This chapter does not deal with fiscal decentralization, which is discussed in detail in Chapter 8.

Degrees of Decentralization[2]

The degree of decentralization (whether fiscal or administrative) can be measured by the extent of autonomy of the subnational entities from the central government.

Deconcentration

Deconcentration shifts the administrative workload from central government officials located in the capital to subordinate field staff in the regions, provinces, or districts. Deconcentration is basically an efficiency measure internal to the central government entity, and therefore does not involve a downward transfer of decision-making authority and autonomy from the central government. However, since it does reduce the workload at the center and brings government closer to the people, deconcentration can be considered a first stage of decentralization, especially in highly centralized governments such as those in transitional economies. Furthermore, an intermediate stage can be achieved through a system of field administration, whereby field staff are given some latitude, within prescribed guidelines, to plan the implementation of central directives and to make adjustments to suit local conditions.

Delegation

More extensive than deconcentration is delegation. The organizations to which authority is delegated (i) are technically and administratively capable of performing specialized functions; (ii) may be exempt from central rules on personnel; (iii) may be able to charge users directly for services; and (iv) have broad authority to plan and implement decisions without the direct supervision of central ministries (although they are ultimately accountable to the government). Examples are some types of executive agencies (discussed in Chapter 6), housing and transportation authorities, school districts, public enterprises or corporations, special service districts, special project implementation units, and regional development corporations.

A major feature of delegation is that it helps insulate the implementation of special high-priority projects from political routine and bureaucratic conflicts. It also prevents revenues gained from income-earning ventures from being mixed with regular government budgets. This is generally appropriate, however, only when there is a direct link between the revenue and the beneficiaries from the service provided (Chapter 7).

Devolution[3]

Devolution carries the highest degree of decision-making independence and involves relinquishing certain functions to subnational governments. It entails creating autonomous subnational governments that (i) have corporate status; (ii) recruit their own staff; (iii) occupy clear and legally recognized geographic boundaries; (iv) raise revenues to finance their functions; and (v) can interact reciprocally with other units in the government system of which they are a part.

In many countries, despite the devolution of functions to subnational governments, the central government still retains some supervisory powers and plays a significant financial role. Also, the central government sometimes tries to keep its hold on local governments through formal and informal controls or regulatory instruments, often linked to project or program funding. This is intended to ensure that subnational governments will act consistently with national development policies and plans, and follow prudent financial practices. (Sometimes, however, it reflects merely a reluctance to let go of central power and control.)

Developments in decentralization worldwide have abused the term to apply to very different phenomena. *Decentralization* has been expanded in its meaning to include also the dispersal of functions to organizations outside the government apparatus, in various forms of alternative service delivery (Chapter 6), and even to privatization. Such an overly broad use of the term, however, makes intelligent discussion difficult. In this chapter, we use decentralization to refer to the varying degrees of dispersing functions and authority along the formal structure of government, i.e., the geographic articulation of state power and activity.

RATIONALE, ADVANTAGES, COSTS, AND RISKS OF DECENTRALIZATION

Rationale and Advantages

Much of the decentralization that occurred especially during the 1980s was politically motivated.[4] In Latin America, fiscal and administrative decentralization grew out of democratization movements when elected governments operating under new constitutions replaced autocratic central regimes. Conversely, strong and consolidated local democracy contributed to a more accountable government in the country as a whole. In most of Africa, regionalism and ethnicity, and the spread of multiparty systems, gave rise to more local control and participation in administrative decision making.

In extreme cases, decentralization was a desperate attempt of the state to keep the country united. Political and ethnic pressures, and the long civil wars in Mozambique or Uganda, for example, paved the way for the granting of more autonomy to all localities, or the forging of asymmetrical federations. Mikhail Gorbachev's draft "Union Treaty," before the August 1991 coup, was a last-ditch effort to prevent the Soviet Union from splintering. In some Asian countries previously governed by autocratic regimes, decentralization was seen as the natural alternative. Ethnic conflicts have also exerted strong pressure for decentralization, as in Indonesia, Philippines, and Sri Lanka. As Dillinger has pointed out, decentralization in most countries has come from ad hoc reactive responses by the national government, rather than as a sequenced set of well-conceived policies.

The literature, however, sets out a clear economic rationale for decentralization. Allocative efficiency of public resources can be raised if expenditure decisions are made at lower levels of government that are more responsive to local demands than by a remote central administration. This closer nexus between expenditure decisions and their beneficiaries also limits opportunities for inefficient resource use. From an efficiency standpoint, the Oates "decentralization theorem" states that each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize the benefits and costs of such provision. In reality, this test is pretty tough to set up and satisfy. A more practical approach, the principle of "subsidiarity," has been adopted by the European Union in assigning responsibilities among levels of government. (Fiscal decentralization was incorporated in the European Union's Single European Act of 1987 and formally adopted by the European Commission in 1993). According to this principle, taxing, spending, and regulatory functions should be exercised by lower levels of government unless a convincing case can be made for assigning these functions to higher levels of government.

The potential gains of decentralization derive mainly from the close contact of government institutions with local residents. First, it may open an environment for public participation in government decision making, resulting in (i) more flexible administration since the government can tailor its goods and services to the needs of the various political, ethnic, religious, and tribal groups it serves; (ii) more effective administration, as local leaders can more appropriately locate services and facilities within communities and integrate isolated areas into regional economies; and (iii) political stability and national unity, as civil society organizations are given a stake in maintaining the political system (see the illustration of northeast Brazil, Box 5.1).

Box 5.1
Rural Development and Community Participation in Northeast Brazil

The chronic poverty in northeast Brazil was caused primarily by the poor resource base in the region and the virtual absence of a functioning rural financial system for the poor. Efforts to reduce rural poverty cost the Government more than $3.2 billion in expenditures over the last decades. Rural development projects initiated by the federal government included drought relief and discrete sectoral projects, and the integrated development of selected areas to increase agricultural productivity. However, these efforts hardly reduced rural poverty in the region.

In mid-1993, the Brazilian federal and state governments reformulated, with the assistance of the World Bank, the poverty intervention program and made the projects community-based, with project funds going directly to community associations to finance small-scale subprojects they had identified themselves. Unlike previous rural development programs, the reformulated program addressed institutional issues such as decentralization, municipalization, community organization and participation, transparency in decision making, and training and technical assistance to municipalities.

The preliminary evaluation of the reformulated program showed a general improvement in the living conditions of the rural poor and an increase in productivity and employment generation in the region. Aside from improved project design and sustainability, what contributed to the positive outcomes were the increased participation by residents in subproject selection and execution, transparency in project design and implementation, and decentralized fiscal and investment decision making by state and local governments.

Source: Johan van Zyl et al., "Decentralized Rural Development and Enhanced Community Participation: A Case Study from Northeast Brazil," Policy Research Working Paper 1498 (Washington, DC: World Bank, 1995).

Second, decentralization may create opportunities for a more accountable government. Residents participating in decision making can easily monitor and evaluate the government's compliance with the decisions made, can demand speedier government operations, and push local institutions to enhance their capabilities in carrying out functions that are usually not performed well by the central government on its own.

Third, decentralization may be a first step to more transparency in government. Given the appropriate policies for information transfer, subnational planning and policy making can be made more accessible even to the remotest residents.

Finally, decentralizing fiscal powers to local leaders can ease the financial strain on the central government since subnational governments can more readily mobilize funds by collecting fees and charges for the services they provide. Unfortunately, this generates the frequent temptation to offload expenditure responsibilities to subnational governments that do not have the authority or capacity to raise the required resources (Chapter 8).

Costs and Risks[5]

Decentralization carries various risks as well. First, unless perfectly designed (which is unlikely), decentralization can entail the loss of scale economies and generate unnecessary duplication and underemployment of staff and equipment. Second, it can create coordination problems and conflict where none exists. Especially applicable to ethnically heterogeneous countries, decentralized decision making may subvert the overall resource distribution and macroeconomic management objectives of the central government (discussed in more detail in Chapter 8). More importantly, decentralization can jeopardize the civil and social rights of certain minorities.

Third, the presumed efficiency gains from decentralization can be undermined by institutional constraints. Subnational governments in developing countries worldwide generally have very weak administrative capacities, which can likely make services to be delivered less efficient and effective (Box 5.2). Where resource endowments and capacities are uneven, as within large countries or across the various islands in an archipelago, decentralization may cause regional inequities to deepen. Also, in countries where different ethnic groups and secessionist movements take up large areas, decentralization/centralization issues can contribute to severe internal societal conflicts. From Kosovo to Aceh, East Timor, the serious implications of the issue cannot be overestimated.

Finally, decentralization can worsen rather than improve overall governance. The generic test here is whether the legitimacy and quality of governance is broadly higher at local level than at national level. If the answer is no, decentralizing into a comparatively worse governance climate will tend to worsen the quality of governance in the country as a whole. Local-level autocrats can be as bad or worse than national-level autocrats.

Box 5.2
Are Local Governments Incompetent?

One of the classic objections to decentralization is that local governments are incompetent. Citing statistics on illiterate mayors, crude accounting systems, and widespread nepotism, critics argue that local governments are incapable of taking on expanded functions.

This argument is not as compelling as it may first appear. As a practical matter, when a major service is decentralized, existing field staff are normally decentralized with it. Thus when primary education was decentralized to the departments and states in Colombia and Mexico (respectively), existing central government teachers were decentralized at the same time. They became no less (or more) competent than they had been when they were employed by the central government.

Technical competence has emerged as a problem when central government employees have refused to be decentralized. In Peru, for example, many central government highway engineers chose to retire rather than accept employment in local government. Local staff proved incapable of assuming the task on its own (a problem exacerbated by the absence of central government financing for the newly decentralized roads). This eventually led to the collapse of the decentralization effort, which was followed by recentralization. Governments can facilitate the transfer of central government staff by requiring local governments to offer them the same wages and benefits they received as central government employees. But this is a two-edged sword. While it makes it easier to decentralize staff, it can make it difficult for local government to adapt wages and benefits to local conditions or to introduce management and personnel reforms.

While transferring staff can address the immediate issue raised by decentralization, the overall management weakness of local government remains a cause for concern. Low salaries, low prestige, and high turnover that results from extensive political interference in personnel decisions can make it difficult to attract and retain competent staff, particularly in very small jurisdictions.

Reform has proven difficult. The management of public spending is at once a highly technical and an intensely political process. The challenge for local governments is to put into practice methods that are both technically sound and politically and bureaucratically feasible (Nellis 1991). Human resource management is also a challenge. Local governments' ability to introduce personnel reforms—including performance evaluation mechanisms, training, and pay linked to productivity, and incentives to attract and retain competent, skilled personnel—is often constrained by powerful public employee unions. These problems are not unique to local governments, however. They are the same factors that affect the competence of staff in central government.

Source: Burki, Shahid Javed, Guillermo E. Perry, and William R. Dillinger. 1999. "Beyond the Center: Decentralizing the State". World Bank Latin American and Caribbean Studies. Box 2.3.

Countries therefore need to assess realistically these costs against the likely benefits. There can be no a priori blanket judgment for or against decentralization, particularly considering the various different meanings of the term and ensuing confusion in many debates.

APPROACHES TO DEFINING SUBNATIONAL TERRITORIES[6]

Table 5.1 lists six approaches to delimiting geographic areas. These are discussed in turn below.

Table 5.1
Approaches to Dividing Geographic Territory

Approach	Key Feature
Functional	Matches area to function
Community	Gives primary consideration to social geography
Efficiency	Considers performance
Managerial	Considers management capacity of government organization
Technical	Considers the landscape or economy of the country—climate, topography, soil conditions, etc.
Social	Considers the natural formation of inhabitants in geographic areas

Source: B.C. Smith, Decentralization: The Territorial Dimension of the State (London: George Allen and Unwin, 1985).

The Functional Approach

The process of matching area to function involves identifying government functions and the associated necessary institutions, and on this basis delimiting the geographic boundaries within which government functions are to be performed. Following Oates' theorem, the hierarchy of geographic communities corresponds to the scale of operations necessary for the optimum performance of the general government.

But there are difficulties. Aside from the fact that the different functional criteria may produce overlapping boundaries, it is impossible to objectively restrict the "natural" geographic area of a problem (such as in health, housing, and the environment) to the functional area that is politically determined by the government. In effect, the determination of functional areas becomes a political judgment as to what the "right" jurisdiction is for a particular function. The functional approach remains the main point of reference, but needs to be complemented by other considerations.

Community Approach

The community approach prescribes that government boundaries should correspond to territories in which the inhabitants manifest common behavior and attitudes. Applying the community approach involves determining two essential elements: (i) the spatial distribution of settlements such as villages, towns, cities, and metropolitan areas; and (ii) the spatial patterns of the activities of inhabitants, indicated by the people's economic transactions, their personal mobility in commuting to work and shopping, recreation, and cultural linkages.

The process mainly involves identifying geographic centers and hinterlands and their social and economic interdependence as indicated by the number of inhabitants employed in banks, shops, schools, hospitals, newspapers, and so on. This is useful for the design of effective land-use plans, traffic management, highways development, and public transport. Also known as the "central town" concept, the approach is applied notably in Belgium, France, Germany, Sweden, and Yugoslavia, which were able to build strong links between their urban centers, hinterlands, and rural areas. The approach is generally consistent with the regional "growth poles" development approach of the French economist François Perroux (popular in the 1960s), which however has rarely been successful and often led to substantial waste.

Complexities in center-hinterland relationships make it difficult to demarcate communities and measure the urban status of centers. But the task of making government boundaries coincide with centers in towns or urban areas, however difficult, would "internalize" the service externalities generated by local government functions. Also, it would produce a more equitable distribution of government goods and benefits among the community of inhabitants. The more homogeneous the community is, the greater the likelihood that government action will be close to the collective preferences of citizens.

Efficiency Approach

Geographic areas may be divided to permit the government to deliver goods and services efficiently and make the best use of its resources. This approach suggests large jurisdictions with large populations, permitting local governments to (i) widen their range of functions to serve more people; (ii) benefit from a larger tax base; and (iii) optimize their workloads. The efficiency approach is most appropriate for local government services such as urban planning, housing, water, sewerage, and transportation. The efficiency approach to decentralization can be embodied in Oates' "decentralization theorem" mentioned earlier.

Measuring the efficiency of an organization according to its output forms the basis for either enlarging or reducing jurisdiction boundaries. However, unlike services whose output is quantifiable, such as highways, sewerage systems, or water supply, objective criteria for measuring the "output" of services of, say, teachers, social workers, policemen, health workers, and the like, are extremely difficult to find.

Many western European countries (notably Denmark, Germany, Sweden, and United Kingdom) have reduced the number of their municipalities through mergers. There is, however, no conclusive evidence that operating in larger jurisdictions is always more efficient than operating in smaller ones. Scale economies constantly change with changes in technology and government function. Also, exploiting scale economies does not necessarily require an administrative entity of optimum size. Scale economies can also be attained by adopting joint service agreement, and by delegating the execution of a variety of local services to provincial governments.

Management Approach

The aim of the management approach is to divide state territory into more manageable parts. It corresponds roughly to the "span of control" criteria for central government organization (Chapter 3). It involves drawing boundaries to reflect the perceptions of central decision makers as to how the flow of work can best be managed. The number and location of field offices are arrived at according to an optimum span of control by the headquarters, or the workload appropriate for a field office. This approach is more appropriate for deconcentration and delegation, rather than for political decentralization or for the constitution of local government units.

Technical Approach

In dividing the state territory, one may consider the natural properties and physical features of regions that may bear significance for administration. Although the term region may mean different things in geography and public administration, administrative regions are often based on geographical regions, i.e., areas with unifying characteristics or properties.

Administrative boundaries are often drawn on the basis of physical geography, especially when governments attempt to manage natural resources such as water supply, land drainage, coastal erosion control, irrigation, soil conservation, forest development, recreation, waste disposal, or wildlife conservation. Also, physical geography can offer an appropriate basis for economic and social planning, especially if the lives of the inhabitants are tied closely to the exploitation of natural resources. Boundaries may usefully be drawn around river basins or watershed areas, for example. Box 5.3 shows how the technical approach can be used as the basis of the administrative efficiency of the organization.

An administrative structure based on geographical features is the Tennessee Valley Authority in the United States (US), probably the best known example of a multipurpose development authority based on a watershed area. The regional boundaries within which the authority operates is determined by the catchment areas of the river. Local authority boundaries are taken into account in subdividing some water regions.

Box 5.3
The British Water Industry

Administrative criteria can also be considered in delimiting a geographic area according to the technical principle. This is best illustrated by the water industry organization in the United Kingdom. Ten authorities in England and Wales are responsible for a range of functions connected with water use—conservation, supply and distribution, sewerage and sewage disposal, land drainage, pollution control, and recreation. Each authority handles a self-contained water processing cycle and thus differs from authorities with fragmented structures, which deal only with some parts of the water processing cycle. The catchment areas, or the areas of land draining to a particular river, determine the regional boundaries of each authority. Each water region is made up of a number of catchment areas, and the subdivision of some water regions takes into account the boundaries of the local authority. The size of each region thus reflects managerial perceptions about the amount of work that a single organization can handle.

Source: C. Gray, "The Regional Water Authorities," cited by B.C. Smith, Decentralization: The Territorial Dimension of the State (London: George Allen and Unwin, 1985).

Social Approach

The territorial structure of government and administration may consider socially distinct regions based on history, ethnicity, language, or some combination of these. The approach is especially useful when, during the process of unification, some areas forming the constituent parts of a country may continue to experience a sense of identity that cannot be overlooked by the constitutional and administrative system.

Changing the boundaries of the states of a federal country is more difficult than changing regional boundaries within unitary states, as states in federal countries are usually protected by constitutional guarantees. However, when state boundaries in a federation owe their origins to the artificial creations of an external power (normally through a colonial experience), restructuring a federation may be easier.

Other Considerations

As noted, the main approach to geographic decentralization is to match area to function. However, other considerations bear on the attainment of national economic objectives. Developed countries have long historical experience of associating spatial change with economic development, but ex-colonial developing countries have spatial divisions oriented to the economic interests of the former colonizing power. Many of the difficulties in establishing links among economic activities in a nation and among ethnic groups can be related directly to colonialism, which left countries with artificial boundaries not conducive to the mobilization of resources for internal markets, and inimical to nation building, especially in Africa.[7]

Attempts to derive economic benefits from existing geographic divisions can be made through the deliberate use of subsidies and taxes either to encourage businesses to relocate from one area to another or to discourage them from doing so. If successful, such regional development strategy can lead to a more uniform distribution of regional wealth and standards of living. In addition, if successful, such a strategy of interregional equalization could lead to a lower degree of conflict and, in time, more rapid economic development. Unfortunately, such an approach has generally failed and produced only waste on a large scale as well as substantial opportunities for corruption. The approach is not to be ruled out, but must be subjected to detailed scrutiny and realistic safeguards.

POLITICAL AND ADMINISTRATIVE DECENTRALIZATION

Because the political and administrative dimensions of decentralization are closely linked in practice, they are discussed here under the same heading. However, it is important to bear in mind the conceptual distinction between the two, as defined at the start of this chapter. Note in particular that, while there are economic and operational criteria to help determine the best administrative allocation of functions, the fundamental decisions concerning the structure of the state are inherently political, resulting from the preferences of the population and the context of the times, and cannot be subject to any technical assessment. (For this reason, the international financial institutions have no mandate and no legitimate role in matters of political decentralization per se.)

Creating a Favorable Environment

The primary concern of political decentralization is creating a conducive political environment for decentralized decision making. The essential components of such an environment are (i) autonomous decision making powers of lower levels of government; and (ii) citizens' access to decision making (see Chapter 14 for a discussion of public participation). In parallel, it is necessary to strengthen autonomous local entities. To prevent different tiers of government from working at cross-purposes, the national constitution should provide the framework within which local governments are to function.

The tensions between urban and rural areas in most developing countries are relevant to assessing the opportunities for administrative decentralization. Typically, the urban elite as intermediaries for the colonial power tended to dominate policy making in central government in the colonial era. Independence, in many Asian countries, meant the emergence of political leadership from rural areas, and an ensuing shift in the spatial composition of legislative bodies and the administrative executive. Some political theorists in the 1960s also fueled rural fears about the adverse terms of trade for rural areas' agricultural products and the "parasitic" role of cities.[8] In Africa and elsewhere, by contrast, postcolonial governments were still in the hands of an urban elite, and policies carried a strong anti-rural, pro-industry bias.

In Asia, cities have tended to suffer from less attention in national policies. The resulting uncontrolled growth of urban areas led to the problem of peripheral growth, and the extension of infrastructure and shelter facilities to the settlements adjoining cities. Integrated approaches to the development of urban and rural areas within a district framework emerged only in South Asia, and were later reflected in the decentralization laws in a number of Asian countries. The district or county construct enabled coordinating mechanisms to be devised for the joint management of resources in urban and rural areas, to provide for supporting urban facilities needed by rural areas, and to plan for spillover development outside cities and districts. Again, the situation was the opposite in Africa where the centers absorbed an increasing proportion of the wealth produced in the countryside, while returning very little in the way of public services.

Legal Framework for Decentralization

However decentralized a country may be, if it is to remain unified the actions of subnational government must be subject to some form of central regulation and monitoring. Central regulation is, of course, most obvious in deconcentrated structures where local government bodies carry out functions on behalf of the central government. But a degree of regulation is also essential in devolved administration, not only to ensure national standards of public services but also to prevent local government actions from interfering with or contradicting national policies and goals.

Normally, the country's constitution should embody the broad outlines of decentralization, namely, the territorial divisions; the general authority and responsibilities of subnational levels of government; the description and role of key institutions at central and local levels; and the conditions under which detailed rules of decentralization are to be established or changed. [9]

Enabling laws, in accordance with the constitutional provisions, would then define the specific parameters of decentralization, and provisions for intergovernmental fiscal relations; the subnational government structure, including procedures for election, accountabilities, and remedies; the classification of local governments within tiers and the division of functions among local governments in different tiers; and the manner by which citizens can access and participate in subnational government activities. Finally, administrative rules would detail the implementation of decentralization, including sections on intergovernmental relations, as in the Philippines (Box 5.4).

Box 5.4
The Philippine Local Government Code of 1992

The Local Government Code is a landmark legislation in the Philippines, considered by far the most far-reaching policy that addresses the decades-old problem of an overcentralized system in the country.

The Code was promulgated in 1991 in accordance with the 1987 Philippine Constitution, which declared that "the state shall ensure the autonomy of local governments," transferring substantial political and administrative authority and responsibilities to local government units.

The Code defined the transfer of two major groups of government activities:

• the transfer of functions and responsibilities:

- **mandatory services**: health (field health and hospital services and other tertiary services); environment and natural resources (community-based forestry projects); agriculture (agriculture extension and on-site research); public works (local roads, waterworks, and minor infrastructure); and social services (social welfare services)
- **other services**: education (school building program); tourism (facilities, promotion, and development); telecommunication services and housing projects (for provinces and cities); and other services such as investment support.

• the transfer of central power and authority:

- **enforcement of certain regulations**: reclassification of agricultural lands; enforcement of environmental laws; inspection of food products and quarantine; enforcement of the national building code; operation of local modes of transportation such as tricycles; processing and approval of subdivision plans; establishment of cockpits and holding of cockfights
- **fiscal management**: broadening of taxing powers, providing the local governments with a specific share of the proceeds from the exploitation of national resources in their area, e.g., mining, fishery, and forestry charges; increasing their share in national tax revenues, i.e., an increase in the internal revenue allotment, from a previous low of 11 percent to a high of 40 percent; and increasing opportunities to generate revenues from local fees and charges
- **entrepreneurial activities**: build-operate-transfer arrangements with the private sector, bond flotation, and loans from private institutions
- **expanded participation of civil society in local governance**: allocation to nongovernment organizations and other civic organizations of specific seats in local special bodies, including the local development council, the local health board, and the local school board.

Source: Republic Act 7160 (Local Government Code of the Philippines 1992).

In many countries, however, decentralization laws and regulations are formulated piecemeal and on an ad hoc basis. In these countries, therefore, all laws and regulations should be codified not only to maintain a coherent and logical framework and to spot duplications and inconsistencies, but also to provide policymakers with a clear set of policy objectives. Following such codification and clarification (including the repeal of conflicting or obsolete legislation), it would become possible to design a legal framework with a clear range of responsibilities for each level of government as well as responsibilities jointly shared by the central and local governments.

In drawing up the legal provisions, one should first adequately address the broad ethos and objectives of decentralization, and only then the nuts and bolts of administration. Often, this is not done, and the overall objectives are left unspecified. Another factor to consider is the institutionalized channel for public participation. In a number of countries, local elections enable citizens to signal their preferences efficiently and enforce leaders' compliance with their wishes. In some cases, citizens' groups and nongovernment organizations (NGOs) are allotted seats in certain local councils responsible for local decision making. Public participation, however, should be seen not only as an instrument for designing a legal framework, but also as a measure of empowerment as an end in itself, against which decentralization will be evaluated.

Some Practical Pointers

Problems must be anticipated as various decentralization measures are introduced. First, the center should always consider the different capacity of lower levels of government to handle new responsibilities. The anticipated effect and costs of decentralization will not be the same for all regions. It is essential that central authorities, based on a study of the capacity of different subnational governments, make a differentiation of the amount of powers to decentralize. Needed adjustments can then be made during implementation.

Second, opportunities opened up for citizen participation do not immediately result in meaningful public participation until the mechanisms have been institutionalized. Local governments should ensure that information is made meaningful and useful to the citizen, and must be encouraged to do so by the central government.

Third, in a deconcentrated system where central regional agencies dominate local jurisdictions, local governments will inevitably face stiff competition from the field offices of the central agencies, which are typically better equipped with technology and manpower. Turf problems and administrative jealousies can frustrate decentralization and make deconcentration less effective. Central authorities need to draw a clear dividing line between functions to be deconcentrated and those to be devolved.

The success of decentralization is determined both at the policy formulation and at the implementation stage. In many developing countries, decentralization failures almost invariably stem from poorly planned and organized implementation strategies. Decentralization is a complex process that typically requires gradual and careful experimentation. In developed countries, decentralization is a product of long social experimentation over a number of decades. The risks of hasty action, including the risk of jeopardizing the sustainability of decentralization itself, are especially pronounced in developing countries. In some cases, however, there may simply be no alternative to the immediate devolution of central powers to the regions.

It is sensible also to allow a degree of flexibility in implementing laws. It should be borne in mind that while decentralization mandates are usually formulated at the center, implementation is shaped and influenced by the local context and environment, which includes historical, cultural, and sociopolitical factors. Also, since decentralization should build on both the strengths and the weaknesses of old and new institutions, the implementers must be creative in making the proper selection and adjustments.

In centralized government structures, deconcentration is invariably the first step toward decentralization. Pilot testing of parts or the whole of the decentralization measure can be useful. Careful recording of factors causing success or failure during pilot testing will provide pointers for improving implementation in other regions, as will clear-eyed ex-post evaluation of such efforts. No matter how well implementation is planned, challenges, interventions, and interruptions should be expected. In the case of the Philippines, for example, interruptions included the conduct of local and national elections and the continued practice of granting "pork barrel" funds to Congress members to dole out at their discretion, a practice which made local budgeting and planning less meaningful and effective.

WHAT BELONGS WHERE? THE GEOGRAPHIC ARTICULATION OF GOVERNMENT FUNCTIONS

Table 5.2 classifies government activities in accordance with their assignment to different levels of government. The table is self-explanatory. The information it contains, while associated with actual experience and sound theory, should be interpreted as indicative and not prescriptive. See the note to the Table for an explanation of the terms.

Table 5.2
A Representative Assignment of Government Responsibilities

Function	Policy and Standards Oversight	Provision/ Administration	Production/ Distribution	Comments
Interregional and International Conflict Resolution	U	U	N, P	Benefits and costs international in scope
External trade	U	U, N, S	P	Benefits and costs international in scope
Telecommunications	U, N	P	P	National regulation not feasible
Financial Transactions	U, N	P	P	National regulation not feasible
Environment	U, N, S, L	U, N, S, L	N, S, L, P	Externalities of global, national, state, and local scope
Foreign Direct Investment	N, L	L	P	Local infrastructure is critical
Defense	N	N	N	Benefits and costs national in scope
Foreign Affairs	N	N	N	Benefits and costs national in scope
Monetary Policy, Currency, Banking	U, ICB	ICB	ICB, P	Independence from all levels essential; some international role for common discipline
Interstate Commerce	Constitution, N	N	P	Constitutional safeguards important for factor and goods mobility

Table 5.2
A Representative Assignment of Governmental Responsibilities
(cont'd.)

Function	Policy and Standards Oversight	Provision/ Administration	Production/ Distribution	Comments
Immigration	U, N	N	N	U because of forced exit
Transfer Payments	N	N	N	Redistribution
Criminal and Civil Law	N	N	N	Rule of law a national concern
Industrial Policy	N	N	P	To avoid beggar-thy-neighbor policies
Regulation	N	N, S, L	N, S, L, P	Internal common market
Fiscal Policy	N	N, S, L	N, S, L, P	Coordination is possible
Natural Resources	N	N, S, L	N, S, L, P	Promotes regional equity and internal common market
Education, Health, and Social Welfare	N, S, L	S, L	S, L, P	Transfer in kind
Highways	N, S, L	N, S, L	N, S, L	Benefits and costs of various roads vary in scope
Parks and Recreation	N, S, L	N, S, L	N, S, L, P	Primarily local benefits
Police	S, L	S, L	S, L	Benefits and costs of various facilities vary in scope
Water Supply, Sewerage, Refuse Management, Fire Protection	L	L	L, P	Primarily local benefits

ICB Independent central bank
L Local government
N National government
P Nongovernment sectors/Civil society
S State/provincial government
U Supranational responsibility

Source: Anwar Shah, "Balance, Accountability, and Responsiveness," Policy Research Working Paper 2021 (Washington, DC: World Bank, 1998), Annex Table 1.

INTERGOVERNMENTAL RELATIONS AND COORDINATION[10]

Pattern of Intergovernmental Relations

In developing countries, intergovernmental relations and coordination have become critical to the strategic coherence of government, as well as to the preservation of a national identity, without which decentralization becomes disintegration, and disintegration most often produces bloodshed on a major scale. The pattern of relations between governments at different levels will vary according to the nature of government, the extent of centralization of functions and resources, and the ideology of control over subnational units. Subnational agencies are becoming more involved not only in service delivery and regulation, but also in policy making and dispute resolution.

Most countries define the formal arrangements that govern intergovernmental relations through legal provisions or executive orders. There are two sets of separate but interrelated relationships: the horizontal relationships between local government and civil society, and the vertical relationships between levels of governments (on which deconcentrated delivery systems are superimposed). Complications are introduced when different levels of government, not to mention nongovernment providers of services, look after different aspects of the same service (e.g., education or health care). The issue of service delivery then becomes much more than just a central-local option; it becomes a question of contestability among multiple providers. Both vertical and horizontal rules are essential if local governments are to perform their functions well.

Instruments of Intergovernmental Relations

In federal systems, intergovernmental relations are primarily defined through (i) formal constitutional change, redefining the roles and responsibilities of the federal and provincial governments; (ii) nonstatutory federal-provincial agreements (often backed by permanent consultative mechanisms) that set out obligations and commitments in specific policy areas, such as the environment; (iii) statutory and binding obligations and commitments, such as intergovernmental fiscal transfers; and (iv) informal agreements among political leaders to undertake a certain course of action. Intergovernmental processes are characterized according to the number of participants (multilateral, regional, or bilateral), the types of participants (bureaucratic or political), or the nature of the interaction (consultative or decision-making).[11]

Some intergovernmental agencies have mandates to forge a consensus through formal collaboration in managing specific challenges, such as the removal of trade barriers, the sharing of river waters, or cross-border crime. Consultative processes facilitate sharing information and experience among all layers of government, and building up integrated databases for policy making and evaluation. (They also help to tone down adversarial relations in a multiparty system.) A similar role is played by provincial governments in relation to lower levels of government, although cities are increasingly establishing direct relationships with national agencies in a deregulated framework.

In unitary systems, the instruments of intergovernmental relations include administrative coordination and fiscal measures. The "provincialization" process envisages a coordinating and consultative role for the provincial or regional governor and administration, as seen in Indonesia, Japan, the Philippines, Zimbabwe, and other countries. The problems and suspicions in setting up such regional structures in transitional economies were mentioned earlier, as a reaction to control by the center. In countries in the French administrative tradition in Asia and Africa, the representative of the government in the district or region has a significant coordination function in relation to government departments, functional agencies, and local authorities.

National Control of Local Government Activities

It is possible to identify three disfunctional patterns of national control of local government: overcontrol, whereby the subnational governments are merely administrative arms of the central government; undercontrol, whereby each tier of subnational government is almost sovereign and competes with other levels of government; and perverse regulation, whereby local governments have some degree of political autonomy, but perverse incentives characterize the relationship with the central government.[12]

Overcontrol could inhibit the responsiveness of local government. It is therefore desirable to move away from detailed and rigid regulation and ex ante financial control toward managing for due process and results. More helpful are normative controls, such as centrally specified personnel qualifications, design standards for infrastructure, building codes, stress on community and NGO involvement, and, of course, protection of human rights and minorities. Transparency can be promoted by requiring local bodies to publish their budgets, including subsidies for services, in simplified formats.

In addition to its control function, central government also has a positive role to play in facilitating decentralized administration, and in promoting national social goals.[13] Shifts in the style of government intervention, from inquisition to assistance and capacity building, will develop positive attitudes in the local staff.

Fiscal and financial controls are essential; however, these and related issues are discussed in Chapter 8.

Modes of Coordination

The challenge in effective intergovernmental relations is to achieve a balance between achieving autonomy for subnational units and retaining needed control of such units; promoting variety and protecting equity; ensuring responsiveness; and preserving efficiency. What is required is judicious use of the instruments of control, coordination, consultation and accountability, and, most of all, common sense and a positive attitude of cooperation from all sides.

As noted earlier, different actors or different tasks may require different forms of coordination. In general, coordination may be

- horizontal or vertical;
- formal and mandatory, or informal and voluntary;
- structural or procedural; and
- institutionalized or ad hoc.[14]

Vertical coordination between different levels of government seeks to assure top-down policy coherence (Box 5.5). In Australia, for example, the Council of Australian Governments gathers together federal and state ministers, as well as the presidents of the Local Government Association for increased cooperation among governments. Vertical coordination is facilitated by national norms for program goals, and uniform guidelines of financing institutions. Local government associations and councils of mayors are often the main interlocutors with the national and provincial governments on issues affecting local governments. Nordic governments regularly consult such associations on financial matters and legislation affecting local authorities.

Box 5.5
Cooperative Intergovernmental Relations in South Africa

The principle of cooperative governance is articulated in Chapter 3 of the South African Constitution and has proven to be a cornerstone of intergovernmental relations. Where government functions are a shared responsibility of national and provincial governments, as in social services, the national government provides the policy framework while the provinces are responsible for delivery of services. This division of responsibilities, combined with the considerable economic disparities across provinces, requires a coherent coordination process to ensure that expenditure planning is aligned with policy goals and to promote equity in access to social services.

To facilitate this coordination, each of the major government sectors has a forum consisting of the national and provincial ministers where policy issues are discussed. Joint meetings are held between the finance forum and individual sector fora to review both policy issues and budget constraints. These joint meetings enhance understanding of the cost of policy choices and encourage developing alternative methods of delivering services.

The fora for finance, education, health, welfare, and transport are supported by technical committees comprised of officials from the national and provincial line departments and treasuries. These committees deal with policy implementation, developing coherent policy within sectors, norms and standards for service delivery, evaluating the affordability of policy choices, and other technical issues. A key focus of the technical committees for the near future is developing service delivery indicators against which to measure government performance.

Source: Laura Walker, personal communication, May 2000.

Horizontal coordination takes place among agencies operating at the same level of government, or between local government and the corresponding civil society. In France, the provincial prefect coordinates procedures for major public works through consultation with local authorities, agencies, and economic and social bodies. The regional planning mechanism in many countries involves consultation with all local authorities and field agencies of ministries, to ensure coordinated investment policies and complementary programs. For example, former Malaysian Deputy Prime Minister Tunku Abdul Razak listed interdepartmental jealousy, lack of day-to-day cooperation, and lack of sufficient direction from the top among the "seven deadly sins" that obstruct the administration of rural development programs.

Horizontal coordination has to contend with vertical functional monoliths, such as health and education agencies, which resist collaboration with other agencies, as well as direction by elected local political executives and the officials designated to coordinate the agencies on behalf of governments. The experience with the District Autonomy Pilot Program in Indonesia illustrates this point.[15] District-level poverty reduction programs or integrated urban infrastructure programs in many countries show the substantial scope for horizontal coordination. These programs are articulated through local elected bodies, and are based on the full involvement of community representatives and civil society (Box 5.6).

Box 5.6
Broadening the Range and Deepening the Base

A systematic approach to coordination involves broadening the range and deepening the base of relationships between actors. "Broadening the range" includes introducing flexible modes of operation or new forms of intragovernmental cooperation, and joint work by different agencies. Ten national and city government agencies came together in Cali, Colombia, to launch an integrated slum upgrading program in consultation with the residents. A similar approach was followed in the Malaysian NADI social development program and the Colombo slums, and the targeting of assistance to the poorest households in Seoul by the Bureau of Social Affairs of Seoul City. The independent low-cost sewer system developed by the community in Orangi (Karachi, Pakistan) developed into a collaboration with the municipal authority, not only for citywide sanitation, but also for other social services needed by the poor.

"Deepening the base" operates in a number of ways: through decentralization and area-based service delivery, by integrating local agencies; through increased consultation in service delivery; through public-community partnerships; and through facilitating technical assistance by networked civil society groups to communities and poorly equipped voluntary groups. In Argentina, India, Sri Lanka, Zambia, and a number of other countries, national and municipal authorities get together to operate citywide programs of basic urban services, with community participation. The FUNDASAL in El Salvador operated for many years as the leading producer of urban housing units for low-income groups, with formal support and financing from the Government. Similarly, national women's cooperative networks have been recognized in India and elsewhere for women's welfare and development, savings mobilization, and training, in concert with city and state agencies.

Source: UN Center for Human Settlements. 1990. "Roles, Responsibilities and Capabilities or the Management of Human Settlements". Nairobi.

Coordination is an essential ingredient not only in policy formulation but also during implementation. Lack of interaction can damage well-designed policies, as in the case of Indonesia where the central ministries formulated and implemented decentralization policies with very little discussion among themselves, leading to uncoordinated activities, conflict, and duplication (Box 5.7). The central ministries were more committed to achieving the development and activities of their own departments than to ensuring that local governments are provided with the necessary logistics for decentralization. The reason, as always, was that the incentives for assisting local governments were much weaker than those attached to the ministries' own activities.

Box 5.7
Poorly Coordinated Decentralization in Indonesia

Although the legal framework for decentralization was established in 1979, the Indonesian Government remained a highly centralized structure. In April and May 1999, the Indonesian Parliament passed two laws to replace the laws that defined the decentralization system in the country. Law 22 revised the assignment of functions and roles of institutions at all levels of government, and Law 25 defined the financing system for devolution, deconcentration, and coadministration of government functions. In some ways, the laws have improved the legal framework of the Indonesian decentralization system, although there were problems in the initial stages.

Problems during implementation further hampered the smooth and successful transition from a centralized to a decentralized administration. Five working groups were formed to draft implementing regulations, and to plan and monitor the implementation process. However, the activities of the groups were not coordinated and harmonized because of lack of interaction among the ministries. Duplication of regulations and policies and unnecessary competition among the ministries concerned resulted. The Ministry of Home Affairs claims that 30 more decrees are needed to support the decentralization laws. It is drafting seven or eight decrees to implement the Regional Law, and the Ministry of Finance is drafting six implementing regulations to support the Fiscal Law. But it is claimed that hundreds and even thousands of local regulations still have to be passed to complete the system. It may take years for Indonesia to start working as a decentralized system.

Source: Claudia Buentjen, personal communication, March 2000.

KEY POINTS AND DIRECTIONS OF IMPROVEMENT

Key Points

Decentralization has been transforming the structure of governance in many countries in recent decades. It has taken place for different reasons, and mainly improving the effectiveness of public service delivery; raising the quality of governance by empowering the local communities; and reducing the risk of national fragmentation along regional and ethnic lines. Decentralization encompasses a variety of different measures, depending on the degree of autonomy of the subnational entities from the central government. Obviously, such autonomy is greater in federal states than unitary states. Generally, the decentralization continuum progresses from deconcentration through delegation to full devolution. Deconcentration is the first stage of decentralization: it shifts responsibility for a service to central government staff working in the region, province, or district, but does not transfer the central government authority. Delegation involves, in addition, the granting of exemptions from certain central rules and broad authority to plan and implement decisions without direct central government supervision. Devolution entails the full transfer of certain functions from the central government to subnational government units—although the central government normally retains some monitoring and financial role.

The economic rationale for decentralization rests on Oates' "decentralization theorem," which states that a public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize the benefits and costs of such provision. The theorem is pretty difficult to apply in practice. A simpler rule is the "subsidiarity principle" applied by the European Union, according to which taxing, spending, and regulatory functions should be exercised by the lowest posible level of government unless a convincing case can be made for assigning these functions to higher levels of government.

The potential gains of decentralization derive basically from the close contact local government institutions can have with local residents. Decentralization can (i) encourage public participation in government decision making; (ii) create opportunities for more accountable government; (iii) provide more transparent government; and (iv) ease financial strain on the central government. Decentralization can therefore result in more flexible and effective government administration because (i) government can tailor its services to the different needs of society, and foster political stability and national unity and (ii) and civil society organizations are given a stake in maintaining the political system.

However, decentralization also carries potential costs and risks, especially when it is an ad hoc reaction to an urgent problem instead of a carefully designed structural reform. Decentralization can cause duplication, waste, underemployment of government staff and equipment, coordination problems, and regional inequities and societal conflicts. Decentralization also has a positive or negative impact on governance. The generic test is whether the legitimacy and quality of governance are higher at local level than at national level. If the answer is no, decentralizing into a comparatively worse governance climate will tend to worsen the quality of governance in the country as a whole.

In *geographic decentralization*—the manner in which state territory is divided into smaller areas with specific authority—the basic principle is to match area to function, i.e., first define clearly the nature and scope of government functions, and on this basis, delineate the area within which the functions are to be performed. Other approaches include the community approach, which considers social geography; the *efficienc*y approach, which considers the costs of producing the service; the *management* approach, which considers the relative organizational capacity of levels of government; the *technical* approach, based on the resources, landscape, or economy of different regions; and the *social* approach, which considers the natural affinity of inhabitants of the different parts of the national territory.

The desirable degree of decentralization, of course, depends largely on the specific function under consideration. Actual experience and sound theory show that certain functions are closely associated with particular levels of government. For example, defense or monetary policy is most often assigned to the national government; education, health, and social welfare to the provincial levels; and fire protection and water supply to local government. However, different functional assignments are possible, especially in the case of small city-states, and any general classification of functions should be considered indicative rather than prescriptive.

Political decentralization shifts decision-making powers to lower levels of government and entails setting the legal and regulatory provisions to ensure that (i) a favorable political environment for decentralized decision making is created; (ii) decentralized entities coordinate and cooperate with each other; (iii) decentralization initiatives are sustained and acquire a degree of political permanence; (iv) decentralized entities act in conformity with national standards; and (v) citizens have access to local decision making.

Political decentralization is linked with *administrative decentralization,* i.e., creation of new organizations and local performance of certain administrative tasks. However, the reverse is not true: administrative decentralization does not necessarily require political decentralization. As noted, through deconcentration, subnational government can perform a myriad of administrative tasks and yet have no autonomous decision-making powers.

In a decentralized setting, coordination and close intergovernmental relations are critical not only for the strategic coherence of government but also for the preservation of a national identity.

Directions of Improvement

Experience worldwide shows that decentralization can be a mechanism to improve political stability, deliver service more efficiently and effectively, reduce the level of poverty, and promote equity. Governments intending to decentralize functions should note the following general principles.

- Decentralization should be understood as a means rather than an end in itself. The goal is to heighten the overall quality of governance.
- There needs to be consensus and support from different sectors for adopting decentralization measures.
- In cases where decentralization is a new development, subnational governments should be given time to learn and gradually adapt to the new system. In parallel, control and regulatory mechanisms should be instituted to guide subnational government operations.
- Decentralization should be a sequenced set of well-conceived policies and implementation of policies should be carefully planned and executed. The risks of hasty action are particularly great in developing countries.
- Normally, the country's constitution should embody the broad outlines of decentralization, enabling laws the specific parameters, and administrative rules the details of implementation. In countries where decentralization laws were made piecemeal, it is highly advisable to

codify all legislation relating to decentralization to maintain coherence and spot duplication and inconsistencies.

- Ensure that mechanisms for public participation and autonomous decision making are installed in the legal and regulatory framework and institutionalized in implementation. Subnational governments must be directed to encourage citizens to participate in decision making.
- Specify the responsibilities for each level of government, and those to be jointly shared by the central and subnational governments. To avoid turf competition and confusion, it is important to be clear about which particular functions are to be delegated, deconcentrated, and devolved. Deconcentrate functions that are national in scope and over which the center wishes to have direct control; delegate special and highly technical functions; and devolve functions that are local in scope.
- To the extent practicable, government functions should be assigned to the lowest possible level of government. There should be a convincing justification, such as spillover and externalities, for assigning them to higher levels of government.
- Ensure that subnational governments are capable to carry out functions and responsibilities transferred to them. Transfer of functions and authority to subnational governments needs to be matched with transfer of appropriate technology, skills, and financial and manpower resources.
- Ensure human resource development and organizational capacity building until the time when subnational governments can independently sustain their own needs.
- Especially in devolution, central government needs to enact regulation to ensure national standards of public services and prevent local government actions from interfering with or contradicting national policies and goals.
- Allow some flexibility to local government in implementing decentralization mandates.

It is important that government enforce vertical coordination among different levels of government, and encourage horizontal coordination among agencies and subnational government at the district and city level. Interagency coordination should lead to convergent actions by field agencies, avoiding duplication of local staff and programs, and exploiting economies of scale. Caution should be taken to avoid both overregulation and undercontrol by central government.

NOTES

[1] Fiscal decentralization is distinct from the use of subsidies and taxes to encourage or discourage economic activity or migration from one geographic area to another, which are instruments of central government power for national purposes.
[2] This section derives mainly from Rondinelli and Cheema, eds. (1983).
[3] Some political scientists define devolution and decentralization as separate processes: devolution as the dispersal of power and authority, and decentralization as the geographic and territorial subdivision of the state. The definitions we provided earlier, however, are more operational.
[4] W. Dillinger (1995).
[5] Rondinelli (1983), Ter-Minassian, ed. (1997), Bahl (1998, 1999).
[6] This section draws from Smith (1985). Please refer to that book for a detailed discussion of the subject.
[7] Blunden, Brook, Edge, and Hay, eds. (1973).
[8] This ideology found its extreme pathological and murderous expression in the Pol Pot regime in Cambodia from 1975 to 1979.
[9] Drawn from Ford in Litvack and Seddon, eds. (1999).
[10] This section has drawn on OECD (1997a), Dillinger (1994), Davey (1993), Asian Development Bank (1998b), and World Bank (1997).
[11] OECD (1997a).
[12] Dillinger (1994).
[13] Tendler (1998).
[14] OECD (1997a).
[15] Asian Development Bank (1998b).

Chapter 8

Managing Local Government Expenditure and Fiscal Decentralization

So long as we do not ensure that expenditure of money upon local objects conforms with the needs and wishes of the locality, invest it with adequate power and assign to it appropriate finances, we will never be able to evoke local interest and excite local initiative.

—Balwantray Mehta, 1959

DISTRIBUTION OF FISCAL RESPONSIBILITIES BETWEEN CENTRAL AND LOCAL GOVERNMENT

As mentioned in Chapter 7, each government level (central, provincial, municipal, etc.) should have its own budget, enacted according to constitutional provisions or law. However, there are strong links between the budget of the central government and the budgets of subnational governments that require particular attention.

"Fiscal Federalism": Key Issues

The degree of devolution, assignment of expenditures, and revenue arrangements should be tailored to the country context and depend on policy and political issues, as has been pointed out earlier. However, certain key principles should govern these arrangements in any country. Chapter 5 explained the efficiency approach to decentralization. It is embodied in Oates' decentralization theorem, which states that each public service should be provided by the jurisdiction that controls the smallest geographic area that would internalize the benefits and costs of such provision. This is a pretty tough test to devise and meet in practice. The European Union has adopted a more operational approach in the principle of subsidiarity for assigning responsibilities among its members. According to this principle, taxing, spending, and regulatory functions should be exercised by lower levels of government unless a convincing case can be made for assigning them to higher levels of government.

The literature on fiscal federalism discusses the complexity of decentralization and gives hypothetical and real-life examples of expenditure assignments (Box 8.1).[1] The need for increased fiscal decentralization is generally admitted. Many observers, however, stress the risk of loss of expenditure control, increased corruption, and inefficiencies in resource allocation that would result from hasty fiscal decentralization, even when theoretically justified.[2]

Box 8.1
Fiscal Management in Federal Systems

In the 1980s, Argentina and Brazil faced similar problems, with subnational deficits added to excess public deficits and high inflation. In the 1990s, both countries continued with fiscal decentralization and with the struggle to bring about macroeconomic stability. Argentina had greater success, partly because it imposed a harder budget constraint on the public sector at the national level and had stronger party control of the subnational governments and of the national legislators. For restraining local and state borrowings, getting the right incentives for subnational governments and particularly for its creditors in Argentina proved more effective than central government rules in Brazil.

In the People's Republic of China, the implementation of the Budget Law in 1994 strengthened the basis for fiscal operations. Central approval of local budgets was abolished and budgetary procedures were clarified, requiring the local and central budgets to be formulated in a consistent macroeconomic framework. Local governments were disallowed from financing any deficits through bond issues, bank borrowing, or grants from the central government. They were required to run balanced budgets or to use accumulated budgetary surpluses and extrabudgetary funds to finance deficits.

Sources: Dillinger, W. and S. Webb. 1999. Fiscal Management in Federal Democracies: Argentina and Brazil. World Bank; Ahmad, E., G. Quiang, and V. Tanzi, eds. 1995. Reforming China's Public Finances. International Monitary Fund (IMF).

Broad Principles of National-Local Financial Interaction

Whatever the degree of devolution appropriate to the country, the legal framework that governs the relationships between the central and local governments and the arrangements for budgeting must be clear and efficient. However, it is impossible to provide for every situation in a codified law or contract. Conflict resolution mechanisms are therefore important to assure smooth intergovernmental fiscal relations. Such mechanisms can operate through specialized bodies. In Australia, India, and Sri Lanka, for example, a finance commission deals with financial relationships between the central government and the other levels of the government; in Germany, a second chamber of Parliament with state representation contributes to intergovernmental policy coordination; and specialized sectoral coordination councils are common in many countries.

The following principles are required for transparency and efficiency of national-local interaction.

- Each level of government should have clearly assigned responsibilities, regardless of what responsibilities are assigned to government as a whole (Box 8.2). Overlaps should generally be avoided, and long concurrent lists of shared responsibilities are particularly ambiguous.

- Fiscal and revenue-sharing arrangements between the central and local governments should be stable. They may be amended from time to time, but renewed bargaining each year should be avoided at all costs.

- Subnational governments need to have a sound estimate of these resources before preparing their budgets. In some countries (e.g., the Ukraine in 1996–1997), local governments had to wait for the draft budget of the central government to be finalized before preparing their own budgets. Such lack of predictability hampers both efficiency and fiscal control at the local level. Without an indication of the amount of resources to be transferred to them, subnational governments cannot program their expenditures. Accordingly, forecasts of revenues should be transmitted to local governments as soon as they are set, and estimates of grants to local governments need to be prepared early in the budget process of the central government.

- Incentives for increased efficiency are needed. Often, the central government reduces transfers to subnational governments when they make economies in spending or improve their own tax collection. This evidently does not stimulate them to seek economies in service delivery or improve tax collection. Subnational governments must be allowed to benefit from savings they make, at least in large part.

The same argument applies with respect to the commercial revenue of state agencies.

- It could be desirable to agree on multiyear contracts between the central government and local governments covering both expenditure assignments and revenue arrangements (tax sharing, grants, etc.). These contracts could, if appropriate, include performance criteria, minimum standards for services rendered by local government, etc. They would define relationships in a transparent manner and would ensure predictability. As with any other contract, of course, the utility of this arrangement would depend largely on how well it is monitored and respected.

- National law should provide standard accounting and budgeting rules for subnational governments.

Box 8.2
Defining Expenditure Assignments of the People's Republic of China

To date, the People's Republic of China (PRC) has failed to work out a law that clearly defines expenditure responsibilities for different levels of government. Expenditure assignments are murky and often motivated by political expediency, shift between levels of government in ad hoc ways. The central government may shift its own expenditure responsibilities to provincial governments in times of difficulty and provincial governments may use their broader responsibilities to bargain for a larger share of revenue. Intergovernmental bargaining has weakened budgetary planning and control and contributed to the instability of the PRC's fiscal system. Without first deciding on expenditure assignment, the PRC authorities have found it difficult to reform tax assignment rules and revenue-sharing mechanisms between the central and provincial governments.

Expenditure assignments between the provincial government and lower-level authorities, such as municipalities and counties, are even more vague. Local governments are often forced to take the responsibility that should belong to higher-level government, accentuating the mismatch between local revenue and local expenditure responsibility. Unspecific and unpredictable, the system of expenditure assignments has created budgetary uncertainty for the central government and made fiscal planning an impossible task for provincial and local authorities, thus adversely affecting the quantity and quality of the public goods and services they supply.

Source: Ahmad, Qiang, and Tanzi, eds. 1995. Reforming China's Finances. Washington, DC: International Monitoring Fund.

For expenditure control and strategic allocation of resources

- Fiscal targets should cover the *general* government.
- Revenue assignment should be fully consistent with expenditure assignment, and sufficient resources should be assigned to subnational governments to allow them to fulfill their duties. When new duties or responsibilities are transferred to subnational governments, compensatory measures should be provided on the revenue side. On the other hand, of course, if some duties or responsibilities are removed, transfers to subnational government should be correspondingly reduced.
- Dumping of the fiscal deficit should not be permitted (defining fiscal targets for general government helps avoid this problem). When balancing its budget, the central government should avoid passing its financial problems to subnational governments through cuts in intergovernmental transfers or increased expenditure assignments, without compensatory measures. To do so would neither change the aggregate borrowing requirements of the general government, nor generate arrears.
- Special mechanisms are needed to control local government borrowing (see Box 8.3 for arrangements in various countries).
- In case of local government budget overruns or accumulation of arrears, the law should stipulate sanctions or emergency measures. For example, local authorities could be forced to cut expenditures or raise taxes, or local budgets could be placed under the authority of the central government for a limited time until the situation stabilizes. An exception should be explicitly provided for instances when the overrun or arrears are directly related to a dumping of central fiscal problems, as mentioned above.
- A sound reporting and accounting system is critical. Subnational government financial operations should be consolidated with central government operations. Systems for budget execution, internal control, and audit for subnational governments should be similar to those of the central government. This leads back to the central question of local government administrative capacity, and hence the issue of the desirable degree of decentralization.

Box 8.3
Arrangements for Controlling Borrowing by Subnational Governments

Country	Control Provisions
Argentina	The provinces may contract debt both internally and externally. The Central Bank oversees the impact on the financial system, and the Ministry of the Economy oversees maximum external interest rates.
Australia	The Australian Debt Council determines the total public debt and the distribution between the different government levels, but in practice market mechanisms operate.
Brazil	The Federal Senate sets overall limits on the amount of debt that states, the federal district, and the municipalities can contract, and establishes the rules and conditions for their external and internal credit operations.
Canada	No formal restrictions. Market mechanisms are in place.
Chile	Municipalities and state-owned enterprises can contract loans for special projects. But this requires a law that must also indicate how the loan is to be repaid.
Colombia	According to constitutional regulations, a local government may not borrow more than it can repay. There is a law that establishes graduated authorization procedures according to debt levels.
Mexico	The states may not in any case, directly or indirectly, contract obligations or loans with foreign governments, companies, or private parties, or loans that must be repaid in foreign currency. States and municipalities may contract loans only for productive public investments.
New Zealand	Generally speaking, local governments must finance current expenditures with revenues for the same year.
Sweden	A balanced budget is required. Local and municipal governments are responsible for their own debt.
United Kingdom	A balanced budget is required.
United States	All local governments must have a balanced budget. Most states have either a constitutional or a statutory requirement for a balanced budget.
Venezuela	Local and municipal entities may not contract loans without the authorization of federal authorities.

Sources: Ter-Minassian, ed. (1997); Petrei (1998).

- Consolidating the expenditure of the different levels of government is necessary also for policy analysis, especially in decentralized systems and federal countries. It would be very difficult to know what is being spent on key sectors if only the accounts of the central government were considered. For the purpose of consolidation, local and central governments should have a common functional and economic classification of expenditures.

FISCAL DECENTRALIZATION: BENEFITS AND PROBLEMS

Prerequisites for Fiscal Decentralization

Some key conditions must be in place for fiscal decentralization.

- Related to political decentralization, a subnational government entity should be responsible to the local population in some appropriate fashion (normally through elections).

- Chief local executives should be elected or appointed directly or indirectly by such a local government entity. It is difficult for the local government to implement its own programs if local executives are appointed or seconded by governments at a higher level, as is the case in many developing countries (Chapter 5).

- Local government must have some taxing powers of its own to have effective control over its budget. If all local government revenues are in the form of fiscal transfers from the central government, it is actually the central government that decides the local budget, impairing the essence of fiscal decentralization.

- Local governments must have adequate tax administration capacity. Poor tax collection defeats the advantage of having some revenue-raising powers.

- Local governments must have some degree of autonomy in determining their service levels before they can be made accountable for delivering services that are important to the local citizens.

Potential Benefits of Fiscal Decentralization[3]

Efficiency

Fiscal decentralization can increase service efficiency and people's economic welfare, as local governments can better suit the differing tastes and preferences of residents and are more responsive to the public. More efficient services will be provided, since people can hold local officials accountable for service delivery at some acceptable quantity, price, and quality.

Revenue mobilization

A decentralized tax structure may lead to more effective tax administration and hence, with the same overall tax rates, greater revenue. Central governments typically exclude potential small taxpayers from the tax net because of the administrative difficulties associated with identifying them, and because the revenue gains are relatively small compared with the administrative costs of collection. Local governments, being closer to the people, may reach the lost potential revenues through some kind of user charges and other minor taxes. This is particularly applicable to subnational governments in transitional economies where small private business is a rapidly growing sector.

Resource allocation and equity

Because local government is closer to the users, it is in a better position to decide on appropriate user charges for some services and administer the system, thus improving the allocation of resources and fostering economic growth, while tailoring charges to ability to pay.

Potential Costs of Fiscal Decentralization

The potential costs are an almost exact mirror image of the potential benefit argument. One of the other argument will be valid, depending on the specific country conditions and time.

Efficiency

The converse of the efficiency case for decentralization argues that fiscal decentralization can worsen efficiency when local bureaucracies are unresponsive, technically and managerially deficient, and poorly motivated—as they are in many developing countries and several developed countries. Also, the assumption that people express their preferences through their votes is not always valid, considering local allegiances in many developing countries that reflect economic dependence, political loyalties, religious affiliation, cultural identities, etc., rather than public tastes and preferences for certain services and government efficiency.

Poor resource mobilization

The same negative effect on tax administration and resource allocation can occur when local capacity is limited. And local government may be more vulnerable to "capture" by powerful local elites. Any revenue gained by expanding the tax base to include small taxpayers can be more than offset by the loss of revenue from underpayment of tax by wealthy people.

Regional inequality

Fiscal decentralization fosters regional inequalities and may lead to unequal treatment of individuals, where persons or households with the same income but residing in different localities are treated differently because of dissimilar tax and expenditure policies of local governments. In decentralized allocation of public goods and services, taxes are collected and expenditures undertaken differently in different jurisdictions. Fiscal decentralization may heighten regional inequalities. Rich regions, with higher income from their larger tax bases, can lower tax rates and provide better public goods and services. The lower tax rates may induce mobile persons to settle in rich jurisdictions, further enlarging their tax bases and concentrating activities and growth in a few cities and localities; and the better public services (especially in education and health) will provide a continuing advantage for human capital formation, growth, and competitiveness. Thus, rich regions become richer and poor regions become poorer.

Resource allocation

Local governments may be unable to build to proper standards and adequately maintain infrastructure and services, primarily because of poor technical and managerial capacity. The case of Tunisia is instructive (Box 8.4). This resource allocation argument against fiscal decentralization is generally the weakest, however. (See Chapter 5 for a discussion of vertical coordination among different levels of government.)

Box 8.4
Decentralization in Tunisia: A Case Study

Until 1974, local governments in Tunisia were responsible for the collection and treatment of used water. However, the quantity and quality of the service were bad. For one, local governments had very little technical expertise. A survey of people employed in the sector revealed that only 4 percent of the total workforce had any skills related to sewerage. Local governments kept no accounting information on service costs and no form of cost recovery was available.

Moreover, most local governments did not invest in the necessary equipment and technology useful for the sector. In 1970, only 20 out of 150 municipalities reportedly had some form of treatment plants, and all of these were overloaded and malfunctioning. Many sewer systems were also either poorly designed or poorly maintained. Manholes, grit traps, and other sewer accessories were out of service. Of the 27 sample lift stations inspected in 1974, only five were functioning.

The implications were serious. The Lake of Tunis, into which used and poorly treated water was discharged, was rapidly deteriorating. Infectious and parasitic diseases such as cholera therefore became prevalent.

Instead of helping local governments improve their systems, the central government of Tunisia decided to take over the provision of service from the local governments. In 1974, the Office National de l'Assainissement (ONAS), a specialized semiautonomous agency, was created and was given a monopoly over the service. ONAS' management was autonomous, it was appropriately staffed, and sound financial procedures were instituted. At first, ONAS operated only in the Tunis metropolitan area, then it gradually covered all other major urban centers of the country. In other parts of Tunisia, municipalities that had their own system continued to operate them but were later integrated into ONAS' operations.

With the help of foreign institutions such as the World Bank, ONAS developed into an effective and efficient institution. By 1987, many of its staff had become competent technical professionals and had replaced the foreign assistants who had been temporarily hired. Service costs had been recovered and the level of sewerage services had increased significantly. By 1988, ONAS was providing full sewerage services to the 30 largest cities, comprising about 50 percent of the urban population of Tunisia.

Most reports consider the centralization of the Tunisian sewerage system a success in terms of production or supply efficiency. Although the financial and technical assistance of foreign institutions and donor agencies may be a big factor in this success, it is also true that the resources for improving the system would have been more difficult to mobilize in a decentralized system. Also, it would have been more difficult and costly to train personnel and improve the financial and accounting procedures of 30 municipalities instead of a single institution.

Source: Prud'homme (1994).

Implementing Fiscal Decentralization

Given the various options for decentralizing expenditure and revenue assignments, problems arise as to their implementation. The major ones are fiscal gaps and fiscal inequities. They are summarized below and discussed in detail in the next two major sections.

Fiscal gaps (vertical imbalances) are the result of inconsistent tax and expenditure assignments. Most major taxes are typically assigned to the central government, resulting in a fiscal gap for local governments with growing spending responsibilities. As argued earlier, the central government is also often tempted to adjust to fiscal difficulties by downloading expenditure responsibilities to local levels without the resources required to carry them out. The mismatch of expenditure and revenue assignments that leads to vertical imbalances also leads to fiscal inefficiency, as differences in levels of services between regions caused by differential fiscal gaps can distort business and investment decisions.

Fiscal inequities (horizontal imbalances) among subnational governments arise from revenue differences between local governments with different tax bases, different technical and administrative capabilities to collect taxes, or different costs and demand for local public services. A grant system may be used to equalize fiscal capacities among subnational governments so that citizens residing anywhere in a country will receive the same level of basic service (see below).

Normally, subnational governments will not have the incentive to provide services whose benefits extend beyond their boundaries, and will therefore tend to underprovide these services. Fiscal transfers can supplement incentives for subnational governments. However, in practice, the extent of spillovers is difficult to gauge, so the matching between transfers and the spillover rate will be somewhat arbitrary.

VERTICAL IMBALANCE: EXPENDITURE AND TAX ASSIGNMENT

Expenditure Assignment[4]

Chapter 5 discusses the principles governing the decision on which level of government should provide a particular public service. Generally, the main guiding principle is to assign each type of expenditure responsibility to the level of government that would benefit only the residents that it represents. On the basis of this general principle of local benefit, purely local expenditure responsibilities should include water, sewer, waste, and fire protection services, while central expenditures should be those whose benefits extend nationwide. However, this principle is far easier to state than to apply. Most public goods and services do not fit neatly within either category. There are services whose delivery can be shared by the central and local governments, such as those with unclear benefit regions, externalities, or national redistributional implications. In such cases, different aspects of delivery of the same service—policy, financing, and actual administration—may be assigned to different levels of government.

The lack of guidelines for sharing responsibility for delivering a particular service (especially when it comes to social spending) has led to diverse practices in various countries. For example, pensions and unemployment benefits are generally a function of central government, but in the United States (US) they are provided by the state governments. The administration of social assistance is a function of local governments in a number of countries, but it is a function of central governments in others.

Public services can be assigned to local or regional governments based on considerations such as economies of scale, cost-benefit spillovers, proximity to beneficiaries, consumer preferences, and flexibility in choosing the composition of budgets for public spending. Generally, the following types of services are the responsibility of central government:

- services that are not differentiated by local demand, such as defense, justice, or international affairs;
- services that would benefit many jurisdictions and can be handled only by contracting or by grant design, such as public transport or air and water quality; and
- services whose local administrative costs significantly outweigh the local benefits, such as income tax collection.[5]

Note, however, that these services may still be administered locally even if the central government makes the policy and provides financing.

Tax Assignment

Revenue sharing

The tax assignment approach entails that subnational governments (i) choose the tax base, (ii) assess the tax base, (iii) decide the tax rate, (iv) collect the tax, and (v) retain the tax proceeds. Rarely are all these conditions met. Some local taxes might be really central grants to local governments, or a central tax and a related transfer program may actually be a local tax. For a tax to be truly local, subnational governments must have the power to both decide on the tax rate and receive the proceeds. Normally, the types of taxes assigned to local jurisdictions depend partly on the overall mix of taxes in the country as a whole.

It is generally recognized that assigning all or most taxing powers to subnational governments with upward revenue sharing is not advisable, since such an arrangement does not allow the central government to perform its redistributive and macroeconomic management roles. The arrangement is, however, carried out in a few countries like the People's Republic of China. Upward revenue sharing is also considered viable in loose confederations where stabilization and redistribution policies lie with the member states, as well as in countries where subnational jurisdictions have homogenous economic conditions and close tax policy coordination and harmonization. Examples are Germany and, of course, the member-states of the European Union.

On the other hand, assigning all taxing powers to the central government and relying entirely on downward transfers to local government is equally undesirable. The arrangement inhibits local governments from matching spending authority with revenue-raising power, hence reducing their fiscal accountability.

Some countries completely separate the tax bases for each level of subnational government, while others allow certain overlaps (Boxes 8.5 and 8.6). Tiers of government in Australia, India, and Germany, for example, have separate tax bases, while Canada and the US have a certain degree of overlap in their tax bases.

Box 8.5
Peculiarity of Local Financing in Transitional Economies

Transitional economies, in many ways, may be considered less decentralized than most countries. However, recent developments show that fiscal decentralization is on the way. Typically, their approach to local financing is revenue sharing on a derivation basis. The system may be considered somewhat decentralized, since local governments decide how they will spend their respective shares.

There are indications that transitional economies are moving toward the the revenue assignment approach. For example, although the central government of the People's Republic of China determines all tax rates and bases, subnational governments collect the revenues from all income taxes and earmark a piggyback on the value added tax for local use. Russia allows its regional governments the option of levying the company income tax at a lower or higher rate.

One peculiar feature of decentralization in transitional countries is the backdoor approach to local government financing. Local governments in these countries, constrained by the limited transfers they receive to finance large expenditure responsibilities, resort to extrabudgetary financing. This can easily be done since local governments, which are responsible for tax collection, still have ties with the enterprises and can therefore exonerate them from taxes. Hence, local governments are able to hive off resources from the sharing pool, resulting in greater retention of revenues at the local level.

Sources: Bahl (1998); Wong (1999).

Revenue sharing can be on a (i) derivation basis, where sharing is based on the source of tax proceeds; (ii) grant basis, where the central government distributes the revenues to all subnational governments based on a formula or the cost of collecting the tax; or (iii) piggyback system, where subnational governments are allowed to add a rate onto the central tax and receive the full amount raised from the piggyback.

Most revenue sharing is made on derivation basis. One problem with revenue sharing, especially when different shares are established for different taxes, is that it gives the administering government the incentive to place more effort on collecting those taxes that will give it the most benefits. This has been the case in the People's Republic of China (PRC), India, and Russia. Creating a pool from which shared revenues can be distributed on a formula basis would avoid this complication. However, formula-based revenue sharing is problematic from the viewpoint of macroeconomic management.

Several criteria for tax assignment

In decentralized tax systems, tax policies must be coordinated between jurisdictions to avoid distortion in the free movement of economic resources (labor, capital, goods, and services) from one region to another, and prevent mobile taxable goods and services (such as capital) from migrating to attractive regions with low tax rates. Such migration would cause jurisdictions to compete with one another through lower taxes or other inducements, and thus create an inefficient and opaque fiscal system in the aggregate.

There should also be rules for allocating tax revenues among jurisdictions to avoid double taxation or no taxation at all. As noted, where the tax bases are relatively mobile, decentralized tax assignment opens opportunities for tax avoidance and evasion.

Taxes assigned to central government should

- *cover mobile tax bases* to avoid movements of factors of production and interjurisdictional tax competition;
- *be sensitive to changes in income* to provide the central government with stabilization instruments and to partly shelter the budgets of subnational governments from cyclical fluctuations; and
- *cover tax bases that are unevenly distributed across regions.* Taxes on natural resources are an example. In this case, however, since the exploitation of the environment will affect the local government concerned, the tax base should therefore be shared between the central and the local government.

Correspondingly, local taxes require

- a relatively immobile tax base;
- an adequate tax yield to meet local needs and the buoyancy to grow at least at the same rate as expenditures;
- a stable and predictable tax yield over time;
- relatively easy administration; and
- a nonexportable tax burden on nonresidents

Table 8.1 shows salient characteristics of four main groups of revenue sources to guide the choice of local taxes. The criteria refer to the above characteristics of an ideal local tax: *mobility* refers to the mobility of the tax base; *adequacy, buoyancy,* and *stability* refer to the tax revenues; *fairness* refers to the conventional notion of tax progressivity; and *administration* refers to the ease with which the tax is administered at locally determined rates.

A Menu of Revenue Instruments

The following considerations apply to the major kinds of taxes. Table 8.2 provides the conceptual basis for tax assignment.

Box 8.6
Fiscal Federalism in the United States

The United States provides a good example of how the revenue assignment system can work. The Constitution allows the states to perform all functions that are not expressly reserved to the Federal Government and do not violate the Constitution, and to levy any tax that does not restrict interstate commerce. For their part, most states have a self-imposed balanced-budget constraint, and determine the rights and powers of their constituent local levels of government. Federal grants, mainly for externalities and equalization, account for about 20 percent of state and local government expenditures.

Table 8.1
Local Taxes

Criteria	Property Tax	Income Tax	Sales Tax	Business Tax
Mobility	+	-	-	-
Adequacy	-	+	-	?
Buoyancy	-	+	+	+
Stability	+	-	-	-
Exportability	+/-	+/-	+	-
Visibility	+	+	+	-
Fairness	+	+	?	-
Acceptability	-	-	?	+
Administration	?	+	?	+

+ good
- bad
+/- good to the extent that it falls on residents; bad to the extent that it falls on nonresidents
? indeterminate

Source: Bird (1995).

Table 8.2
Conceptual Bases of Tax Assignment

Type of Tax	Determination of Base	Rate Setting and Collection	Administration	Comments
Customs Tax	F	F	F	International trade taxes
Corporate Income Tax	F, U	F, U	F, U	
Resource Tax				
Resource Rent (profits/income) Tax	F	F	F	Very unequally distributed tax bases
Royalties, Fees, Charges; Severance Tax; Production, Output, and Property Tax	S, L	S, L	S, L	Benefit taxes/charges for state-local services
Conservation Charges	S, L	S, L	S, L	To preserve local environment
Personal Income Tax	F	F, S, L	F	Redistributive, mobile factor, stabilization tool
Wealth Tax (tax on capital, wealth, wealth transfers, inheritance, and bequests)	F	F, S	F	Redistributive
Payroll Tax	F, S	F, S	F, S	Benefit charge, e.g., social security coverage
Multistage Sales Tax (value-added tax [VAT])	F	F	F	Border tax adjustments possible under federal assignment; potential stabilization tool
Single-Stage Sales Tax (manufacturers/wholesale/retail)				
Option A	S	S, L	S, L	Higher compliance cost
Option B	F	S	F	Harmonized, lower compliance cost

continued on next page

Table 8.2 (cont'd.)

Type of Tax	Deter-mination of Base	Rate Setting and Collection	Adminis-tration	Comments
"Sin" Tax				
Excise Tax on Alcohol and Tobacco	F,S	F, S	F, S	Health care a shared responsibility
Betting, Gambling Tax	S, L	S, L	S, L	State and local responsibility
Lottery Tax	S, L	S, L	S, L	State and local responsibility
Racetrack Tax	S, L	S, L	S, L	State and local responsibility
Taxation of "Bads" Carbon Tax	F	F	F	To combat global/national pollution
BTU Tax	F, S, L	F, S, L	F, S, L	Pollution impact may be national, regional, or local
Motor Fuel Tax	F, S, L	F, S, L	F, S, L	Tolls on federal/provincial/local roads
Effluent Charge	F, S, L	F, S, L	F, S, L	To deal with interstate, intermunicipal, or local pollution issues
Congestion Toll	F, S, L	F, S, L	F, S, L	Tolls on federal/provincial/local roads
Parking Fee	L	L	L	To control local congestion
Motor Vehicle Tax				
Registration, Transfer Tax, and Annual Fee	S	S	S	State responsibility
Driver's Licenses and Fee	S	S	S	State responsibility
Business Tax	S	S	S	Benefit tax

continued on next page

Table 8.2 (cont'd.)

Type of Tax	Determination of Base	Rate Setting and Collection	Administration	Comments
Excise Tax	S, L	S, L	S, L	Residence-based tax
Property Tax	S	L	L	Completely immobile factor, benefit tax
Land Tax	S	L	L	Completely immobile factor, benefit tax
Frontage, Betterment Tax	S, L	L	L	Cost recovery
Poll Tax	F, S, L	F, S, L	F, S, L	Payment for local service
User Charges	F, S, L	F, S, L	F, S, L	Payment for services rendered

F = federal; L = municipal or local; S = state or province; U = supranational entity

Source: Shah (1998).

Value-added tax

Local administration of a value-added tax (VAT) is problematic, as each local government could set its own standard tax rates and methods of administration. There are also opportunities for local protectionism by setting higher VAT rates on purchases from outside suppliers. But even if the VAT rate and base structure are determined by central government, VAT proceeds should not be shared between levels of government; otherwise, some resource-rich areas would benefit greatly, while others would collect little net revenue.[6]

Nonetheless, the VAT is a subnational tax in Brazil and some transitional economies (e.g., People's Republic China and Russia) where central and provincial governments share VAT proceeds on a derivation basis. The problems noted above are mitigated because the tax is collected by a central tax service, and (in the People's Republic China, at least) the central government makes up for low yield in exporting to the provinces. Still, protectionist measures have been taken in some Chinese provinces. In Brazil, the decision to allow VAT as a subnational tax has led to administrative problems and economic distortions. Overall, one useful way to funnel VAT proceeds to subnational governments is for the central government to administer and collect VAT, and earmark a share of it for a distributable pool, to be allocated among the recipient local governments on a formula basis.

Corporate income tax

The corporate income tax must be levied by the central government since it fails all the tests of a good local tax: it imposes high compliance costs, generates incentives for tax avoidance, offers an opportunity to export the tax burden to other regions, and is an uncertain and volatile revenue source. Corporate income taxes are still levied at the subnational government level in many developing and transitional economies and especially in the latter, where this tax base is among the fastest growing. Problems have not yet arisen because businesses tend to operate in a single province, but they will become apparent once businesses begin to operate in more than one province. It would therefore be advisable to begin tax planning in preparation for a smooth shift in company tax administration responsibilities.

Personal income tax

The individual income tax is a popular tax instrument for central government in most countries. The tax is, however, assigned to subnational governments in some countries (the Scandinavian countries, Switzerland, the Baltic countries, Russia, and the other former Soviet Union countries). Assigning personal income tax to subnational governments has advantages and disadvantages.

The personal income tax does meet most of the tests of a good subnational government tax: it is relatively easy to administer, resident-based, buoyant, and has fairly stable yields. However, the personal income tax is related to the redistribution function of a central government and is therefore more appropriately left to the central government. Also, it is the single best instrument of countercyclical fiscal policy.[7] Finally, because of labor mobility, there is never a perfect correspondence between individuals' residence and the place where they receive their income.[8]

Excise and sales taxes

These are appropriate for subnational government if levied on businesses that operate within local boundaries. Local governments can thus recover the costs of "housing" these industries and public service costs. The tax is, however, not beneficial to local governments if levied against monopolistic industries because there is no correspondence between the tax burdens and expenditure benefits within local boundaries. Retail sales taxes are commonly used by local governments, as the burden falls on the taxing jurisdiction, administration is relatively easy, and revenue yield is significant and grows approximately in proportion to local public expenditure requirements.

Motor vehicle tax

Motor vehicle ownership and use represent an excellent but much neglected tax for urban governments in developing countries. Motor vehicles are easily taxable, and the tax burden falls on persons with higher incomes. All forms of vehicle taxation are likely to improve the distribution of income, and in terms of horizontal equity, most may be considered fair (Box 8.7). Vehicles used for public transport and financing for lower-income people can easily be exempted from such taxes.

Property and land taxes

Residential property taxes are often considered the ideal tax for local governments. Since property owners are the primary beneficiaries of local govenment services, the tax on *real* property is directly related to their benefits. Also, the tax is better administered by local governments rather than by the central government since it requires identifying each parcel of property and tracking improvements in those properties and changes in ownership. There are problems and limitations, however, when the quality of services is systematically higher in localities with higher property values and hence greater revenue (Box 8.8)

Box 8.7
Tax on Motor Vehicle Ownership

There are different ways of taxing motor vehicle ownership and use. Each of these has advantages and disadvantages for subnational governments.

Restricted area license charges and *parking fees and taxes* are most desirable in terms of economic efficiency: they can be designed to approximate the excess of the social over the private cost of using congested streets without restricting the use of uncongested streets. *Local fuel taxes* and *unrestricted license taxes* can be expected to provide good yield, buoyancy, and stability. *Automotive sales and transfer taxes* are likely to be less effective in revenue performance because of the narrower tax base and the greater likelihood of year-to-year variations in the base. *Fuel taxes* are the easiest to administer and are relatively easy to impose because they are usually hidden in the sales price of the fuel. Road tolls are also likely to be accepted by the public since they are linked to the benefit derived from the use of the roadway. Local *fuel and sales taxes* can overlap substantially with the national taxing authority and require greater coordination with the central government. On the other hand, *license taxes* and *congestion and parking charges* in most cities can normally be imposed without interference from higher-level governments.

Box 8.8
Local Property Taxes

The property tax is undoubtedly the most widespread form of local taxation. Unfortunately, experience suggests that such taxes are not easy to administer, particularly in countries where inflation is endemic (for example, Brazil), and that they are never politically popular owing to their visibility and certain inherent administrative difficulties. Even in the most sophisticated countries, local property taxes can seldom yield enough to finance local services. As noted elsewhere, no developed country that depends significantly upon property taxes for local fiscal resources has a local government sector that accounts for more than 10 percent of total public spending (Bird and Slack 1991). Similarly, property taxes seldom account for more than 20 percent of local current revenues—or less than 1 percent of total public spending—in developing countries. Moreover, despite substantial efforts in some countries and considerable foreign assistance, these figures have not changed (Dillinger 1991). The property tax, it appears, may be a useful, even necessary, source of local revenue, but it is most unlikely to provide sufficient resources to finance a significant expansion of local public services in any country. Indeed, countries have often been hard-pressed even to maintain the present low relative importance of property tax revenues in the face of varying price levels and political difficulties.

continued on next page

Box 8.8 (cont'd.)

A recent study (Dillinger 1991) concludes that a number of conditions must be satisfied for local property taxes to play a more important role in financing local activities. The political costs of relying on the property tax are so high that no government will willingly risk doing so provided it has access to cheaper sources of finance. Intergovernmental transfers, which can be spent as local governments wish (such as access to taxes on business which can largely be exported), must therefore be curtailed not simply to make property taxes more attractive, but more importantly, to confront local decision makers with the true economic and political costs of their decisions.

But even if this structural precondition is met, a number of other policy reforms are needed to turn the property tax into a responsive instrument of local fiscal policy. First, local governments must be allowed to set their own tax rates: very few developing countries give their local governments freedom in this respect. Second, the tax base must be maintained adequately. In countries with inflation, some form of index adjustment is therefore advisable. In other countries, the assessing agency must be provided with direct financial incentives to keep the tax base up to date. Finally, a series of procedural reforms is often needed to improve collection efficiency, valuation accuracy, and the coverage of the potential tax base (Kelly 1994). None of these steps are easy, either politically or, in some instances, in terms of available technical resources. Nonetheless, countries that want to have responsive as well as responsible local governments must follow this hard road. There are no shortcuts to successful local property taxation.

Source: Bird (1995).

Nontax revenues

Local governments may depend more on user and benefit charges, which can be efficient and relatively easy to administer, and can provide significant revenues. In the US, about one sixth of state and local government revenues comes from these sources. In most countries, however, revenues from user and benefit charges remain a distant potential rather than a reality. Often, revenue-generating essential local services are provided at subsidized rates. In the People's Republic of China and Russia, for example, public transit, utilities, and housing are not self-sustaining and, in fact, are part of national wage policy. The same holds true in many developing countries where the poor population is large, and affordability and politics are major problems.

Lottery proceeds are also sometimes a popular way of raising local revenue. Lotteries are easy to administer, and the tax is well hidden from public perception and generally produces no public resistance or resentment. However, lotteries are the most regressive form of taxation, falling almost exclusively on the poor, and should not be considered as an efficient and equitable source of local government revenue, especially in developing countries.

HORIZONTAL IMBALANCE: INTERGOVERNMENTAL FISCAL TRANSFERS

Intergovernmental fiscal transfers are instruments to correct the horizontal or vertical imbalances in the fiscal capacities of different subnational governments. These fiscal transfers can be broadly grouped into revenue-sharing arrangements and grants. Revenue sharing was discussed earlier. Grants can be conditional or unconditional, and open-ended or subject to ceilings. The mix of these transfers depends on the objectives of policymakers.

Policy Options and Conflict

The policy options for countering vertical and horizontal imbalances are

- correct each imbalance separately;
- correct both imbalances in an integrated system of equalization grants; or
- correct only the vertical imbalance and largely ignore the horizontal imbalance.

In the first policy option, the vertical imbalance can be addressed through tax-sharing or grant arrangements, and the horizontal imbalance through transfer payments from rich to poor regions. This is the approach used in Germany. In the second option, used in Australia and Canada, horizontal and vertical imbalances are addressed simultaneously through a system of grants that includes both equalization payments and special-purpose grants. The last option makes use only of tax-sharing and grant arrangements. However, it can also be matched with special-purpose grants, as is broadly the case in the US, to reduce horizontal imbalance in specific functional areas (Box 8.9).

Box 8.9
Fiscal Transfers: Principles and Practices

Objective	Grant Design	Good Practices	Practices to Avoid
To bridge fiscal gap	• Reassigning responsibilities • Tax abatement • Tax sharing	Tax abatement in Canada and tax base sharing in Brazil, Canada, and Pakistan	• Deficit grants • Tax-by-tax sharing as in India
To reduce regional disparities	• General nonmatching • Fiscal capacity equalization transfers	Fiscal equalization programs of Australia, Canada, and Germany	General revenue sharing with multiple factors
To compensate for benefit spillovers	• Open-ended matching transfers with matching rate consistent with spillout of benefits	RSA grant for teaching hospitals	
To set national minimum standards	• Conditional nonmatching block transfers with standards of service and access conditions	• Indonesia roads and primary education grants • Chile, Colombia, and South Africa education transfers	• Conditional transfers with conditions on spending alone • Ad hoc grants
To influence local priorities in areas of high national but low local priority	• Open-ended matching transfers (preferably with matching rate to vary inversely with fiscal capacity)	Matching transfers for social assistance as in Canada	• Ad hoc grants
To stabilize the economy	• Capital grants, provided maintenance is possible	Limited use of capital grants and encouraging private-sector participation by providing guarantees against political and policy risks	• Stabilization grants with no future upkeep requirements

Source: Shah (1998).

Policy objectives in addressing vertical and horizontal imbalances may either agree or conflict with each other. They may include the following:

- ensuring overall fiscal stability for the national economy;
- providing an acceptable degree of equity between individuals in different regions;
- encouraging efficient use of resources across the country; and
- ensuring minimum standards for services provided.

To illustrate these conflicts, when the central government increases income taxes for financial stabilization, it will inevitably reduce the tax bases of local governments and, hence, local revenue. Conversely, reducing central expenditures may raise expenditure needs at the local level. The central government, hoping to raise education standards in a certain region, for example, may opt to provide the local government with larger education grants even if the subnational government has greater revenue than other subnational governments but has invested poorly in education in the past.

Fiscal Transfer Options

The main transfer options may be grouped into two major categories: (i) conditional or specific-purpose transfers and (ii) unconditional transfers. In turn, conditional transfers may be matching grants, requiring a corresponding local contribution; or nonmatching grants for specific purposes. Unconditional grants may take the form of either revenue-sharing arrangements or block grants, general-purpose grants that are in effect budget support for local government. Close-ended distribution refers to grants with caps; open-ended distribution to grants without ceilings. The matrix in Table 8.3 summarizes these options.

Transfers may be given only to poor regions by central governments, or may be organized on a cooperative basis from richer to poorer regions. Both types of distribution can be transparent. Germany uses the latter type of distribution. Other countries will be able to replicate the German system only to the extent that they enjoy the same high degree of political cohesion. Elsewhere, the very visibility of the redistribution criteria may lead to strong political opposition by better-off provinces, particularly when regional ethnic differences are significant. In these cases, equalization transfers from the center to all provinces are preferable and may be politically inevitable.

Table 8.3
Fiscal Transfer Mechanisms

Transfer Mechanism	Mode	Redistribution Criterion
Conditional Transfers	Matching grants	With or without equalization formula, Close- or open-ended
	Nonmatching grants or specific-purpose payments	
	Block grants	
Unconditional Transfers	Revenue-sharing arrangements	With or without equalization formula
	General-purpose grants	Open- or close-ended

Central governments use *conditional grants* to increase influence over local spending, to attain and maintain minimum standards of local services, or to ensure a socially optimal outcome, especially in cases of interjurisdictional spillovers. The extent to which central governments impose conditions on grants varies from one country to another. At one extreme, conditions may be such that subnational governments are reduced to acting as mere agents of the central government; at the other extreme, conditions may be limited to reporting, leaving subnational governments with wide elbow room for local innovation and experimentation.

Matching grants are particularly effective in addressing spillover problems. Matching grants generally alter local spending priorities, as local governments adjust their finances to take the central governments' expenditure preferences into account. Indeed, changing local priorities is an objective of matching grants. These grants however also improve the leverage of local governments with respect to the size of the grant because of the size of their own contribution.

Capital grants specifically finance public investment projects or the delivery of vital public services for subnational governments. They are normally used in countries where the capital markets are not well developed, or where subnational governments do not have the fiscal strength to access such markets directly.

As mentioned earlier, capital needs are normally excluded from consideration in formulating equalization grants because of the difficulties associated with measuring and assessing the relative investment needs of different regions. A prudent approach may consist of using *block grants* or a *general-purpose equalization grant* to finance large infrastructure projects (such as regional airports and irrigation projects), and some recurring investments (such as roads and housing) financed through capital grants, with smaller investments. (See Schiavo-Campo and Tommasi [1999] for an analysis of the process of public investment programming.)

Open-ended grants encourage local governments to internalize identified spillovers and to deliver the required level of services. Of course, such arrangements are dangerous for overall macroeconomic stability, and central governments generally prefer capped grants with absolute monetary ceilings.

Grants may have a built-in redistribution mechanism or simply be distributed on an equal per capita basis. Redistribution mechanisms are usually used for general-purpose transfer systems, but can also be part of conditional grants, as in cases where poorer regions with greater education or health needs receive more grants. However, this approach then requires an overall framework for evaluating whether grants formulated separately can actually achieve the aggregate equalization objective.

One risk with all types of transfers from the central to local government is inducing local government to overspend without a clear link to citizens' preferences—the so-called "flypaper effect", which describes a situation where the direct link between the taxpayer or voter and the services provided is broken. This is based on an empirical investigation of a number of countries, where revenues shared with local governments tend to "stick" with the latter in the form of higher expenditure rather than being passed on to taxpayers in the form of lower taxes. Hence, overprovision of services is not an explicit manifestation of public choices for those services but only of the greater availability of funds from central government. Empirical estimates suggest that the magnitude of the flypaper effect in some countries is considerable (Ahmad and Craig 1997). Of course, the solution to this problem lies in the hands of the local population and depends on the strength of the accountability mechanisms at local level.

Fiscal Capacity Equalization Transfers

More important than just filling fiscal gaps, fiscal transfer mechanisms should redistribute resources so that all regions will have the same financial capacity to provide the same standard of basic public services, assuming that they exert the same effort to raise incomes from their own sources and operate at an average level of efficiency. In an effort to equalize horizontal differences among subnational jurisdictions, the national government may try to resolve through unconditional equalization systems only regional differences in revenue or tax assignment, as in the case of Canada.

A more complicated formula is needed if both expenditure and revenue differences are simultaneously addressed, as in the case of Australia and Denmark, where the formulation of transfers incorporates the assessment of revenue capacities as well as expenditure needs (Box 8.10). The People's Republic of China introduced an interesting pilot scheme in that direction (Box 8.11).

In formulating such transfers, it is especially important to estimate expenditure needs independently of the actual expenditure of individual subnational governments. Otherwise, the transfers will be merely gap filling, with the obvious risk that recipient local governments will raise their expenditure to receive larger transfers. But such a system should also distribute lump-sum transfers so that even if equalization factors are taken into account, the recipient subnational governments can choose how to spend the money.

Box 8.10
Fostering Interregional Equity through Fiscal Equalization in Australia

Although Australia is a federal country comprising eight states and territories, most taxation power is assigned to the federal (Commonwealth) government, which accounts for almost three fourths of general government revenue. The federal nature of the system is preserved through large-scale intergovernmental fiscal transfers: in 1998–1999, these totaled about US$20 billion equivalent, about half of which came in the form of unconditional block grants.

The fiscal transfer mechanism is designed to address both vertical and horizontal fiscal imbalances (see text). The vertical imbalance is addressed by transferring enough resources to permit states and local governments to spend almost 50 percent of general government expenditure (while raising about one fourth of revenue). The Australian system also has a mechanism to partly remedy the horizontal fiscal imbalance—differences in revenue capacity among the states—by focusing on equal access for all citizens to certain basic social services.

Until World War II, the annual negotiation between the states and the federal government concerned both the total amount of grants to be allocated and their distribution among the states. This generated a great deal of contention and the zero-sum nature of the allocation system made a national consensus very difficult. In the system introduced since then, the annual negotiation has centered only on the total amount. As soon as that figure is agreed, the allocation among the states follows a formula designed to equalize access to basic social services (thus providing a greater per capita amount to poorer states).

According to the allocation principle, each state is given "the capacity to provide the average standard of state-type public services, assuming it does so at an average level of operational efficiency and makes an average effort to raise revenue from its own sources." This simple and powerful principle sets all the incentives in the right direction. Because these averages are *assumptions* used in the allocation formula, each state has a positive incentive to raise its revenue effort and its service efficiency above the national average. If it succeeds, it retains the increase in revenue and all the cost savings, and the national averages for the following years are automatically raised, adding a dynamic dimension to the fiscal and efficiency incentives.

In 1997, one of the authors asked the Chairman of the Australian Grants Commission whether the efficiency of the system depended on the relative interregional equality of income evident in Australia. He replied, rightly, "And how do you think it got that way?" Assuring that each citizen has access to quality basic education and health is probably the best single route to remedying both interpersonal and interregional income inequalities in the long term.

Source: Frank Jotzo (to be published); author's interview with the Grants Commission chairman, January 1997.

Box 8.11
Pilot Equalization Scheme in the People's Republic of China

As a first step toward a formula-driven redistributive system, the People's Republic of China (PRC) introduced in 1995 a pilot transfer payments scheme. It was aimed at solving the urgent problem of meeting payroll in some provinces. Initially, the formula had two parts: an objective factor that attempted to measure the gap between standard expenditures and local fiscal capacity, and a factor for subsidies to regions with large ethnic minority populations. The latter was in line with the PRC policy for improving the welfare of its minorities.

The fiscal shortfall was determined by standard expenses on wages of civil servants, standard administrative expenses, agriculture and other productive expenditures, and other expenditures such as price subsidies. On the other hand, special transfers to provinces with minority regions were determined by the fiscal gap between the minority regions and the national average.

In 1996, another factor was added to the formula to reward the provinces for good tax effort. Tax effort is now measured by provincial tax collection relative to the national average. Generally, the transfers that a province was expected to receive in 1999 would be based on its fiscal gap and tax efforts in 1998.

There is large room for improving the PRC fiscal transfers system. For one, stronger links still need to be established between a province's fiscal need and its transfers. Also, there should be a better means of measuring provincial revenue growth, since it depends on a number of factors other than tax effort. Finally, over the long term, there is a need to measure fiscal needs more appropriately to include factors other than government personnel and costs of government.

For a detailed elaboration of the pilot transfer payments scheme in the PRC, refer to Annex IV of this chapter.

As repeatedly stressed in this book, one should be very skeptical of imported "models" of public administration. However, the Australian fiscal equalization system described in Box 8.11 comes close to the notion of a good "model" to be considered by other countries because it provides positive incentives to the constituent states for fiscal mobilization and for efficiency in basic social services. Moreover, it takes the politics largely out of the contentious issue of geographic allocation of resources. It does so through a mechanism of grants to the states, calculated *as if* each state had average efficiency in local resource mobilization effort and in service provision. States with greater than average efficiency retain all of their higher-than-average revenue or cost savings. This system is worth considering even in developing countries, particularly those where different ethnic groups are concentrated in different regions. However, because the effectiveness of the system depends largely on solid data about local revenue and unit cost of services, countries must first ensure that such data are available and have wide credibility. Annex III elaborates on an equalization grant system.

Designing Intergovernmental Fiscal Transfers

The following provides pointers (Shah 1994) on designing fiscal transfers. Some criteria may conflict with others. Policymakers must therefore assign priorities to the various factors.

- *Autonomy*—Subnational governments should have complete independence and flexibility in setting priorities and should not be constrained by the categorical structure of programs or uncertainty associated with decision making at the center. Consistent with this objective is tax-base sharing (which allows subnational governments to introduce their own tax rates on central bases), formula-based revenue sharing, or block grants.
- *Revenue adequacy*—Subnational governments should have adequate revenues to discharge their designated responsibilities.
- *Equity*—Allocated funds should vary directly with fiscal need and inversely with the taxable capacity of each province.
- *Predictability*—The grant mechanism should ensure predictability of the subnational government's shares by publishing five-year projections of funding availability.
- *Efficiency*—The grant design should be neutral with respect to subnational government choices or resource allocation among different sectors or different types of activity. The current system of transfers to finance lower-level public sector wages in countries such as Indonesia and Sri Lanka contravenes this criterion.
- *Simplicity*—The subnational government's allocation should be based on objective factors over which individual units have little control. The formula should be easy to comprehend so that "grantsmanship" is not rewarded, as has apparently occurred with plan assistance in India and Pakistan.
- *Incentive*—The proposed design should provide incentives for sound fiscal management and discourage inefficient practices. There should be no specific transfers to finance the deficits of subnational governments.

- *Safeguards for the grantor's objectives*—The grant design should ensure that the grant recipients adhere to certain well-defined objectives of the grantor. This is accomplished through proper monitoring, joint progress reviews, and technical assistance with the help of a selective matching transfer program.

SUBNATIONAL GOVERNMENT BORROWING

Local borrowing has become an important issue in intergovernmental fiscal relations. Aside from the growing share of local debt and deficits over time, local borrowing has spurred macro concerns because of the debt crisis in some subnational governments in Brazil, the inflationary impact of subnational financing in Argentina, and city-level bankruptcies in the US.

Types of Local Financing

Borrowing is a major source of funds for the capital requirements of subnational governments, especially if large capital investment responsibilities are decentralized. Increases in current tax revenues will normally not suffice to finance public investments that are lumpy in nature. Also, since the benefits of public investments presumably last for decades, public borrowing allows future beneficiaries to share in financing such investments. Borrowing may also serve as a useful stopgap for local deficits caused by a vertical imbalance in subnational government revenue and expenditure assignments.

Subnational governments may obtain financing in four ways: (i) borrowing through the central government, (ii) borrowing through another public intermediary, (iii) borrowing directly from the capital markets, or (iv) financing through private participation in the delivery of public services. This last element is discussed in Chapter 6.

Borrowing through the central government ensures subnational governments of long-term credit. A major disadvantage, however, is that credit allocation through this channel will most likely become enmeshed with politics, possibly resulting in inefficient borrowing for unproductive public investments, as politically attractive investments are not necessarily the productive ones. To a lesser extent, the same is true for borrowing through a public financial intermediary, with the additional disadvantage that the debt of a financial intermediary is an implicit liability of the central government and thus less transparent.

In contrast, subnational governments' direct access to capital markets allows for the development of a more transparent and market-based relationship with lenders, and a greater chance for the central government to enforce a hard budget constraint. This is easier said than done in developing countries and transitional economies, where capital markets are nonexistent or are highly imperfect. It may still be possible, however, to explore possibilities for some local governments to access the international capital markets. Evidentiary requirements will be heavy and interest rates higher, of course (unless a central government guarantee is provided—which would be entirely inconsistent with the principles discussed here), but a good track record of timely repayment will lessen these problems in time for the local government concerned.

The main issue here is moral hazard. Subnational government access to capital markets involves implicit central-government guarantees, which allows imprudent action by both lenders and subnational governments, creating contingent fiscal liabilities for the central government. (On the general issue of fiscal risk, see Schiavo-Campo and Tommasi [1999], and for an in-depth analysis, Polackova [1998, 1999].) Accordingly, imprudent behavior carries no penalty, and good local fiscal discipline earns no reward. The key to appropriate policies on subnational borrowing is the proper design of fiscal decentralization in general, and the design of the mechanism for controlling local borrowing powers, in particular.

Three important considerations must be taken into account in designing decentralized borrowing powers: (i) minimize, if not eliminate, the implicit central government liability; (ii) insulate credit allocation from political influence; and (iii) strengthen capital markets as the preferred channel for local government credit.

Control of Subnational Borrowing

A good system of decentralized borrowing is one in which the regulatory framework controls excess borrowing through the following.

- Subnational governments should be required to disclose adequate and timely financial information based on standard accounting to both potential lenders and the central authorities.
- Explicit bankruptcy procedures should ensure that delivery of basic services continues, even at a reduced level, during the debt management and restructuring period.

- Local borrowing in excess of specified amounts or for violation of specified criteria should be subject to penalties.
- Subnational governments must be assured of access to revenue sources to serve as collateral for their debts. Without such collateral, lenders will rightly assume an implicit guarantee from the central government.

Various countries use different mechanisms to control subnational borrowing. These mechanisms may be broadly grouped into four categories: (i) control through market discipline, (ii) cooperation among different levels of government, (iii) controls based on administrative rules, and (iv) direct controls by the central government. Most countries use a combination of these approaches. Box 8.12 presents a comparative summary of control mechanisms in various countries.

The market discipline approach

Relying on the capital markets to control local borrowing assumes that a capital market exists and functions reasonably well; the government lets the capital market operate freely, without favoring government borrowers; and a bailout in case of default is perceived to be unlikely. As noted earlier, the realities in developing countries suggest that these countries cannot rely on market discipline. Most developing countries have widespread experience with central government intervention to prevent default by subnational governments. Also, because of short-term electoral cycles, local politicians tend to be unresponsive to warnings from the credit market.

The cooperative approach

Local borrowing can also be controlled through negotiation between the central and subnational governments. As argued at the start of this chapter, fiscal deficit targets should be set to cover the general government, prevent downloading of the central deficit, and improve overall fiscal transparency. For this to be realizable, however, subnational governments should be allowed to participate in some appropriate fashion in formulating macroeconomic programs and of the fiscal framework. This approach may slow the process somewhat, but has the greater advantage of promoting the flow of information among levels of government, thereby increasing awareness among subnational government officials of the fiscal implications of their actions and improving the overall effectiveness of the public expenditure management system. The cooperative approach can work best

Box 8. 12

Subnational Borrowing Controls in Selected Countries[a]

Country	Market Discipline		Cooperative Control		Administrative Control		Rule-Based Control		Borrowing Prohibited	
	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic
Industrial Countries										
Australia			■	■						
Austria					■	■				
Belgium			■	■						
Canada	■	■								
Denmark			■	■						
France	■	■								
Germany							■	■		
Greece					■	■				
Ireland					■	■				
Italy							■	■		
Japan						■			■	
Netherlands							■	■		
Norway					■	■				
Portugal	■	■								
Spain					■	■				
Sweden	■	■								
Switzerland							■	■		
United Kingdom					■	■				
United States							■	■		

[a] Classifications indicate the predominant form of control. Some countries may use a combination of several techniques.

Box 8. 12
Subnational Borrowing Controls in Selected Countries[a]

	Market Discipline		Cooperative Control		Administrative Control		Rule-Based Control		Borrowing Prohibited	
Country	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic
Developing Countries										
Argentina					■	■				
Brazil					■	■				
Bolivia					■	■				
Chile					■	■				
Colombia					■	■				
Ethiopia						■			■	
India					■	■				
Indonesia					■	■				
Korea, Republic of					■	■				
Mexico						■			■	
Peru					■	■				
South Africa			■	■						
Thailand									■	■
Transitional Economies										
Albania									■	■
Armenia									■	■
Azerbaijan									■	■

[a] Classifications indicate the predominant form of control. Some countries may use a combination of several techniques.

Box 8. 12
Subnational Borrowing Controls in Selected Countries[a]

Country	Market Discipline		Cooperative Control		Administrative Control		Rule-Based Control		Borrowing Prohibited	
	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic
Belarus									■	■
Bulgaria									■	■
China, People's Republic of									■	■
Estonia					■	■				
Georgia									■	■
Hungary					■	■				
Kazakhstan									■	■
Kyrgyz Republic									■	■
Latvia					■	■				
Lithuania					■	■				
Poland									■	■
Romania									■	■
Russia	■	■								
Slovenia									■	■
Tajikistan									■	■
Ukraine									■	■

[a] Classifications indicate the predominant form of control. Some countries may use a combination of several techniques.

Source: Ter-Minassian, ed. (1997).

in a situation where local officials are reasonably competent and representative, and where there is strong national leadership in economic and fiscal management. (Box 8.13.)

Box 8.13
Cooperative Approach to Controlling Local Borrowing in Australia

Australia uses the cooperative approach through its Loan Council, a long-established forum for the negotiation of state debts. Comprising representatives from all the Australian states and one from the central government, the council discusses the global debt limits of each state and monitors compliance with such limits. Monitoring is done through a before-and-after analysis of outstanding debts.

State borrowing was characterized by attempts to elude debt limits by resorting to off-budget operations, innovative financing techniques, and through borrowing by state-owned enterprises. Therefore, the Loan Council, in 1993, decided to shift its focus to prior analysis and subsequent monitoring of the net financing requirements of each state. It requires the states to present detailed projections of their yearly budgetary operations to show developments in their finances. To strengthen market discipline on state borrowing, the council facilitates the collection and timely dissemination of this information.

Source: Ter-Minassian and Craig in Ter-Minassian, ed. (1997).

Rule-based approach

This approach makes use of the constitution and laws to restrict and guide subnational government borrowing. Among other things, rules for borrowing commonly set absolute limits for subnational government indebtedness; specify the purpose or conditions for borrowing; and prohibit certain types of borrowing that involve macroeconomic risks, such as borrowing from the central bank.

The rules may be determined more by political considerations than by sound macroeconomic management. Also, the approach lacks flexibility and thus fosters practices circumventing the rules, including reclassifying current expenditures as investment; creating off-budget entities whose debts are not included in debt ceilings; borrowing through local government-owned enterprises; using hidden debt instruments (e.g., sale and leaseback arrangements of the so-called “private revenue” bonds in the US); and accumulating payment arrears to suppliers.

Direct control

Particularly in unitary countries, the central government may directly control subnational borrowing in different ways: setting limits on subnational debts; authorizing individual borrowing operations; or centralizing all government borrowing, with onlending to subnational governments. Administrative controls must be more stringent for foreign than for domestic borrowing, for several reasons. The Asian financial crisis has demonstrated however that only fully centralized control of foreign borrowing can prevent the contagion effect of a deterioration of the credit ratings of one borrower on the ratings of other borrowers, and on the country as a whole. The Republic of Korea provides a good illustration of this (Box 8.14).

In developing countries and transitional economies, therefore, direct central control of subnational borrowing appears preferable. But it is very important to avoid cumbersome and intrusive controls. The national authority must not micromanage local government through the back door of controlling its borrowing. There is no substitute for restraint and common sense in the practical implementation of this approach.

Box 8.14
Key Features of the Local Borrowing System in the Republic of Korea

Local autonomous bodies in the Republic of Korea are allowed to borrow, subject to an elaborate regulatory framework that details the conditions for all debt instruments. The regulatory framework has the following general objectives: (i) to limit the aggregate amount of local borrowing; (ii) to expand the responsibilities of local bodies, given the short period of service of local officials compared with the maturity of debts; and (iii) to spread economic activities to poorer regions of the country.

The regulations for local borrowing in the Republic of Korea include detailed eligibility criteria. Local governments with a history of sound financial policies, such as those with no overdue obligations, a low debt-service ratio, and low fiscal deficit, may borrow. There are also regulations determining the types of projects that can be financed by borrowing. They include capital projects, disaster rehabilitation projects, and welfare improvement projects (not clearly defined). However, there is no preordained central government ceiling on the overall amount of borrowing.

A particular feature of borrowing regulations in the Republic of Korea is compulsory bond placement, a practice introduced in 1979. Cities, through an

continued on next page

Box 8.14 (cont'd.)

ordinance, can decide that those who will benefit from projects financed through borrowing should share in their financing. Aside from compulsory bond placements, local governments can issue bonds on the international market, particularly in Japan and the United States. Bonds are offered at well below domestic market rates, even after considering movements in exchange rate.

The functions and responsibilities of the Government of the Republic of Korea at different levels may be said to be historically closely integrated. This close integration extends as well to the borrowing process. Hence, the risks of borrowing are also shared in the sense that central government approval of any local borrowing automatically implies a state guarantee.

Despite the detailed and strict regulatory framework for borrowing, however, local borrowing could still have adverse macroeconomic effects. The absence of an overall ceiling on borrowing could lead to excessive or poorly timed borrowing, or to the inefficient use of borrowed resources.

Source: Chu and Noregaard in Ter-Minassian, ed. (1997).

KEY POINTS AND DIRECTIONS FOR IMPROVEMENT

Key Points

The *distribution of fiscal responsibilities* between central and subnational governments should be governed by the principles of

- clear responsibilities for each level of government;
- stable and predictable revenue-sharing arrangements;
- providing incentives for increased efficiency of local government; and
- uniform accounting and budgetary rules for subnational government entities.

It is also important for expenditure control and good resource allocation to define fiscal targets to cover general government as a whole, thus avoiding the temptation to dump fiscal problems on local governments; put in place mechanisms to control local government borrowing, and sanction expenditure overruns as well as accumulation of arrears; and assure sound accounting, reporting, and audit.

The potential benefits of *fiscal decentralization* include higher service efficiency—as local government is closer to the users; more effective tax administration; and improved resource allocation and equity. The potential costs are a mirror image of the potential benefits. Fiscal decentralization can worsen service efficiency when local authorities are unresponsive; reduce resource mobilization when local authorities are less honest or capacity is weaker; and foster inequities when local government is "captured" by powerful local interests. The cost-benefit balance of fiscal decentralization depends therefore on the specific country and local situation. Generally, as mentioned earlier, the key influence is the relative quality of governance at central and local levels of government. When local government is more representative and accountable than national government, fiscal decentralization can be presumed to carry a net benefit. Local capacity however needs to be expanded commensurate with the new responsibilities.

How to deal with *fiscal imbalances* is the key implementation issue in fiscal decentralization. Vertical imbalances between central and subnational governments result in general from a mismatch between revenue and expenditure assignments. Horizontal imbalances between subnational government entities at the same level result from differences in wealth and tax revenue between different regions and localities in the country.

Concerning *vertical imbalances*, expenditure responsibilities should in principle be assigned to that geographic level of government where they would benefit only the residents of the region. In practice, however, many public services have unclear benefit regions or carry implications for the country as a whole. Generally, the central government should be responsible for national functions (e.g., defense and international relations), services that benefit several jurisdictions, and services whose local administrative costs would outweigh the local benefits.

Tax assignment to local governments must be accompanied by coordination across jurisdictions—to avoid distortion and undesirable competition in offering tax incentives—and by rules preventing double taxation or tax loopholes. Accordingly, taxes assigned to central government should cover mobile tax bases and tax bases that are unevenly distributed across regions; taxes assigned to local government should be those that cover immobile tax bases as well as tax bases that are easily administered. Therefore, local value-added taxes are generally to be avoided as they carry the risk of competitive tax reduction or, conversely, of local protectionism by setting tax rates higher for purchases from outside suppliers. The corporate income tax, too, fails the tests of a good local tax, with its high compliance costs, incentives for tax avoidance, and uncertainty of revenue. Assigning personal income taxation to local government has advantages as well as disadvantages. Sales taxes are well suited for local government if they are levied on local businesses. The revenue sources best suited for local administration are local property taxes and motor vehicle taxes, as well as user charges.

As a general rule, *revenue sharing* to remedy overall vertical imbalances should be from the top down, because assigning most taxing power to local government and then sharing revenue upward would weaken the key macroeconomic and redistributive functions of central government. On the other hand, relying entirely on downward transfers would reduce local financial accountability and disempower local government. Local government revenues should therefore comprise an appropriate mix of own-tax revenues as well as some revenue sharing from the top. Revenue sharing can be on a derivation basis, whereby revenue is shared on the basis of where it was collected; on a grant basis, whereby the revenue is redistributed according to a formula or to the cost of collecting the tax; or on a piggyback basis, which allows subnational governments to add a percentage amount to the central tax.

Horizontal imbalances are corrected by intergovernmental fiscal transfers, which can be conditional or unconditional, and open ended or subject to caps. A variety of considerations apply to the different types of transfers. More important than just filling fiscal gaps, however, is the role of fiscal transfers in redistributing resources to assure that all regions have the same financial capacity to provide *basic* public services, assuming they exert the same effort to raise income from their own sources and operate at an average level of efficiency. (The Australian system of grants from the center to the states is particularly effective in this regard.)

As noted earlier, good fiscal federalism requires robust controls on expenditure overruns, arrears, and borrowing by subnational government. When local borrowing carries an implicit national government guarantee, it creates a contingent liability for the national government while encouraging imprudent behavior by both local government and the lenders. In principle, therefore, central government guarantees for local borrowing should be minimized, at the same time as local credit allocation is insulated from political influence from the center, while private capital markets are strengthened as the preferred channel for credit to local governments. This is particularly difficult to accomplish in developing countries and transitional economies, where capital markets are undeveloped and direct central control of subnational government borrowing remains generally necessary.

Directions of Improvement

The first priority in this area is to review the distribution of fiscal responsibilities between levels of government to make sure that it is clear and explicit. Next, it is necessary to verify that the formal assignment of responsibilities is in fact carried out and, where it is not, to assess whether the lack of implementation derives from insufficient local capacity or from central government interference.

It is also important to combat the temptation to "download" fiscal problems by devolving expenditure responsibilities to local governments without the means to carry them out. This practice makes it difficult for local governments to operate, and at the same time gives them an alibi for bad performance. Defining fiscal targets for general government instead of only for the central government (as recommended in the International Monetary Fund Code of Fiscal Transparency) would help accomplish this purpose. In developing countries and transitional economies, therefore, improving fiscal statistics at the local government level is important not only to promote a healthy fiscal policy overall, but also to help protect local governments against unfunded mandates.

Because fiscal decentralization carries costs and risks as well as benefits, it is essential to examine, *case by case*, whether a specific move toward fiscal devolution is likely to carry a net benefit. Such an examination should rest in part on the feedback of informed persons from local government and civil society, rather than a mere desk review by a central entity. Local administrative capacity is an important determinant of the effectiveness of decentralization. Weak local capacity is not necessarily a reason to keep expenditure responsibilities centralized. However, every move toward fiscal decentralization should be accompanied by measures to strengthen local capacity and governance, and should assure that independent channels of feedback and complaint between the local population and the central government are open.

It is especially important to consider the impact of fiscal decentralization measures on poverty, income distribution, and regional inequalities. Although all major policy changes entail shifts in the interpersonal and interregional allocation of resources, when a loss is likely for poor and vulnerable groups, appropriate compensatory measures must be incorporated in the design of decentralization and forcefully implemented. Again, there is no substitute for ascertaining the views of local civil society in this respect.

When assigning taxes to local governments, it is necessary to encourage coordination across jurisdictions to avoid undesirable competition in offering tax incentives, double taxation, or tax loopholes. Such coordination can also exploit scale economies in tax administration and improve local administrative capacity by benefiting from the experience of other jurisdictions. Coordination in the tax area can thus become a testing ground for greater general cooperation and, to that extent, can alleviate local capacity constraints and build regional social capital.

Property taxes are the most suitable for assignment to local government, especially in developing countries where the only alternative may be overreliance on transfers from central government. Taxes on certain types of property, such as automobiles, are inherently progressive and relatively easy to administer. However, taxes on land and buildings, which can yield much greater revenue, are difficult to administer and are a frequent source of corruption. Improvements in this area are therefore important for effective fiscal decentralization in developing countries, but always difficult—especially in regions with weak governance and powerful local elites. Directions of improvement include mainly

- giving local governments the freedom to set their own property tax rate;
- improving the property tax valuation system;
- giving the assessing agency direct financial incentives to maintain the tax base and keep assessments up to date;
- strengthening procedures for collecting real estate taxes, normally including the power to seize the concerned property for nonpayment of taxes;
- assuring effective external audit of tax valuations and the assessment process; and
- introducing robust measures to raise the cost of corruption.

The objectives of fiscal transfers are often in conflict—between stabilizing and reducing of regional disparities, or between compensating for benefit spillovers and setting national service standards. Hence, it is important to ensure that the fiscal transfer system as a whole is internally consistent and trade-offs between objectives are explicit. In practice, this entails relying not on a single type of grant but on a judicious combination of conditional and unconditional, capped and open-ended, and capital and current grants.

In revenue sharing, it is advisable to move away from annual bargaining (which is time-consuming, heavily politicized, and a potential source of corruption) and toward a rule-based arrangement, whereby only the overall amount to be transferred is decided annually, with the distribution to regions and localities governed by explicit criteria. In addition, the tax assignment and revenue-sharing rules must provide the right incentives for efficiency and fiscal discipline by local governments. For example, certain tax-sharing arrangements can lead local governments to put all efforts into collecting those taxes that give them the most benefit, and neglect the rest. A review of the actual behavior of local government in response to central rules, based partly on a survey of informed local opinion, can help pinpoint those rules that have had a disincentive effect, and can be a good basis for improving the fiscal regulatory framework.

Rule-based mechanisms, e.g., centrally set limits on local debt, borrowing, expenditure arrears, and approval of major loans, are also used to assure fiscal discipline in local government. In developing countries, where capital markets are undeveloped and there is an implicit assumption that the central government will bail out local governments if they get into trouble, such direct controls are unavoidable. It is important, however, to exercise them efficiently, avoiding cumbersome and intrusive controls that micromanage local government under the guise of controlling its borrowing.

Annex III

EQUALITY IN DIVERSITY: FISCAL EQUALIZATION IN AUSTRALIA

by Frank Jotzo

INTRODUCTION

The Australian fiscal equalization system is often seen as a model for other countries because of several reasons. Fiscal equalization manages to overcome large imbalances between own sources of revenues and own expenditures at the regional level. In doing so, the transfer system aims to distribute the funds so that all states have equal capacity to fulfill their fiscal responsibilities. Further, the grant system is designed to allow the states to decide how they use the funds and to avoid central government interference in state policy choices. This article examines the fiscal relations between the federal and state governments in Australia, looking in particular into the design of the grant system. It should be stressed here, that for incentive reasons, it is preferable to assign sufficient own sources of revenues to regional governments. However, a well-designed grants system can be a reasonable second-best solution for overcoming fiscal imbalances.

FISCAL IMBALANCES IN AUSTRALIA

Revenues

Australia is a federation of eight states and territories. There are three layers of government, namely, the federal, state, and local governments. The Australian tax system has evolved in a way that has given the central level ever more taxation powers. Today, all major taxes are levied by the federal government. Of these, the income tax is the most important. In a tax reform effective from July 2000, a value-added tax will be introduced.The states levy a variety of smaller and often inefficient taxes, such as payroll tax (on wage payments by employers), transactions taxes (stamp duties and taxes on financial transactions), as well as taxes on tobacco, alcohol, petrol and gas, motor vehicles, and gambling. These taxes are regulated by the states and vary between states (Australia 1998a). After introducing the value-added tax, some of these taxes will be abolished.

The federal government (Commonwealth) levies 76 percent of the total tax revenue, and accounts for 72 percent of total government revenue in Australia. The States account for only 24 percent and local government for 4 percent of revenue (Figure 1, left pillar).

Expenditures

The structure of expenditure differs markedly between levels of government. For the federal government, more than one third of total expenditures is on social security payments. Other significant own-purpose expenditures occur in the areas of debt servicing, defense, and general public service. The states are responsible for expenditures on education, health, and the police. The largest expenditure category is education, followed by health, with the largest outlay for hospital funding. Other significant areas of state outlays are for debt servicing and transport (road and rail). Transport infrastructure and housing, as well as recreational and cultural amenities, are in the realm of bothstate and local governments. Public servants' salaries are paid separately by each level of government for its employees.The expenditure that the states make to meet their responsibilities account for 38 percent of total government outlays, which far exceeds their revenue raising capacities. By contrast, the central level accounts for 57 percent of expenditures for central level functions, which is much less than its share in total revenue (Figure 1, second pillar).

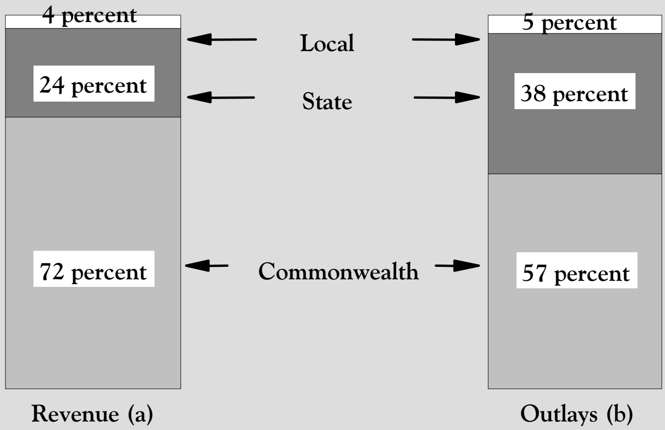
Vertical fiscal imbalance

The persistent mismatch between the revenue raised and expenditure undertaken at the federal and state government level is called vertical fiscal imbalance (VFI). If the imbalance cannot be remedied by changing the assignment of taxes and other sources of revenue, then a system of intergovernmental fiscal transfers is necessary. This is the case in Australia (James 1992).

Horizontal fiscal imbalance

Horizontal fiscal imbalance (HFI) arises when governments at the same level have different per capita capacities to raise revenue and unavoidable differences in their per capita costs of providing services. Such differences occur naturally between states that differ in their structural characteristics. The extent of HFI between states in Australia is probably lower on average than in many other countries, and certainly lower than in

Figure 1
Composition of Government Own-Source Revenue and Own-Purpose Outlays



Source: Australian Treasury.

Indonesia. The major states do not differ too much in structure; each has one or more metropolitan centers, some service manufacturing and heavy industries, and contains a significant rural area under agriculture.

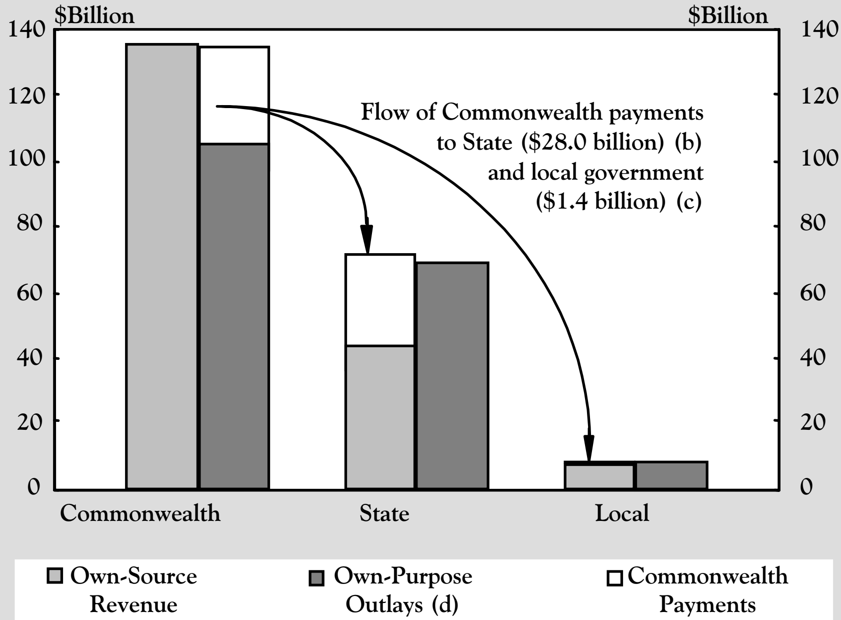
HFI is defined not in terms of actual revenue raised and cost of services provided, but on the basis of the *potential* of state governments to raise revenue and to provide services (Searle 1996). *Actual* revenue and outlays depend on each state's

- structural characteristics,
- policy on public spending and taxation (high or low levels of service, provision and tax rates), and
- efficiency of service provision and revenue collection.

Intergovernmental Fiscal Transfers

The Australian fiscal transfer system has to overcome a high degree of VFI and at the same time aims to remedy HFIs between the states. The main instruments are specific grants (specific purpose payments, SPPs) and block grants (general revenue grants) from the federal to the state and local governments. In the financial year 1997/98, total transfer payments from the central level to the states and local governments was Australian dollar ($A) 29.4 billion. Of this, just over half was in the form of block grants, and about one third as SPPs. The rest is made up of specific grants paid through the states (to be handed on to universities, local government, etc.) and some direct payments to local governments.

Figure 2
Flow of Payments from the Federal Government Commonwealth to Other Levels of Government, 1997/98



Source: Australian Treasury

Specific grants

SPPs are meant to enable the federal government to pursue national objectives in areas that are part of the states' fiscal responsibilities. SPPs can be used to capture spillover effects between states, support standardization, provide seed money, and channel expenditure through the states in activities that are better performed by state administrations. Examples are interstate roads, higher education, and support programs for indigenous people, all of which might not receive adequate state funding from a national point of view. SPPs are generally unpopular with the states because they are seen as an intrusion of the central level in functions that are constitutionally assigned to the states. SPPs are paid both directly to the states and through the states, which means that state governments pass the funds on to local governments and universities. The largest functional category is health with A$6 billion, followed by education. Other important categories for SPPs are housing, social security, and transport.

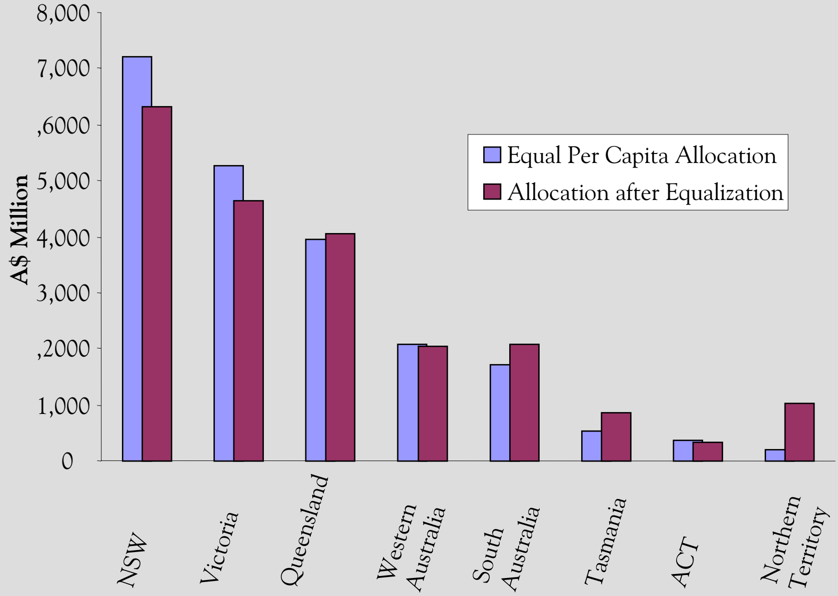
Block grants

Block grants (general revenue grants) are paid without any conditions on their use by the states. They are used to remedy any remaining VFIs and to address HFIs by allocating different per capita shares to individual states. All states receive payments, but the per capita amounts differ. The allocation system for these grants is examined in detail below.

The total pool of block grants is principally a matter of negotiation between the federal and state governments. For the last few years it has been indexed to inflation, so the real level of block grants has remained the same. After the tax reform, the pool will consist of the revenue generated by the value-added tax, which will rise with the growth of the economy (Australia 1998b).

Figure 3 shows the distribution of general revenue grants between the States and the effect of differentiating the per capita payments to remedy HFIs. New South Wales and Victoria, the two most populous states, get much less in block grants than they would if the money were distributed on an equal per capita basis. For example, in the last financial year New South Wales received A$6.3 billion in general grants, but would have received A$7.2 billion if there were no horizontal fiscal equalization. South Australia, Tasmania, and the Northern Territory receive substantially more than their equal per capita share. The Northern Territory receives A$1 billion instead of A$0.2 billion. For the other states, the effects of horizontal equalization are not very large.

Figure 3
General Revenue Grants, 1997/98: Comparison of an Equal Per Capita Distribution with that after Equalization



Source: Commonwealth Grants Commission.

Fiscal Equalization through Block Grants

The principle of fiscal equalization

The principle of horizontal fiscal equalization applied in Australia is that "each State should be given the capacity to provide the average standard of State-type public services, assuming it does so at an average level of operational efficiency and makes an average effort to raise revenue from its own sources." (Commonwealth Grants Commission [CGC] 1998a).

There are three crucial aspects to this definition. First, fiscal equalization aims to achieve equal *capacity* among the states to provide public services, not equal results. It is left to the states to determine how much service they provide, how efficiently they provide it, and how much own revenue they raise. Second, using Australia-wide *averages* as the reference means that no particular level of services and taxes is prescribed. The standard is defined by what the states actually do, not by what some authority might consider to be the correct spending level. Lastly, the states are free to decide what kind of services they provide, and in which manner.

Consequently, a state's policy choices do not directly affect the amount of revenue assistance it receives. Horizontal equalization is based solely on differences in the structure of the states. For example, if a state opts for lower tax rates, the shortfall in revenue will not be made up by increased fiscal transfer payments from the Commonwealth. That state will have to provide less services to its residents, provide them more efficiently, or borrow. By contrast, if equalization were based on performance rather than capacity, or on external standards rather than averages, then judgements would have to be made on the correct level of services and tax rates to determine transfer payments.

It is one of the principles of the Australian federation that states should be free to pursue individual policies in the fields of their responsibility. The design of the fiscal equalization system is in keeping with this principle. However, the fact that the states have only a limited range of taxes they can levy and regulate means that the leeway for differentiation in taxes is small. In practice, the states do not differ very much in their tax structure. Differences in service provision are larger.

Equalization in practice: the result

The pool of general revenue assistance is distributed between the states to achieve horizontal fiscal equalization according to the principles set out above. Each year an independent authority, Commonwealth Grants Commission CGC (see Appendix 1 of this book for description and interview), determines the grants allocation per capita in each state (CGC 1998a).

The allocation of block grants is determined by each state's costs of service provision, revenue-raising capabilities, and receipt of SPPs relative to the average of all states. The distribution of grants is determined by these three factors (for details see below). Starting from a hypothetical equal per capita distribution across the states, the amount paid per capita (Table A3.1, column [1]) is adjusted for expenditure needs, revenue needs, and receipt of specific grants.

As can be seen from the Table, the grants for New South Wales for example are adjusted downwards because of lower cost of service provision

Table A3.1
Disaggregation of 1997/98 General Revenue Grants Distribution

Province	Equal Per Capita Grants (1) $ p.c.	Expenditure Needs Per Capita (2) $ p.c.	Revenue Needs Per Capita (3) $ p.c.	Per Capita Adjustment for SPPs (4) $ p.c.	Financial Assistance Grants Per Capita (1)+(2)+(3)+(4) (5) $ p.c.	Total (6) $ m
New South Wales	1,145.39	-60.52	-97.26	17.48	1,005.09	6,326.1
Victoria	1,145.39	-228.97	68.02	23.82	1,008.26	4,639.5
Queensland	1,145.39	-24.08	40.04	8.89	1,170.24	4,046.2
Western Australia	1,145.39	251.62	-196.25	-75.57	1,125.19	2,037.1
South Australia	1,145.39	65.35	202.65	-14.02	1,399.38	2,082.5
Tasmania	1,145.39	254.05	406.08	-29.47	1,776.05	840.8
Australian Capital Territory	1,145.39	-178.17	88.48	33.90	1,089.61	339.2
Northern Territory	1,145.39	4,886.89	-28.87	-485.01	5,518.41	1,016.5
Australia	**1,145.39**	**0.00**	**0.00**	**0.00**	**1,145.39**	**21,327.9**

Source: Commonwealth Grants Commission.

(expenditure needs, -A$60.52 per capita) and higher revenue-raising capability (revenue needs, -A$97.26 per capita), but adjusted upwards because of lower-than-average receipt of SPPs from the federal government (adjustment for SPPs, -A$17.48 per capita). The net effect is a lower-than-average amount of block grants per capita. The disaggregation also shows that the favorable treatment of the Northern Territory is entirely due to higher expenditure needs, while the high level of specific grants substantially reduces the amount of general revenue assistance to the Northern Territory.

The grant allocation tends to be higher for the less populous states. The more densely populated eastern states of New South Wales and Victoria have the lowest allocations, while the Northern Territory with its extremely small and dispersed population and particular socioeconomic structure (high share of aboriginal population) receives a disproportionately high share. Payments of block grants per capita to the Northern Territory are almost five times as high as in the national average. The allocations have changed over time, both because of changes in the structure, expenditures, and revenue of the states, and because of changes in the assessment methods. The overall pattern in the distribution of funds however has remained stable.

Equalization in practice: the methodology

CGC has developed an elaborate methodology to determine the allocation of general revenue grants. At the core is a comprehensive assessment of disabilities in revenue-raising capacity and expenditure needs for each state relative to the average of all states.

If a state raises less (or spends more) than the average, this is due either to a deliberate policy choice, less efficiency in revenue raising (or service provision), or structural factors (called disabilities). A *disability* is defined as "an influence beyond a government's control that requires it to spend more (or less) per head of population than other governments to achieve the same objective, or reduces (or increases) its relative capacity to raise revenue from the same effort" (CGC). Fiscal equalization is concerned only with disabilities, not with the effects of policy choices or administrative efficiency. Revenue and expenditure needs can be either positive or negative, depending on whether structural characteristics put a state in an unfavorable or a favorable position relative to the Australian average. Table A3.1 details revenue and expenditure needs due to disabilities.

Expenditure assessment

Expenditure assessment is at the core of the Australian fiscal equalization system. CGC currently determines the cost and level of service provision in a total of 49 categories. The assessment is thus very detailed; education expenditure for example is analyzed in seven separate subcategories (Table A3.2).

Table A3. 2
Categories for expenditure assessment (1998)

Education
Preschool education, government primary education, nongovernment primary education, government secondary education, nongovernment secondary education, technical and further education, transport of rural children
Health
Hospital services, nursing home services, mental health services, community health services
Law, Order, and Public Safety
Police, administration and justice, corrective services, public safety and emergency services
Welfare
Family and child welfare, aged and disabled welfare, other welfare services
Culture and Recreation
Culture and recreation, national parks and wildlife services
Community Development
Planning and environment, aboriginal community services
General Public Services
Superannuation, other general public services
Services to Industry
Agriculture and fisheries, Brucellosis eradication, mining, fuel and energy, tourism, soil conservation, other services to industry
Transport
Road maintenance, other transport
Economic Affairs and Other Purposes
Debt charges, other services
User Charges
Technical and further education user charges, hospital patient fees, fees and fines, property titles, other user charges
Trading Enterprises
Urban transit, nonurban transit (freight), nonurban transit (passengers), country water supply and sewerage, country water supply and sewerage user charges, housing, housing user charges, other trading enterprises

Source: Commonwealth Grant Commission.

Expenditure assessment consists of three steps: (i) examining the characteristics of each state's population, economy, and physical environment; (ii) determining whether and how these characteristics influence the need for or the cost of public services; and (iii) deciding whether there are disabilities. Analogous to revenue assessment, the result is *expenditure needs,* which is the difference between the per capita amount a state needs to spend to provide the standard level of services and the Australian average per capita expenditure.

The cost of providing public services depends mainly on socio-demographic and geographic characteristics. Examples for such structural factors are the relative number of school-age children (education), the relative number of aboriginals (health), and the population density and dispersion (various services). Taking the subcategory road maintenance as an example, the Northern Territory is assessed to need 2.3 times as much money per capita of its population than the national average to provide road maintenance of the average Australian quality. This is because the Northern Territory has a very low population density that results in a high road length per capita, and because it is costly to maintain roads in remote parts of the state. If the policy of the state government is to provide road maintenance at below or above average quality, this does not affect the assessment. The Northern Territory has much higher-than-average costs of service provision in almost all expenditure categories, which is the reason for the very high assessed expenditure needs of A$4887 per capita (Table A3.1, column [2]). As can be seen in the Table, expenditure assessment has a significant impact on the distribution of grants.

In many cases, the definitions of disabilities and what might be suitable indicators are debatable, and some necessary data are not readily available even though the Australian statistical system is comparatively comprehensive. The question of which expenditure categories should be included in the assessment is an issue of debate between the states, too. Such difficulties tend to affect the assessment of expenditures more than that of revenue. Consequently, the work of CGC requires a great deal of judgement as well as thorough economic and statistical analysis. This part of CGC's work uses up substantial resources.

Revenue assessment

For each state, CGC determines the revenue raising capacity and the revenue raising effort for 20 revenue sources, of which 14 are taxes and 6 are nontax revenues (Box A3.1).

For each revenue source, indexes are calculated by putting each state's assessment in relation to the Australian average. The results of the categories are then weighted with their share in average expenditure to yield aggregate revenue needs.

The results of revenue assessment can be expressed as *revenue needs*, defined as the difference between the per capita amount a State needs to spend to provide the standard level of services and the average Australian per capita expenditure. Revenue needs can be positive or negative. This is the measure presented in Table A3.1, column 3. Revenue-raising capacity depends on the available revenue base. In the assessment of revenue capacities it is not relevant whether a revenue source is actually levied in a particular state, at what rate, and how efficiently. Differences in revenue bases between states can be due to differences in the structure of industry and demand, the value of property, natural-resource availability, and so forth.

An example for a characteristic that affects revenue disabilities is mining revenue, which consists largely of royalties. The assessed revenue raising capacity for Western Australia and the Northern Territory in this category is around four times as high as in the Australian average. This is because these states are rich in minerals and have a large area per capita. By contrast, the revenue capacity in mining is assessed lower than average in the more populous states, where mining plays a less important role.

Box A3.1
Categories for Revenue Assessment (1998)

Taxes
Payroll taxation, land revenue, stamp duty on conveyances, financial transaction tax, stamp duty on shares and marketable securities, gambling taxation, insurance taxation, vehicle registration fee and tax, stamp duty on motor vehicle registration and transfer, drivers' license fee, tax (business franchise fees) on petroleum products, tobacco and liquor, other tax revenue.
Nontax revenue
Interest earnings, mining revenue, electricity and gas, metropolitan water supply, metropolitan sewerage, other enterprises.

Source: Commonwealth Grant Commission.

Adjustment for specific grants

The fact that SPPs from the Commonwealth to the states are at a relatively high level presents a difficulty for fiscal equalization. The receipt of a specific grant changes both a state's revenue and its expenditures. It is debatable however to what extent SPPs represent disabilities according to the definition above. To achieve full equalization, other grants received from the federal government need to be counted as revenue. However, this runs counter to some of the intentions behind specific grants because the recipients of SPPs are subsequently punished by receiving less in block grants. However, there is no evidence yet that any state has refused a specific grant offered to it for this reason. This may be because CGC bases all its assessment on a period of five years, averaging out year-to-year fluctuations. The money received through SPPs thus reduces block grants only after a lag of several years.

CGC is now including most SPPs in the calculations, so that differences in the per capita allocation of specific grants between states are almost fully compensated by the allocation of block grants. The adjustment for SPPs has the effect that the states that benefit from equalization receive slightly less than they would if SPPs were excluded (Table A3.1, column [4]). This is because the states that need more financial assistance generally also receive more specific grants.

CONCLUSION

The Australian grants system is a technically sophisticated way to address vertical and horizontal fiscal imbalances. However, it has to be kept in mind that the system of intergovernmental fiscal relations in Australia exists in a very favorable environment. The nature of relations between the federal level and the states, and to a certain extent between states, is generally cooperative. The Australian federation as a whole is relatively homogenous and stable. The small number of States and the fact that there are only two levels of government that are important fiscally, help to make the system workable. Applying the same principles in a different environment may not be possible politically, or may not yield similar results.

Regarding the technical implementation of fiscal equalization, the Australian example shows that it requires a substantial amount of technical resources. Australia has a sophisticated statistical system both on the national and the regional levels, which is essential for equalization. Even with this superior statistical base in a relatively small country, CGC is quite a large organization, taking up substantial resources. It is far from clear how a similar system would perform under less favorable conditions. In Indonesia, a similar system of fiscal equalization would probably be only feasible if the assessment of revenue and expenditure were restricted to some core categories.

Studying intergovernmental fiscal relations in Australia can provide important insights and ideas for reform in Indonesia. Ultimately however each country needs a system tailored to its specific requirements.

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Appendix

THE COMMONWEALTH GRANTS COMMISSION

Background and Interview with Bob Searle, Secretary of the Commission

The Commonwealth Grants Commission (CGC) is an independent statutory authority that provides advice to both the Commonwealth and state governments on the distribution of the pool of general revenue assistance. It is only concerned with the distribution, not with the total amount of block grants paid to the states. The size of the pool is negotiated annually between the federal and state governments.

CGS's motto is "equality in diversity," expressing the aim of providing states with equal financial capacity while leaving them free to make their own decisions on taxation and service provision.

CGC was established in 1933, in the wake of the attempted secession of Western Australia, to assess claims made by states for financial assistance. It was thus concerned only with claimant states' minimum financial need, not overall fiscal equalization. The role of CGC changed and was expanded with the introduction of general revenue-sharing arrangements in 1976 that necessitated the calculations related to horizontal fiscal equalization. It conducts a full review of relative attributes (relativities) and the methodology used to calculate them at five-year intervals. In between these reviews, the relativities are updated annually, using the latest available data but retaining the same methodology. CGC does a substantial amount of statistical analysis, and it even conducts some original data collection, mainly in the area of expenditure assessment.

The commission is headed by four part-time members who are appointed for a limited period by the federal government after consultation with the state governments. The commission has a permanent staff of around 50.

Overall, CGC is considered an integral part of Australia's federal structure, with an important role in promoting fiscal and political stability between the state governments and the Commonwealth government. It can be credited with fulfilling its role as a competent technical advisory body, in effect acting as an impartial arbiter between atate governments.

Interview with Bob Searle, CGC, Canberra, 10/12/98

How many out of the 50 staff of the Commonwealth Grants Commission are technical?
All but four or five of the 50 staff work in a technical environment, their background mainly being in statistics, economics, and accounting.

How important is technical work relative to negotiating the state's interests?
The Commission is not involved in any negotiations with the states. All its work is on technical aspects of fiscal equalization.

How close is the cooperation with the states?
The states are involved in the technical aspects of the Commission's work, and there is communication with the states at all stages of the process of determining the relativities. The states are particularly involved in the reviews of methodology, to a lesser extent in the annual updates.

With which state institutions does the Commission have contact?
The states communicate with the Commission principally through their state treasuries. All other arms of government channel their participation through the treasuries. Submissions are the main instrument for the states to put their arguments forward. There is a formal process for these submissions to the Commission, and states also comment on each other's submissions. The Commission also has some contact with other state departments, for example, education, health, and police. This is important for expenditure assessment.

How closely does the Commission keep the states informed of its work?
In the three years leading up to the review of methodology to be published in February 1999, there have been approximately eight conferences with the states on technical matters. The Commission also produces detailed working papers on past assessments. These were originally exclusively for the use of the states but are now distributed to reference libraries also.

Do the states have an influence on Commission methodology?
Yes, they do. It is necessary to find a basis of assessment which is fair to all states. The most important influence the states wield is by proposing areas to be used to identify disabilities.

Do the losers accept technical arguments?
There is general consent on the technical ability of the Commission. Whether states agree on particular assumptions underlying the relativities calculations in another

matter. Generally speaking however, the states are very accepting of the Commission's judgements. They know that they are dealing with an expert body, and that they themselves could not do it any better.

How does the appointment process for the Commissioners work, and is there proportional representation in terms of party politics?
Commissioners are appointed for their particular expertise rather than their representational role. The only condition is that the commissioners cannot be full-time employees of a state or the federal government, since they might then be seen as being biased.

What happens in the appointment process is that the heads of the Commonwealth and state treasuries get together and consider names. It is a cooperative movement—if any of the parties involved has an objection to a particular candidate, that person will have little chance of becoming a commissioner.

Have there been swings in the Commission's position on equalization?
No. The Commission developed the concept of fiscal equalization in the 1930s. There has been a development process over time, but as for changes in the federal government, there has been no political involvement.

The Australian parliament is currently debating a tax reform proposal. It includes the introduction of a value-added tax levied by the central government, the revenue of which will be distributed to the states. Will there be changes in the Commission's role after the tax reform?
There will be very little difference for our work. The revenue from the new value-added tax will be distributed to horizontal fiscal equalization principles, and the Commission will continue to determine the equalization formula. The only difference is that the states will have less own revenue, because they will have to stop levying some of their taxes.

From the Commission's point of view, should there be less specific grants?
The Commission is not concerned about the extent of special purpose payments, as long as they can be included in the Commission's assessment. Currently, they are accounted for in the calculation of relativities and do not negatively affect horizontal fiscal equalization. In fact, SPPs can serve good purposes, and the Commission acknowledges that.

From the point of view of the Commission, would it be desirable if the Commission had influence over the amount of general revenue to be distributed, too?
That really has never been a concern. For horizontal fiscal equalization, control over the amount of funds to be distributed is not necessary, as long as the level of funding available is high enough. That is of course the case.

We deliberately do not see ourselves as giving economic policy advice, such as on the total amount of grants payments. Otherwise, we might be seen as an arm of government. We need a high level of independence for our work.

Can or should the Commission be a model for other countries?
I think all federations are different, so they should have different systems of fiscal transfers and equalization. There has been a continuous stream of interest from other countries in the Australian system, and it has frequently been studied. That probably speaks for itself.

Can the Commission assist countries that want to reform intergovernmental fiscal relations, and how?
We frequently have officers from other countries visiting, and some are staying with us for some time. The topic they usually focus on is expenditure equalization. Our involvement is through technical cooperation programs, organized by international agencies such as the World Bank and the IMF, or AusAID.

What are the most recent examples for technical assistance to developing countries?
South Africa has modeled its new system of intergovernmental fiscal transfers on the Australian system. The ANC had contacts with us even before Mandela was elected. After the election, members of the South African commission came here.

More recently, China has initiated an international search for suitable models of intergovernmental fiscal relations, and is now concentrating heavily on the Australian system.

Annex IV

THE PILOT INTERGOVERNMENTAL TRANSFER SCHEME OF 1995-1996 IN THE PEOPLE'S REPUBLIC OF CHINA[1]

A transitional transfer payments scheme was introduced in 1995 as the first step toward a formula-driven redistributive system. The initial formula had two parts: an objective factor that attempts to measure the gap between standard expenditures and local fiscal capacity, and a policy component that directs subsidies to regions with large ethnic minority populations. In 1996 a third factor was added to the formula to reward good tax effort. Since then more tinkering has been done.

The 1996 formula for transfer was as follows

Transfer to province i = f(measured fiscal shortfall of province i) + g(special transfer to province i as a minority region) + h(province i's good tax effort)

The fiscal shortfall is measured as

Standard expenditure = standard wage expenses + standard administrative expenses + agriculture and other productive expenditures + other expenditure

where

- *standard wage expenses* are derived from standard wages, number of civil servants, and a regional wage factor;
- *standard administrative expenses* are those for government administration, police and security, and other government agencies. In 1995 the actual expenditures for all government units were included. In 1996 this was shifted to include personnel and running costs for fully funded units, and lump sum costs for units that received only partial funding from the budget.
- *agriculture and other productive expenditures* are expenditures for agriculture and other productive departments.
- *other expenditure* includes price subsidies.

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[1] World Bank.1998. Managing Public Expenditures for Better Results. Washington, D.C. Annex 9.

The policy component, or special transfers to province i as a minority region, also calculates the fiscal gap between the minority regions and the national average as

$(NR - PR_i) \times POP_i$

where

NR = national per capita revenue; PR_i = province i's per capita revenue;
POP_i = population of province i

The coefficients a_1 and a_2 are determined ex post, as the ratio of funds available for transfer divided by the size of the gap. For example, in 1996 the central government had Y2.2 billion to devote to equalization transfers, compared with a fiscal gap of Y63 billion. So a_1 was derived as 0.035. Similarly, the total fiscal gap for minority regions was estimated at Y13 billion in 1996, while the amount allocated to filling the gap was only Y1.2 billion in the central budget; the coefficient a_2 was derived as 0.09.

Finally, the tax effort reward was derived in 1996 as follows: if province i had revenue growth in 1995 that exceeded the national average, then the total transfer to province i would be supplemented by the coefficient a_3, where

$a^i_3 = 0.5 \times (r^i - r)$
and
r^i = revenue growth of province i
r = national revenue growth

so that

$$\textbf{(Transfer to province i)}_t = \{(1 + a_3^i) \times [\, a_1 \times (\text{standard expenditure}_i - PR_i \times POP_i) + a_2 \times (NR - PR_i) \times POP_i]\}_{t-1}$$

and t = current year, t - 1 = previous year

In other words, the transfer to province i for 1997 will be based on its fiscal gap and tax effort in 1996. The system should be recognized as transitional and does not obviate the urgent need to get a more appropriate transfer scheme installed.

Recommendations for Improving the Pilot Scheme

For the transfer scheme to be effective, it must be more adequately funded. The scheme was allocated only Y2 and 3.46 billion in 1995 and 1996, respectively. These comprised just over 1 percent of the total of nearly Y300 billion in central transfers to the provinces in 1996 and was dwarfed by the tax rebates of Y195 billion. Because of the small sums allocated, their effect on the distribution of fiscal resources is marginal: the coefficients a_1 and a_2 are very small, so that the scheme provides only a very weak link between a province's fiscal need and their transfers.

At present the scheme mixes two sets of considerations: fiscal need and support for ethnic minority regions. These objectives should be kept separate, with one equalization scheme that provides transfers according to need (plus a tax effort factor), and the other scheme to support ethnic minorities reported separately. The total of Y3.46 billion spent on the pilot scheme in 1996 was in fact split into Y2.2 billion for the equalization scheme, and Y1.2 billion for the minority's scheme.

The transitional scheme duplicates the old pre-1994 equalization transfers under quota subsidies, which totaled Y11.1 billion in 1996 and were heavily biased toward minority regions. These schemes should be merged as soon as possible—if the pilot scheme is considered an improvement over the quota subsidies, then it should simply absorb and replace the quota subsidies.

The tax effort measure takes the gap between national revenue growth and the provincial revenue growth. This is a convenient proxy that should be replaced by better measures as better data become available. Provincial revenue growth depends on too many factors other than tax effort, most notably economic growth and structural change.

Finally, it is urgent that the pilot transitional scheme be replaced by a model that measures fiscal needs more appropriately. At present, the measured fiscal gap only considers the personnel and running costs of government, with wage costs weighing heavily. This reflects the short-term concern in meeting payroll requirements. In the long run, however, it is more appropriate to look at fiscal needs in terms of the costs of providing services such as education, health care, government administration, public transport, water, sewerage, and sanitation services. This package of fiscal needs should contain not only wages and running costs but also some capital costs for building schools, clinics, roads, etc. Regional cost differentials in providing these services must also be included in the calculation of fiscal need—the present regional factor contains only a small differential for wage supplements and is insufficient.

NOTES

[1] See Shah (1994) and Ter-Minassian, ed. (1997).
[2] See Prudhomme (1994).
[3] Drawn in part from Bahl (1999), Ebel and Yilmaz (1999), and Prud'homme (1994).
[4] This section and the following are drawn from a number of authors: Rodden (2000), Ter-Minassian (1997), Bahl (1998, 1999), Shah (1998), Bird and Wallich (1993), Wallich, ed. (1994), Ebel and Yilmaz (1999).
[5] Bird and Wallich (1993).
[6] See McLure (1998), cited in Bahl (1998).
[7] Problems have however been experienced in the US where subnational governments regularly raise tax rates during periods of economic contraction, thus worsening the situation.
[8] US cities compensate for this by levying local income tax on commuters as well as residents. In Russia, the personal income tax is fully returned to the local government of the place of employment and none to the place of residence. As labor mobility increases and housing becomes less scarce, this will become a significant problem with personal income tax sharing in Russia.