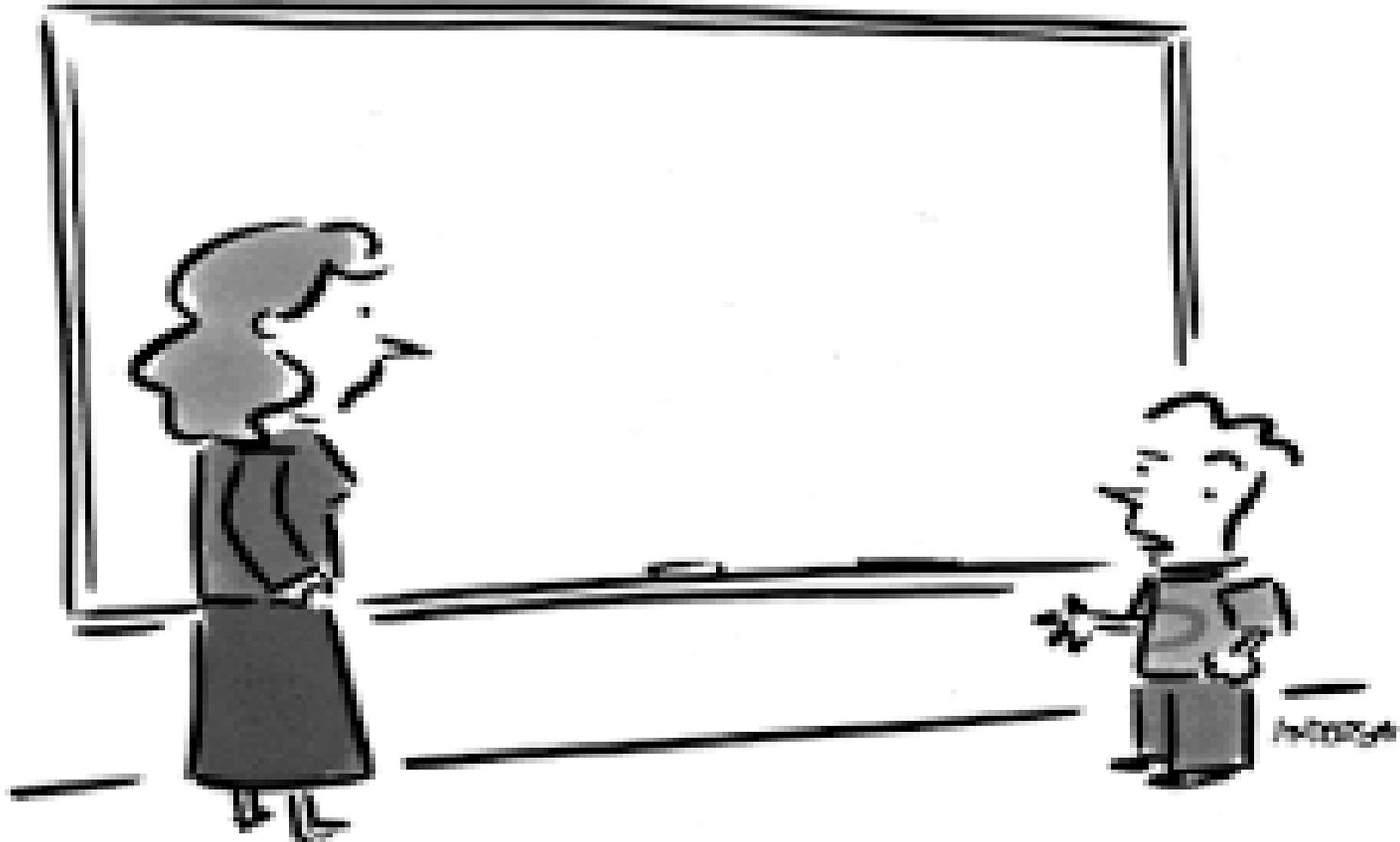


# The Art of Fiscal Decentralization

Principles, practices, problems and pathways

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“Before I write my name on the board, I’ll need to know how you’re planning to use that data.”



We should approach fiscal decentralization as a integrative and comprehensive system.

(1) Expenditure Assignment

(2) Revenue Assignment

(3) Intergovernmental Transfer

(4) Subnational Borrowing



# Why Fiscal Decentralization?

- We are moving the government closer to the people.
- Efficiency: Decentralization allows the subnational government to provide services that are mostly in line with the preferences of the people at the lower level of administration.
- Responsiveness- it is quicker for the subnational government to respond to the needs of the people.
- Accountability- it is more effective for subnational government to be held accountable for the quality of services provided to the people at the lower level of administration.
- Subnational Autonomy: Increase fiscal autonomy of the subnational government, thus leading to lower concentration of political power, lowering the damage of corruption and strengthening democracy and competition.



# Some General Problems

- Administrative capacity of subnational governments (lack of technical, bureaucratic and logistic ability to collect regional tax revenues and inability to formulate and implement public programs)
- The size of Local corruption and local administration.
- Inability to develop national public expenditure systems

# East Asia Decentralizes (WB 2005)

From 1990s several East Asian countries including Cambodia, China, Indonesia, Philippines and Thailand were starting their transition from highly centralized to decentralized systems of government.

*Structural factors:*  
Sustained periods of growth and urbanization

*Political factors:*  
Move to more open and democratic governance systems

*Fast starters:*  
Philippines (late 80s)  
Indonesia (late 90s)

*Gradualists:*  
China (80s and mid 90s)  
Vietnam (late 90s)

*Cautious movers:*  
Thailand (late 90s)  
Cambodia (late 90s)

*Initial challenges:*

- Development of policy frameworks unrelated to pace or appetite for reform.
- Oversight and regulation of new intergovernmental arrangements were underdeveloped.
- Conflict between central-local authorities and between politicians and bureaucracy.





## Expenditure Assignment

- Definition...it is the assignment of responsibilities or functions amongst different layers of the government.
- This is the first and fundamental step in the design of intergovernmental fiscal system.
- **WHY???**



## One Cardinal Rule of Expenditure Assignment

- “Finance follows Function”
- Function: Establishing clear definitions and demarcations of expenditure functions and needs at different layers of the government.
- In other words, we should first define the roles and responsibilities at different layers of the government.
- Without clear definitions of expenditure function, revenue assignment would lead to instability, inefficiency in the delivery of public services.



Generally, there is no general governing principle except for subsidiarity principle.

- Responsibilities for the provision of services should be at the lowest level of the government that is compatible with the size of the “benefit area” associated with those services”.
- “each public service should be provide by the jurisdiction having over the minimum geographical area that internalize benefits and costs of each provision.” (Oates)



# When to centralize expenditure assignment

## (I) Externality:

The central government may provide the service when the provision of service in a given jurisdiction provides positive and negative externalities that spill over to other jurisdictions.

Such a jurisdiction would have the incentive to underprovide services with positive externalities because other jurisdictions are also sharing benefits of the services.

Similarly, there will be overprovision of services with negative externalities because other jurisdictions are also bearing the cost of the services.



## (2) Macroeconomic Stability

- Costs and benefits of macroeconomic stability are widely shared within the boundary of a country.
- Hyperinflationary pressure or exchange rate crisis require an massive intervention from the central government.



### (3) Economies of Scale

- When efficiency of the provision of a service is an increasing function of the scale or the size of the production.
- In other words, when the costs of provision for a given public service is sufficiently high for a given geographical area.
- There may be a case for centralization of expenditure function.



## General Pattern of Expenditure Assignment

- Central government (Defense, foreign affairs, foreign trade, and migration)
- Sub-national government (Local police, fire, sanitation, transportation, utilities, primary and secondary education.)
- Concurrent expenditure (health, infrastructure)

# Examples of expenditure assignment

Function	China	Indonesia	Philippines		Thailand		Vietnam
			Responsibility	Provision	Responsibility	Provision	
Defense	C	C	C	C	C	C	C
Foreign affairs	C	C	C	C	C	C	C
Environment and natural resources	C, R, L	...	...	...	...	...	C, R, L
Unemployment insurance	L	...	...	...	...	...	...
Industry and agriculture	C, R, L	L	...	...	...	...	C, R, L
Education	L	L	C	C, R, L	L	L	C, L
Health	L	L	C	C, R, L	L	L	C, L
Social welfare	L	L	C	C, L	L	L	C, R, L
Police	L	C	...	C, L	L	L	C
Highways	C, R, L	C, R, L	...		L	L	C, R, L

Sources: "East Asia Decentralizes. Making Local Government Work" World Bank, Washington, DC, 2005

C= Central (National), R=Regional, L=Local, (...) = not identified

## In general...

<b>Responsibility</b>	<b>Expenditure category</b>	<b>Comments</b>
<b>Central</b>	Defense, postal services, national highways, ports and civil aviation	Such services provide benefits beyond a single jurisdiction, benefits and costs are spread nationwide
<b>Local</b>	Local roads, fire protection, water and sewage, parks, police	Primarily local benefits
<b>Shared</b>	Education, health, social welfare	Significant spillovers, benefits are not only local, but nationwide as well



# Some Problems

## (1) **Mis-sequencing between revenue and expenditure assignments.**

- It is more politically convenient to start with revenue assignment and then stumbles onto expenditure assignment.
- **(2) Lack of clarity and formality in expenditure assignment**
- Poorly designed revenue assignment
- Populist and pork-barrel projects at the subnational level rather than long-term development project.
- Inefficiency due to inconsistencies and conflict between poor expenditure assignment, revenue assignment and intergovernmental transfer.



# More Problems

- **(3) Misassignment of expenditure function**
- When there is a mismatch between the nature of the function and the level of the government to which the function is assigned.
- In Vietnam, the assignment of expenditure for national defense to the subnational government
- The assignment of local drainage provision to the national government.
- Expenditure for national defense and security and certain foreign policies are co-shared at various levels of the government in Vietnam. Why not clear and exclusive assignment?
- Expenditure functions for pensions, unemployment and income support schemes are assigned at some lowest levels such as county-level governments in China.



# More Problem

(4) Lack of clarity between the role of public and private sector in service provision in transitional economies

One of the legacies of the command and control economy in transition economies is the concentration and control of responsibilities at the national level and the public sector.

What is the role of the state?

**The role of the state is primarily restricted to address market failure.**

- (1) When the markets are inefficient (externality, imperfect information, thinness of markets...etc.
- (2) When the market generates inequalities

However, in REALITY....????



# Revenue Assignment

- The assignment of revenue to subnational levels of government
- (1) Tax Revenue (2) Non-Tax Revenue



# Assignment of Tax Revenue

- (a) Which level of government chooses the taxes, from which subnational governments receive revenues,
- (b) which defines the tax base(s),
- (c) which sets the tax rate(s), and
- (d) which administers the tax(es).

The autonomy to set the tax rate at the subnational government is the most significant dimension of revenue autonomy or fiscal decentralization.



## General principles of revenue assignment

- (1) Less mobile tax bases (to preclude the movements of factors of production)
- For example: Property Tax
- (2) Taxes with low income elasticity. (to stabilize the subnational government from cyclical fluctuations and provide revenue buoyancy)
- (3) Tax bases that are evenly distributed across regions.



## USER CHARGES

- Fulfill the “benefit principle” (those who benefit from the provision of services should pay the tax).
- Usually wide spread on local level
  - health service. building permits. market service, ID and birth certificate, Garbage collection fees, Motor vehicle inspection, Animal registration
- Should focus on a few high revenue-yielding items.
- clear parameters for setting prices for particular service



# Personal Income Tax

- Pros
  - Substantial revenue source
  - Provide moderate or low level of economic distortion
  - Easy to administrate if piggybacked on a central government PIT
- Cons
  - Where to pay: residence vs. origin principle
  - taxation based on the filing of tax declaration (residence principle)



# Corporate Income Tax

- **Pros**

- Substantial revenue source

## **Cons**

- (1) macroeconomic stabilization role
- (2) Difficult calculation of tax base and often compliance problems
- (3) Usually suffer from uneven and unfair distribution of tax base
- (4) Could lead to tax-induced factor movements



# Revenue Sharing

- transfer of funds by assigning a predetermined share of the revenue from the higher level of the government to the lower level of the governments.
- Types of sharing
  - (1) Principle of Derivation
  - (2) Formula-based
  - (3) Surcharge



# Principle of Derivation

- revenue sharing is based on the national revenue derived within the subnational entities
- the least attractive form of revenue sharing because it severely restricts the fiscal autonomy of the subnational governments

# Central and Local Revenues in China, 2005

Items	Total Government Revenues (Billion Yuan)	Central Government (Billion Yuan)	Sub-National Government (Billion Yuan)	Sub-National Sharing Ratio (%)
<b>Central Tax</b>				
Tariffs	106.2	106.62	0	0
Consumption Tax	163.38	163.28	0	0
Consumption Tax and Value-Added Tax on Imports	431.18	421.18	0	0
Vehicle Purchase Tax	58.33	58.33	0	0
Cargo Tax	1.38	1.38	0	0
<b>Shared Tax</b>				
Value Added Tax	1079.21	793.14	286.08	27
Business Tax	423.25	12.96	410.28	97
Stamp Tax on Security Exchange	6.73	6.53	0.2	3
Personal Income Tax	209.49	25.69	83.8	40
Company Income Tax	534.39	320.4	213.99	40
<b>Local Tax</b>				
Urban Maintenance and Development Tax	79.57	0.47	79.1	99
Tax on Contracts	73.51	0	73.51	100
Resources Tax	14.22	0	14.22	100
Tax on the use of Arable Land	14.19	0	14.19	100
Urban Land Using Tax	13.73	0	13.73	100
Agricultural and Related Tax	5.94	0	5.94	100

Shen, Chunli, Jing Jin, and Heng-fu Zou, 2012, Fiscal Decentralization in China: History, Impact, Challenges and Step Forward. *Annals of Economics and Finance* 13, Table 4. P.15



# Practices

- In China, the principle of derivation governs the sharing of VAT and CIT between the center and the subnational governments.
- Tax revenues are concentrated in a small number of provinces
- Formula-based Revenue Sharing: The formula for VAT could include parameters such as provincial population, GDP, or level of consumption per capita
- the formula for the CIT could include labor (payroll), capital (assets) and output (sales).



# Revenue Sharing in Alaska

- Property Tax (2 percent on appraised value)
- Severance Tax on Oil
- Tax per barrel
- Royalties
- Production surcharge for hazard
- Corporate income tax (9.4% of apportioned income as a function of (1) percentage of corporate sales and tariffs from Alaskan Operations (2) percentage of production in Alaska (3) percentage of property holdings in Alaska.



# Intergovernmental Transfer

- A transfer of funds among or between different levels of government.
- Intergovernmental transfers and assignment of revenues cannot be considered separately from assigning the expenditure responsibilities
- Without a clear demarcation and understanding of competencies and expenditure obligations of different levels of government, decentralization create instability and controversy.



# Vertical Equalization

- **Vertical fiscal imbalance (VFI)**  
describes the variance between a central government's revenue and expenditures against those of subnational governments.
- **Equalization measures:** Increase subnational revenue, revenue sharing or intergovernmental transfer.



# Horizontal Fiscal Imbalance

- Differences among the same levels of sub-national governments in their revenue bases and expenditure needs
- Intergovernmental transfer as an equalization payment to compensate for differential expenditure needs and revenue raising abilities of different states.



# Financing

- Why choose grants over sub-national taxes?
  - Central government is better able to control sub-national spending
  - Sub-national taxes may have distortionary effects
  - Sub-national taxation may lead to high inequalities
  - Sub-national taxes may have high administrative and collection costs
- Why NOT choose grants over taxes?
  - Taxes allow sub-national authorities to adapt the level of services to local preferences
  - Asymmetric information and efficient allocation of resources
  - Taxes come with increased accountability
  - Sub-national authorities can't blame grants for the poor quality of services

# Does revenue = expenditure?

- Local – Uneven: some raise enough others raise very little as a proportion of own.
- To Balance this equation = Intergovernmental Transfers



# General-Purpose Transfers

- General-purpose transfers are provided as general budget support, with no strings attached
- block transfers when they are used to provide broad support in a general area of subnational expenditures (such as education) while allowing recipients discretion in allocating the funds among specific uses



# Specific-Purpose Transfers

- Specific-purpose, or conditional, transfers are intended to provide incentives for governments to undertake specific programs or activities. These grants may be regular or mandatory in nature or discretionary or ad hoc.
- input-based conditionality (types of expenditure, capital and operating expenditures)
- output-based conditionality (service delivery)
- Performance-based grants



## Conditional matching transfers

- finance a specified percentage of expenditures using their own resources.
- open ended--- the grantor matches whatever level of resources the recipient provides.
- closed ended--- the grantor matches recipient fund only up to a pre-specified limit.



## Intergovernmental transfer formula

- Fiscal Capacity Equalization using –  
Macroeconomic Indicators  
– Representative Tax System
- • Fiscal Need Equalization through  
Representative Expenditure System



# Fiscal Capacity

- How to Measure of Fiscal Capacity:
- Fiscal capacity is the potential ability of a subnational government to raise revenues from its own sources relative to the of cost of its responsibilities

## **Macroeconomic Indicators**

- (1) State Gross Domestic Product
- (2) State Factor Incomes
- (3) State Factor Incomes Accruing to Residents only
- (4) Personal income
- (5) Personal disposable income



# Representative Tax System

- As the representative tax yield for a subnational government can be calculated by multiplying the state's base by the national average tax rate
- The purpose of the RTS is to measure the own-revenue-raising-ability of subnational governments.
- consistent estimates of the potential revenue that could be raised in each subnational government under a standardized tax policy.



# Representative Expenditure System (RES)

- The estimates of representative expenditures indicate how much it would cost a subnational government to provide an average level of public services that actually prevailed nationwide.
- Example: Fiscal Needs for a highway program:
  - (i) the number of registered private and commercial automobiles; (ii) the number of registered truck; and (iii) population density,
- the derivation of the workload measure involves estimating the number value for each province.



## Practices (Indonesia)

- fiscal capacity approach
- calculated as a function of estimated own revenues, realized tax shares for each tax for each state and 5 % of realized natural resource revenue shares while provincial own-revenue estimates (PAD) were derived as a function of provincial manufacturing and services GDP.
- This approach is based on measuring the extent to which the subnational governments are utilizing their available tax bases relative to the national average.



# Practices in Myanmar

- The transfers are made based on two broad criteria- development needs and fiscal constraints.
- Under the criteria of development needs, there are three parameters- total populations in states/regions (from 2014 Population and Housing Census), State/Region Poverty Index (from Integrated Household Living Condition Assessment 2009/10) and total land area (Square Kilometer).
- Fiscal constraint dimension consists of three variables- Per Capita GDP of states/regions (From Planning Department), Urban Population as a percentage of the total population from 2014 Population and Housing Census), and Per Capita tax collection from previous fiscal year.



# Issues

- What is the impact on equalization payments to horizontal and vertical fiscal imbalance?
- Independence of parameters
- Data limitation and measurement error



# The art of Decentralization

- General Principles and Formulas
- broad based consultations on the design and implementation of the intergovernmental fiscal system
- Sensitivity of political, social, historical and cultural contexts.