

Scientific Background: Theme Paper

Richard Bird, Bernard Dafflon, Claude Jeanrenaud and Gebhard

Kirchgässner

Assignment of Responsibilities and Fiscal

Federalism

1. Introduction

Over the past 30 years, a clear trend has emerged worldwide towards the decentralisation of spending and revenue-raising responsibilities to sub-national levels of government (states, regions, provinces, cantons, Länder) and to the third tier (the local, communal, municipal level). For Ter-Minassian (1997, 3), “this trend is evident not only in federal, but also in many unitary countries, including some that have a long tradition of centralist government”. Political developments in post-communist Central and Eastern Europe (the countries in transition and the Balkans), together with recent discussions in the European Union (EU), and new trends in Latin America, Asia and Africa, show that this tendency does indeed exist worldwide. Decentralisation requires us to rethink the role and responsibilities of the various government layers in relation to the traditional policy objectives of allocation, distribution and stabilisation. Fiscal federalism can no longer be accepted solely as an “economically efficient” means of providing and financing public services. Decentralisation can more effectively promote democratic and participatory forms of government, seeking to improve the responsiveness and

accountability of politicians and bureaucrats, and to ensure closer correspondence of the basket of publicly provided goods and services with the preferences of beneficiaries and taxpayers in the various sub-central jurisdictions. Carried out efficiently, fiscal federalism or fiscal decentralisation can provide an alternative to the market as a way of promoting the coincidence between the three circles of budgetary policy: those who decide, those who benefit, and those who pay.

The argument that decentralisation of spending responsibilities and revenue sources promotes efficiency and welfare has a long history in economic literature. But for the purposes of this discussion, we can start with what may be called the TOM model of fiscal federalism, after the first modern authors (Tiebout, 1961; Oates, 1968; and Musgrave, 1961) who built the existing theoretical parts into a consistent and coherent framework. The canonical view is that decentralisation has definite advantages in the allocation branch, but can entail significant costs in terms of re-distributive policy and macroeconomic management. The theory is based on four key assumptions: local public goods, the territorial variant of benefit taxation, mobility, and no spillovers. The main analytical task of fiscal federalism has been to define the appropriate assignment of allocative responsibilities to decentralised government levels and matching revenue sources. Initially, distribution and stabilisation were considered essentially “central” responsibilities (Oates, 1999, 1121).

Much of the established theoretical literature of fiscal federalism has been based on issues that arose within developed countries in a quest for

efficiency. Thus, consideration of economic decentralisation alternatives is littered with normative problems and propositions:

- The best assignment of responsibilities (but who assigns?);
- The tier most capable of performing this or that function, often paying too little attention to the distinction between decentralisation, devolution and de-concentration (Bird, 2001, 3);
- The highest capability of managing the production function;
- How to gain economies of scale and internalise benefits, and the costs of such provision;
- The right level of government at which taxes should rest;
- Why there should be fiscal competition, but no tax competition;
- Why and how fiscal disparities should be corrected.

The value judgments from which such prescriptions derive may be clearly articulated. But this commonly amounts to the allocative and distributive propositions associated exclusively with economics, perhaps embellished by minor additions that recognise certain distinctive local characteristics of federalism.

The objectives and relationships of federal countries are much more complex than this. They cannot be confined within a framework that treats general resource-allocation and income-distribution questions as the only, or even the predominant, policy problems. Evidence for this interpretation is to be found both in the general suspicion of economists' prescriptions among policy makers, and in the otherwise surprising lack of communion between

economists' writings on federalism and that of other specialists, such as political scientists, constitutionalists and politicians. The fundamental criticism is that for many years, students in the theory of federal public finance, with a few exceptions (Wiseman, 1989 and 1990; Wildasin, 1997), have treated economic objectives as separate from the political and constitutional aspects of federation. Policy-oriented research has clearly demonstrated that the tendency in public policy discussion to distinguish between economic objectives on the one hand, and political and constitutional objectives on the other, was inappropriate. When the constitutional and regional aspects of federalism are considered, there are certain constraints on federal public policies. These cannot conveniently be waived either by assuming a "centralist" federal structure, or by postulating that federal constitutions may easily be adapted to fit in with the policy norms derived from economic arguments. The theory cannot neglect the fact that the constitutional (formal) reservation of power to sub-national levels of government, places the conflict of policy ends versus means in the centre of the picture. And this alone adds a dimension to the study of fiscal policy that is perhaps more significant here than in other policy environments.

Real world fiscal arrangements rarely follow the idealised model; they are loaded with historical developments and political ad hoc solutions. It would be very difficult to change them in a significant way following the canon of fiscal federalism, especially when they are specified in the countries' constitutions. It is simply not realistic to start from tabula rasa. In any case, are economic fundamentals the only adequate logic of good governance? What about the significance – and the policy consequence – of a top-down versus a bottom-

up political procedure for the assignment of functions and revenues at (de)centralised levels? It is clear that while the theory is a powerful tool for understanding the key issues, it does not lead to solutions for specific situations.

On the other hand, comparative studies of specific issues in various countries contain a wealth of information on the great variety of national experiences, which help to reformulate the conceptual or theoretical underpinnings.

According to Ebel and Yilmaz (2001, 2):

“Developing countries are turning to decentralisation to escape from the traps of ineffective and inefficient governance, macroeconomic instability, and inadequate economic growth ... Throughout post-communist Central and Eastern Europe, decentralisation of the state is the direct result of the transition from socialist system to market economy and democracy ... In Latin America, the origin ... is the political pressure from the people for democratisation ... In Africa, decentralisation has served as a path to national unity ...”

This diversity of causes and reasons creates a challenge to understand, appreciate and compare fiscal federalism and decentralisation across different countries, and to present a general framework helpful for understanding the issues and policy-design for adequate solutions in the various national situations. With three main themes, the present conference is a tentative multidisciplinary answer to this challenge.

2. A general framework

This paper is organised in the following way: this section presents in general the major policy-relevant topics in inter-governmental fiscal relations, while in the following section we develop four major issues, selected as subthemes for this part of the conference owing to their importance and actuality. First let us consider fiscal federalism and decentralisation in general. What have been the most frequently debated issues during the last decade, on which both theoreticians and practitioners should concentrate their analytical efforts, and for which a common applicable positive theory is needed? As a possible gateway to this question, the following table summarises several recent publications on inter-governmental fiscal relations. The authors or institutions that produced these texts (mentioned in the top line), are all involved in practical policy design, policy making or training programs at the forefront of decentralisation. In the first vertical column of the table, 19 major topics are enumerated, all of which are mentioned or analysed in detail in the given sources. In counterpoint, we have introduced in the last column the issues that were initially proposed for the preparation of the sessions on fiscal federalism. One can readily see in the table that some topics, like those numbered 5 to 8, are present in each selected source. From this frequency, one could infer that they are essential to the understanding of fiscal federalism and decentralisation. Others like the concept of decentralisation (1), budgeting (10), borrowing and debt (11), score four or five times, thus giving a good image of actual problems. Some topics have been left out of the debate: these are numbers 4, 7, 11, 12, 15, 16 and 19 in the table. This is not because they

are less relevant or important, but because a selection had to be made for reasons of time and space.

Table 1 Major topics in inter-governmental fiscal relations

	Major topics	WBI	TM	Bird	UI	CoE	LH3
1	Concepts of fiscal decentralisation	X			X	X	X
2	Political mechanism necessary to make fiscal decentralisation work	X			X	X	
3	Constitutional and legal framework	X			X	X	
4	Macroeconomic perspective	X	X		X		
5	Expenditure assignment	X	X	X	X	X	X
6	Revenue assignment	X	X	X	X	X	X
7	Local revenues/taxes	X	X	X	X	X	X
	Territorial variant of the benefit principle			X		X	X
8	Inter-governmental grants, equalisation	X	X	X	X	X	X
9	Financing infrastructure	X				X	
10	Budgeting	X	X		X		X
11	Borrowing and debt	X	X		X	X	X
12	Poverty alleviation	X					
13	Accountability and transparency	X			X		X
14	Measures of decentralisation	X		X			
	Measures of fiscal disparities					X	
15	Tax administration				X		
16	Metropolitan areas			X			
17	Fiscal competition			X			X
18	Functional federalism: drawing new boundaries, alternative institutional structure			X		X	X
19	Minimum service level, guaranteed access to local public goods				X		X

Sources: WBI: World Bank Institute, 2001; Ter-Minassian, T., ed., 1997; Bird R. M., 1999; Conway F. et al., 2000; Council of Europe, 1998; Dafflon, B., Jeanrenaud, C. and Kirchgässner, G., (2001). *Assignment of responsibilities and fiscal federalism*, preparatory mimeo for the International Conference on Federalism 2002, St Gallen.

We now turn to the four subthemes. The first is about political decision structures in fiscal federalism. It concerns two major and highly relevant issues. One pertains not only to topics 5 and 6 but also to topics 10, 13 and 18 in the matrix above. The question that must be asked is: how can federal fiscal structures be augmented with political decision rules in order to get an optimal political and economic outcome of public budgetary processes? The geographical area covered by many locally provided (public) goods and services seldom coincides with the borders of the jurisdictions. Therefore, new forms of federal structure are necessary, which do not make the old ones obsolete, but supplement them. If these problems are solved, the second issue is how the actual budgetary process is to be organised. Concrete budgetary institutions can have a major effect on the fiscal outcome of the jurisdictions. But what is at stake here is really how budgetary procedures can respect democracy and promote accountability.

The second subtheme is concerned with equalisation (topic 8) and fiscal disparities (topic 14). Fiscal equalisation refers to attempts within a federal system of government to reduce fiscal disparities among jurisdictions. Because sub-national jurisdictions do not have the same revenue-raising capacities to meet comparable needs, some sort of inter-jurisdictional financial compensation may be needed, and indeed justified, not only on equity but also on allocative grounds. In addition, since a balance between the assignment of responsibilities and the assignment of revenue sources at decentralised level is not guaranteed over time, fiscal equalisation is becoming increasingly relevant, and a much-debated political issue.

Fiscal competition (topic 17) is analysed in the third subtheme. In developed federations, competition between jurisdictions at the same level is usually valued as beneficial for the provision of public services, because it gives choice to potential residents. But it is not necessarily beneficial for tax, and the issue is hotly debated at the moment in the EU (1997) and in many countries belonging to the Organisation for Economic Cooperation and Development (OECD) (1998).

The last subtheme relates to fiscal decentralisation in transition economies and developing countries. It is transversal to topics 1, 2 and 3. What is the meaning of the terms: decentralisation, de-concentration, delegation, and devolution? And how do we proceed from the existing political and economic organisational structures? These questions, which are at the core of fiscal federalism, are set out in the specific context of transition economies and developing countries. This is a particular challenge, since in these countries, the search for new forms of fiscal arrangement is keen, not only for efficiency reasons, but also to break away from collective ownership and control in transition economies and from colonialism and ethnic strife in developing countries.

3. Selected subthemes

3.1. Political decision structures

3.1.1. Assignment of functions and revenue sources

The main question for any federal structure is which task should be assigned to which governmental level, and how it should be financed. Following the distinction of Musgrave (1959), the government has to perform three main

tasks: changing the allocation by providing public goods and correcting the external effects of private economic behaviour; redistributing income in order to equalise income distribution which is the result of market forces; and stabilising the economic process in order to reduce business cycle fluctuations. The solution usually proposed is that redistribution and stabilisation should be performed at a national level whereas, according to the “correspondence principle” stated by Oates (1972), the provision of public goods should be performed at the lowest governmental level. This allows an approximate correspondence between those who benefit from their provision, those who have to pay, and those who decide on the amount provided. While the correspondence principle is generally accepted and can also be applied to the relation between national and supra-national governmental levels (e.g. to account for the existence of international public goods), the Swiss example shows that, under certain conditions, redistribution can also be successfully performed at the state (cantonal) level. Although today it is questioned whether any government should really try to stabilise business cycle fluctuations at all.

Most traditional discussion takes only the three usual governmental levels into account: federal, state and local government. On the other hand, the geographical area covered by many locally provided (public) goods and services does not always coincide with the borders of the jurisdictions, and this violates the correspondence principle. New forms of federal structure may be necessary, which supplement existing ones. However, even in well-functioning democracies such new elements of the federal structure often

have a “democratic deficit”, because the existing (direct-democratic and/or representative) political structures do not fit with them.

A second issue is which revenue sources should be assigned to which federal level. Principally, there are two different kinds of federal structure to handle this problem: the “Swiss-type” (or “US-type”) and the “German-type”. In the Swiss-type, there is a certain separation between revenue and expenditure of the different federal levels, and each level has its own revenue source. This gives the different political units at state and local levels considerable leeway in designing their tasks and fulfilling their responsibilities. Moreover, it allows a reflection of the preferences of citizens in the different regions of a country. As a result, there is fiscal competition on the tax and revenue side of the public budget. However, this can result in significant disparities between regions, and in some instances demand a well-developed system of fiscal equalisation.

By contrast, the German-type takes all major revenue sources together, and different governmental levels receive (fixed) shares of total revenue, distributed at state and local levels according to certain criteria. The leeway of sub-federal units to collect taxes is strictly limited; there is expenditure competition, but hardly any tax competition between these units. This makes it difficult for them to follow the correspondence principle, because their revenues are more or less fixed. On the other hand, disparities between the regions are, *ceteris paribus*, smaller, and there is less demand for an extensive system of fiscal equalisation.

In reality of course, all federal systems are located somewhere between these two extremes. But as the Swiss and German examples show, there can be considerable variation between different countries.

In a Swiss-type system with tax competition especially, there is the additional question of which taxes should be assigned to which government levels.

Following the arguments presented above, the traditional solution is that progressive income taxes should be assigned to the federal level because they are the main tax instruments used for income redistribution. Thus, indirect and/or property taxes could be assigned to lower levels. The United States tax system is – more or less – designed in this way: for example, sales taxes differ between states, and property taxes between local jurisdictions. On the other hand, it has been argued that progressive taxes, with their built-in tax increase because of inflation and/or economic growth, should instead be assigned to levels where citizens have more ability to control the politicians, i.e. at lower governmental levels, whereas proportional (indirect) taxes might be assigned to the higher levels. This is the Swiss solution, where the value added tax (VAT) is a federal tax, whereas personal and corporate taxes (as well as property taxes) are mainly at the disposal of cantons and local communities. As the two examples below show, both solutions are possible.

- Many problems arise in federal states because sub-national governments are commonly assigned revenue sources that are inadequate to finance the expenditures for which they are responsible. Traditionally, central governments have claimed as their own most of the major revenue sources, notably income, payroll, and sales taxes, leaving little room for sub-national governments to levy their own taxes

on these bases and hence rendering them dependent on federal transfers.

- According to conventional criteria, the only revenues clearly suitable for local and state governments are those they can administer efficiently, and which fall primarily on their own residents. Sub-national governments should not, for example, be allowed to impose taxes that are shifted to other jurisdictions, and it is normally assumed that they are not appropriate jurisdictions to apply progressive taxes. User charges and taxes on land and real estate generally seem to qualify under these criteria; income taxes and VATs do not. Retail sales taxes and excise taxes, such as those on motor vehicles and fuel, in many circumstances may also be appropriate sources of revenue at least for regional (state) governments, which are likely to be able to administer them more efficiently. Taxes on payrolls and labour income may also in some cases be effectively applied by larger sub-national governments, but taxes on capital and business income, other taxes on business, and multistage sales taxes such as the VAT, are clearly unsuitable at any but the national level, both for administrative and policy reasons. Though popular, sub-national business taxes are generally highly distorting and undesirable.

However, the prospect for sub-national revenues sketched above is too limited. Experience in a number of countries shows that personal income taxes and even VAT can be employed successfully as regional revenue sources. The critical element to ensure efficiency and equity is that the sub-national government is politically responsible for imposing its own rate, even

though the most efficient way to administer it is usually as a surcharge on a central tax.

3.1.2. *The budgetary process*

No matter how the assignment problem is solved, another problem remains: that of how the actual budgetary process is organised. One of the major questions is to what extent, and at which governmental level, direct popular rights should be granted in this process. Both Switzerland and the United States have broad experience regarding this question, because in both countries at state (cantonal) and local levels, the forms and extents of such rights vary considerably. The available empirical evidence shows that in most situations, *ceteris paribus*, such rights tend to result in lower public expenditure and revenue, as well as in lower public debt. Moreover, greater participation of the citizens in sub-federal fiscal decisions can reduce the tendency of a “race to the bottom” at these levels, and therefore allow for some income redistribution at state and local levels. On the other hand, decentralised fiscal decisions may make it difficult if not impossible to meet national fiscal objectives, for example the Maastricht criteria. Thus, it has to be asked how federal fiscal structures can be augmented with political decision rules in order to get an optimal political and economic outcome from public budgetary processes.

The budgetary process itself also has to be taken into account. Budgetary rules, such as a strong position of the head of the financial department in the state or local government, transparency rules providing the citizens with reliable information about both sides of the public budget, or rules creating

close connections between public expenditure and revenue, can induce fiscal discipline which might also result in lower public expenditure and/or revenue, as well as lower public debt. Thus, specific budgetary institutions can have a major effect on the fiscal outcome of the jurisdictions. Moreover, transparency of the budgetary process not only allows the citizens to control their (state or local) government more effectively, but also gives them the opportunity to compare the results of different jurisdictions at the same level. Thus it is possible to learn more easily from each other, and in this way improve the budgetary process as well as its outcome.

3.2. Problems of equalisation

Inter-governmental transfers form a large and sometimes predominant portion of lower-level government expenditure. The design of the transfer system therefore plays a key role in federal financial systems. The assignment of tax and expenditure between the centre and sub-national levels is often not coordinated, and lower-level governments have revenues that do not match their needs. This can be explained by the fact that the most appropriate level of government for taxation (the federal government) and the optimum level for applying the policies (sub-national governments) are not the same. This gives rise to a vertical financial imbalance: the federal government has fiscal income available that exceeds its needs as defined by its expenditure assignment, while the local governments find themselves in the reverse situation. Inter-governmental transfers can compensate for vertical fiscal imbalance.

Transfers are a means of allowing the centre to carry out federal policy using lower-level governments. Often, the federal government does not have an

administrative structure that permits it to implement its policy on its own, or the local governments are able to do so more efficiently.

3.2.1. *Objectives of the transfer system*

Inter-governmental transfers target four principal objectives.

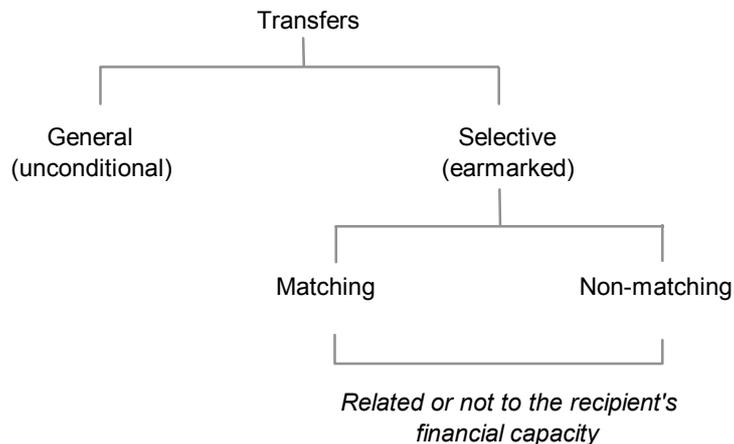
- Correcting vertical fiscal imbalance: transfers are used to fill the gap between revenue-raising capacity and needs.
- Implementing federal public policy through local governments: transfers make it possible to achieve the same result as, for instance, a minimum standard imposed by regulations, while leaving local governments more freedom in the choice of instruments.
- Compensating for jurisdictional spillovers: local government units providing services to people living in other jurisdictions (and thus not carrying the fiscal burden) must receive adequate compensation. The rationale for transfer is both equity and allocative efficiency.
- Reducing horizontal fiscal imbalance and harmonising tax burdens: transfers mean bringing in additional resources to government units with a lower fiscal capacity or too heavy a revenue effort.

In addition to the above-mentioned objectives (main objectives) the transfer system must be organised so as to avoid, to the greatest possible extent, undesirable side effects such as loss of autonomy for government units, incitement to inefficiency, reduced accountability, and high monitoring costs.

3.2.2. *Types of grant*

The design of the specific instruments used, and of the overall transfer system, should match the problems to be solved. There are a large variety of instruments, each with its own effect on the behaviour of the recipient. The taxonomy of transfers is based on a limited number of criteria. First, there is the question of whether the amount received can be used freely (general or unconditional grant) or must be spent for a specific purpose (selective grant).

Figure 1 Traditional transfers categories:



Moreover, the transfer can represent a fixed proportion of the expenditure (matching grant) or bear no relation to it (non-matching grant). The aid received can be reserved for a limited area (narrow-based selective grant), or can be used to finance expenditure in a large area (comprehensive block grant). In addition to types of aid where the amount is based on a formula, there is also aid based on projects where the grantor decides to provide resources, or not, depending on its interest in the project. The theory of fiscal federalism provides a certain number of recommendations that make it possible to select the type of instrument best adapted to each objective.

3.2.3. *Choosing the appropriate grant design*

Several criteria must be considered when selecting the appropriate type of grant: allocative efficiency, cost efficiency, accountability, autonomy of sub-national government units, and equity.

- **Allocative efficiency:** transfers reduce the perceived cost of services in sub-national jurisdictions, thus distorting local spending priorities. Consequently, transfers lead the recipient to offer services that do not correspond to local preferences, or that lead to a loss of well-being. The value of the service for the population is then less than what should have been spent in order to produce it. A selective transfer linked to expenditure (a selective matching grant) is the one that produces the greatest inducement effect, and thus also creates the most distortion in local priorities.
- **Cost efficiency:** firstly, the reduced tax price of services favours lower efficiency and higher costs. In fact, incitement to put pressure on costs is reduced when expenditure is largely covered by federal government funds. The federal government would then benefit most from cost reduction. From this point of view, grants based on products (output-oriented transfers) offer an advantage compared with grants based on inputs (input-oriented transfers).
- **Accountability:** for lower-level governments to feel accountable towards their electors, it is important that the greater part of resources necessary in order to supply a service are levied in the region where the service is delivered. In other words, government units responsible for service

provision should also be responsible for levying taxes. However, transfers distort this principle.

- **Autonomy of lower-level governments:** the more restricted the area covered by the transfer, the higher the rate of aid becomes – it becomes politically difficult to do without it – and the more the autonomy of lower-level governments is reduced. From this point of view, general (or unconditional) grants are the most appropriate. Transfers covering a broad field (comprehensive block grants) also contribute towards preserving the decision-making power of lower-level governments.
- **Equity:** matching grants benefit rich government units that can afford to finance these requirements. This is also true when rates are not in line with the jurisdiction's resources. A poor government cannot afford to spend money, even if a higher proportion of the costs are covered by the centre. Unconditional grants or revenue-sharing arrangements thus constitute the appropriate means of achieving horizontal equity.

3.2.4. *Transfers in developing and transition economies*

In developing countries and transition economies, setting up a transfer system raises particular problems. Sub-national governments, which often lack the capacity to mobilise revenues, depend on transfers for a large proportion of their financial needs. The negative consequences of transfers (reducing accountability and efficiency) are then even more apparent. In the absence of a formula, the attribution of the amounts often results in a political bargaining

process. Without a well-designed transfer system that follows economic objectives, successful decentralisation cannot be achieved.

3.2.5. *In search of an improved grant design*

Bearing in mind past experiences, it is possible to propose a variety of improvements in grant design in order to limit undesirable side effects.

- Rewarding results obtained: grants should be linked to output (a lump-sum amount for each service unit) instead of representing a fixed percentage of expenditure.
- Rewarding cost-cutting efforts: the profit from a cost reduction should return to the government where it originated. This condition is fulfilled with transfers based on outputs. If input-oriented transfers are used, the transfer formula should take into account a specified percentage of standard costs (and not a percentage of expenditure). In both cases, the above-mentioned condition is fulfilled.
- Limiting loss of local autonomy: comprehensive block grants offer the recipient the possibility of bearing local preferences in mind when allocating funds within the area covered by the grant. A bargaining process between the grantor and the recipient regarding policy objectives, program planning, and the selection of performance indicators can preserve local autonomy.
- No detailed regulations: it is necessary to avoid a link between obtaining resources and following specific rules. Grants must remain an incentive-based instrument, and detailed implementation rules change their nature. Regulations mean that grants become a form of

compensation for accepting uniformity, and diminish the opportunities for expressing local preferences or innovation.

- Contracting: a federal task may be delegated to a lower-level government by means of a contract. Preservation of local autonomy depends on the way in which this contract is negotiated (whether or not the objectives are discussed, and whether or not program planning is included). Efficiency is greater if the central government can choose the entity that will provide the service through a competitive process (tender to potential public and private suppliers).

3.2.6. *Regional disparities*

In older federations, differences between the constituent members, in terms of size, geography, population and economic potential may be so great that without equalisation measures, fiscal federalism would result in regional disparities which would be unacceptable. Local and regional governments differ greatly in their ability to raise local/regional (tax) revenue to meet the expenditure demands placed upon them. Yet at the same time, virtually all federal countries recognise diversity to some extent in the way they establish and run their (inter-governmental) fiscal systems. Pressure on the expenditure side of public budgets can not only be different from one electorate to another, but may also necessitate differentiation to attain both economic efficiency (e.g. to attain some minimum standard in service delivery) and political stability (e.g. among regions with different languages or traditions). Of course, these disparities (or differences) have their own costs in the traditional triumvirate of expenditure assignment, distribution of tax sovereignty, and transfer payments.

The resulting problem is really one of balance: how much differentiation is acceptable; are local/regional disparities (and the consequent costs) the result of local choice or the consequence of exogenous circumstances; what, if any, should be the design and level of equalisation?

For new democracies and economies in transition, these questions are difficult to answer, not only from a technical point of view, but also politically. What could or should be solidarity when one has not much above a mere decent level of resources? The European Charter of Local Self-Government, for example (Council of Europe, 1998), gives only general guidance. It states that (i) local governments should have full discretion over the execution of their responsibilities, (ii) resources available to local government should match their responsibilities and be sufficient to enable them to keep pace with changes in the costs of their functions, and (iii) financially weaker local governments should be protected by equalisation procedures that do not diminish local government discretion. Fiscal equalisation here refers to attempts within a federal or significantly decentralised system of government, to reduce fiscal disparities among sub-national jurisdictions by using explicit transfer of monetary resources.

3.2.7. The concept of equalisation: is it a good idea?

The fundamental question that precedes equalisation is: should a reassignment of functions and responsibilities and/or of revenue sources be considered before any attempt is made to equalise? This question presupposes that, even with a balanced initial position in the assignment of functions and resources, the eventual evolution of the two sides of the

decentralised public budget will not be concomitant. There are three possible answers: leave it, reassign or compensate. Admittedly, equalisation follows negative answers to the first and second. But if reassignment is partially achievable, would equalisation in one form or another still be necessary? In this context, there is an array of related questions. Is there any correlation between the importance of expenditure decentralisation and the need for equalisation? Is expenditure/cost/need equalisation a frequent or a sound policy? Is there any evidence that revenue equalisation is easier or more effective than need equalisation?

Turning to the contributors to equalisation, why should the centre or rich regions be willing to support poorer ones? Efficiency and equity arguments are generally put on the table when fiscal equalisation *stricto sensu* (vertical or horizontal) is considered. But jurisdictions that are potential contributors may prefer targeted regional policy – especially if paid exclusively by the centre (e.g. in Switzerland: assistance to mountain areas with the aim of strengthening structurally weak regions). Regions with large urban areas, which would be potential contributors, often argue that despite higher financial capacity, their public sector also has greater needs due to their role as labour market and production centre (workplaces need more or specific public infrastructure; jobless people tend to concentrate in cities). It is also argued that implicit equalisation (e.g. the effects resulting from a progressive national income tax, or unemployment benefits) should be measured before any step towards explicit equalisation is organised. Or inversely for poorer jurisdictions, adverse effects in the form of the regional impact of direct central

expenditures or investments, which allegedly benefit already richer jurisdictions, should be measured and first compensated.

These questions inevitably raise other difficult questions, such as the equalisation target, and the classic “who decides what?” Two objectives are generally considered. (i) Relative and partial equalisation, which sets out nationwide minimum standards for the provision of public services and a nationwide admissible difference in fiscal burden (e.g. $\pm 10\%$ of the national average). (ii) Minimal equalisation, when there are no constitutional provisions and no claims from the regions (local governments) that equalisation measures should compensate entirely for the difference between the regions (local jurisdictions) in order to obtain identical economic or fiscal conditions. The pragmatic objective would be to render regional (local) disparities politically acceptable so that the remaining differences do not endanger the cohesion of the nation. The additional crucial question is whether the decision for (i) or (ii) belongs to the centre alone, or is a joint decision of the both the centre and the regions, rich and poor. The same question can be duplicated at the regional-local level and need not be answered the same way.

3.2.8. *Financial capacity of sub-level government*

Measuring the fiscal disparities between regions or local governments, or setting out a benchmark indicator of their fiscal capacities is another crucial problem. Measurement is not easily separable from the objective, and the indicator components often directly influence the calculation of the equalisation entitlements. Other features of the equalisation formula could be a ceiling or a floor, the marginal rate of compensation and the tax-back (the

automatic decline in equalisation entitlement that results when a region's measured revenue-raising capacity increases).

3.3. Fiscal competition

The third subtheme examines fiscal competition between governments. It has often been attacked as wasteful and distorting. It has been said to result in such undesirable outcomes as “tax jungles” which impose high compliance costs on taxpayers, or “fiscal wars” or “races to the bottom” as competing jurisdictions lower their tax rates (and spending) in an effort to retain their tax bases. On the other hand, fiscal competition has also been said to be beneficial, providing both a useful check on the propensity of governments to expand, and a stimulus to use scarce fiscal resources more efficiently.

While there is still much to be learned about inter-governmental competition, what we know so far does not lend strong support to either position in this debate. Neither the theoretical nor the empirical literature concludes that fiscal competition is inevitably harmful or beneficial (Wilson, 1999). The outcome, it seems, depends upon a variety of factors that need to be carefully specified in each setting in which the question is considered. To the extent, for example, that taxes finance cost-reducing public infrastructure, they do not distort private decisions. Most taxes are not “benefit taxes” in this sense, however, and hence may produce “spillovers” that reduce government accountability and may result in distortions and hence reductions in economic well-being. When, for example, governments impose taxes that are borne to some extent by non-residents, the economic cost of taxation is lower than it should be, and the result is likely to be excessive government spending. In effect, non-residents end up paying for services to residents. On the other hand, if taxes

result in some tax-base shifting to other jurisdictions, the perceived economic cost of taxation will be higher and there may be too little spending.

Evidence in the United States (Wasylenko, 1996), Canada (Mintz and Smart, 2001), Switzerland (Feld and Kirchgässner, 2000), and Germany (Buttner, 1999) shows that fiscal competition between sub-national jurisdictions exists and may be important. Fiscal differentials appear to be more important within nations than between nations, and to affect location choices most within smaller areas. In general, the greater the number of governmental units, the shorter the “economic distance” between them, and the greater their autonomy with respect to business-related taxes, the more intense fiscal competition is likely to be (Grewal and Mathews, 1977).

Even if fiscal competition among regions to some extent exerts a desirable constraint on public sector expansion, it may at the same time exacerbate regional inequalities, and in some circumstances affect the sustainability of the public sector in general, as has happened on occasion in Brazil and Argentina (Webb, Perry and Dillinger, 2001). Moreover, there may be competition not only between jurisdictions at the same level (horizontal competition) but also between governments at different levels (vertical competition), when different levels of government tax the same base, or if taxes at one level are deductible or creditable at another. The nature and effect of both horizontal and vertical fiscal competition may also be affected by the structure of inter-governmental fiscal transfers. In Canada, for example, the equalisation system tends to reduce horizontal spillovers and fiscal competition, but at the same time has probably resulted in provincial governments being larger than would otherwise have been the case.

Theory and experience both suggest that the key to productive fiscal competition, whether vertical or horizontal, is to make the relevant decision makers at all levels fully accountable for their decisions. In the end, the ultimate mechanism driving “good” competition between governments is on one hand the ability of citizens to compare governments in terms of the services they provide and the taxes they levy, and on the other their ability to affect and alter the decisions of those governments (Bird, 2000). Both information and democracy are therefore necessary at all levels of government, though they are not necessarily sufficient to ensure that governments will operate both efficiently and effectively in the interests of their citizens.

3.4. Fiscal decentralisation in transition economies and developing countries

3.4.1. General background

There is little difference between the expected outcome of decentralisation in transition economies, developing countries, and the industrialised world. Transferring expenditure and responsibility for taxation to sub-national government units theoretically improves efficiency in service delivery, allows better mobilisation of resources, and makes governments more accountable for and responsive to the needs of the population. One key question is how to adapt the decentralisation process to existing organisational and economic structures. In transition economies, the problem is to set up a new system of inter-governmental finance. In developing countries, the aim is to improve performance in public service delivery and to promote macroeconomic stability.

However, the question of whether the benefits of fiscal decentralisation exceed its costs is less obvious in transition economies and developing countries, because the basic conditions for successful empowerment of local governments are rarely met. Local governments in developing countries often lack the institutional and technical capacity to manage resources efficiently; they have limited capacity to raise revenues, and frequently no capacity to borrow. They are also less accountable to citizens than sub-central government units in the industrialised world. In transition economies, setting up well-designed inter-governmental fiscal relations is a key factor for a successful economic transition.

The choice of the most appropriate arrangements for sharing fiscal responsibilities between the different levels of government (de-concentration, delegation or devolution) is also less clear-cut. This choice also depends on the weight attached to the objectives of the central government (correcting macroeconomic imbalance, improving welfare for the national population) and the local governments (cost-effective service production, more efficient allocation, improved responsiveness).

The process of fiscal decentralisation in formerly planned economies started in 1990 in Poland and Hungary, and a year later in Romania, Bulgaria and the Russian Federation. Now, about 40 countries are undergoing a transition from central planning to a decentralised government system and a market economy. Eastern European countries and the republics of the former Soviet Union and former Yugoslavia form the majority of these.

Before the reforms began, most of the resources of the sub-national governments came from transfers from the central government. Usually, these transfers were the result of bargaining, and so were not based on clearly defined allocation rules. The downward shift of responsibilities, without sufficient resources being provided to local governments through revenue assignment or increased transfers, has resulted, in some countries, in vertical imbalance and excessive borrowing at sub-national level.

A primary source of concern arising from expenditure decentralisation in developing countries is that local governments may lack the institutional capacity to assume their new functions. However, this should not be an absolute barrier to decentralisation, and there are several ways to improve administrative and technical capacity at the lower level. These include reforming recruitment policy (competitive hiring), pooling the services of professionals, sharing equipment, or outsourcing services to private providers. Technical knowledge can also be borrowed from higher-level governments. Moreover, decentralisation can be adapted or organised according to the capacity of each sub-national government to provide public services (asymmetric decentralisation).

Central governments often have a paternalistic approach regarding their fiscal relations with sub-national government units, which is not compatible with accountability and the efficient use of resources. At the end of the year, local governments receive deficit grants to balance their budget (soft budget) or can expect a bailout if they accumulate too much debt. However, enforcing a hard budget constraint is a first precondition for accountability and the efficient use of resources. To achieve this objective, it is also necessary to enable and

induce sub-national governments to cover a significant part of their expenditures through taxes or user charges. A further question is whether, and to what extent, sub-national governments should be allowed to borrow. If the budget must be balanced every year, how should inter-generational equity be achieved, since many investments in infrastructure are made by local governments?

3.4.2. *Main issues in the decentralisation process in transition economies and developing countries*

Following the failure of central governments to fulfil their tasks in a satisfactory manner and also because of pressure resulting from globalisation, a large number of developing countries – about 70 according to Shah (1998) – have opted for greater decentralisation. Governments decide to shift some tasks down when they think that sub-national governments or some other type of organisation can achieve their goals more effectively. When the decentralisation process is initiated from the top, an approach that has been adopted in most developing countries, the rationale of shifting down responsibilities is to achieve the goals of the central government more efficiently (Bird and Vaillancourt, 1998). The weakest forms of decentralisation – de-concentration or eventually delegation – are generally adopted. What are the pre-requisites for successful decentralisation? One obstacle to the transfer of expenditure and tax responsibilities to sub-central governments seems to be the lack of administrative capacity at the local level. The first question is thus how to build decentralised governments' capacity to deliver public services and mobilise the local tax bases. Which functions should be shifted down? Is asymmetric assignment based on population size and/or fiscal

capacity a strategy that can be recommended? Can de-concentration (or delegation) be seen as a first stage in the process of building a devolved system? How should fiscal discipline be enforced? Finally, is it possible to identify a pattern of success or failure?

Regarding revenue assignment in transition economies and developing countries, the first task is to assign sufficient resources to governments in order to make them accountable. The reduction of the sub-national governments' dependence on revenue from enterprises and other assets (housing, retail units) is another important problem. The decentralisation of public services and markets should take place in a coherent manner, whereby privatisation is the ultimate form of decentralisation. The involvement of local governments in purely private activities may hamper the market decentralisation process. Another question to consider is whether the inter-governmental transfer system should be redesigned (from a bargaining mechanism to a formula-based system). The aim of vertical transfer is not only to correct vertical and horizontal imbalance, but also to make sub-national governments accountable and promote the efficient use of resources. In transition economies, sub-national governments often have unlimited access to borrowing and are used to soft budgets. Hard budget constraints must be implemented (no deficit grants, no expected bailout), and borrowing at the local level must be controlled (e.g. passive control through guidelines, direct control of new state borrowing by central government or control of capital spending) in order to avoid macroeconomic mismanagement. Finally, it is necessary to consider how local governments will be permitted access to capital markets (by direct borrowing, borrowing

though the central government, or borrowing through a public financial institution).

When decentralisation is a bottom-up process (Bird and Vaillancourt, 1998), the economic rationale of shifting down responsibilities is to allow citizens to express their preferences and receive public services according to their needs. Decentralisation, here in the sense of devolution, also improves accountability, responsiveness, and microeconomic efficiency. However, while improving allocative efficiency, decentralisation may be a threat to macroeconomic stability. We must consider how sub-national borrowing should be controlled and what the appropriate mechanisms might be (e.g. equalisation programs) to compensate for horizontal fiscal imbalance.

With the reduction in barriers to exchanges and the movement to integrate markets on a major regional or world scale, the mobility of goods and above all of capital, both human and physical, has increased. The consequences of market integration on the decentralisation process is a matter on which economists have been unable to agree. There are sound arguments for concluding that globalisation and regional economic integration are factors that facilitate decentralisation by reducing the economic cost of smallness (Alesina and Spolare, 1997). The trend towards decentralisation, observed in developing countries and transition economies, can be interpreted as a by-product of increased market integration at a global and regional level. In a borderless world, local governments may be in a better position than the central one to compete for direct international investments through tax incentives or the provision of better services to business (Shah, 1997).

Political and fiscal decentralisation allows countries to make more credible commitments to international investors.

There is also evidence showing that economic integration exerts new pressures on fiscal centralisation. In a borderless economy, as a result of regional specialisation, different regions within a country face unequal risks of being adversely affected by an economic shock of some kind. Regions more at risk would move in favour of a strong central government. In fact, building larger fiscal units may be seen as a way of sharing the risk on a broader base (Garrett and Rodden, 2000). It is also possible that fiscal policy will become more important even if the business cycle is symmetric, which will mean more responsibilities for the centre.

References

- Alesina, A. and Spolare, E., 1997. On the Number and Size of Nations. *Quarterly Journal of Economics*, 112(4), 1027-1056.
- Bird, R.M., 1999. Fiscal Federalism. *In: J. Cordes, R. Ebel and J. Gravelle, eds. The Encyclopedia of Taxation and Tax Policy*. Washington: The Urban Institute Press, 127-130.
- Bird, R.M., 2000. Fiscal Decentralization and Competitive Governments. *In: G. Galeotti, P. Salmon, and R. Wintrobe, eds. Competition and Structure: The Political Economy of Collective Decisions*. Cambridge: Cambridge University Press, 129-149.
- Bird, R.M., 2001. Rationales and Forms of Decentralization. *In: R. Bird and T. Stauffer, eds. Intergovernmental Fiscal Relations in Fragmented Societies*.

- Basel and Fribourg: Helbing & Lichtenham, Publications of the Institute of Federalism, *Séries Études et Colloques* 33, 1-13.
- Bird, R.M. and Staufer, T., eds, 2001. *Intergovernmental Fiscal Relations in Fragmented Societies*. Basel and Fribourg: Helbing & Lichtenham, Publications of the Institute of Federalism, *Séries Études et Colloques* 33.
- Bird, R. and Vaillancourt, F., eds, 1998. *Fiscal Decentralization in Developing Countries*. New York and London: Cambridge University Press.
- Buchanan, J.M., 1950. Federalism and Fiscal Equity. *American Economic Review*, 40, 583-599.
- Buttner, T., 1999. *Determinants of Tax Rates in Local Capital Income Taxation: A Theoretical Model and Evidence from Germany*. CESifo Working Paper No. 194, September 1999.
- Conway, F. et al., 2000. *Intergovernmental Fiscal Relations in Eastern Europe, a Sourcebook for Policy Analysts and Trainers*. Washington: The Urban Institute Press.
- Council of Europe, 1998. *European Charter of Local Self-Government (1985) and Explanatory Report*. Strasbourg: Council of Europe Publishing.
- Dafflon, B., ed., 2002. *Local Public Finance in Europe: Balancing the Budget and Controlling Debt, Studies in Fiscal Federalism and State-Local Finance*. Cheltenham: Edward Elgar.
- Ebel, R.D. and Yilmaz, S., 2001. *Concept of Fiscal Decentralization and Worldwide Overview*. Room document, International Symposium Québec Commission on Fiscal Imbalance, Québec, 13-14 September 2001, mimeo.

- European Commission, 1997. *Toward Tax Co-ordination in the European Union: A Package to Tackle Harmful Tax Competition*. COM (97) 495 final.
- Feld, L. and Kirchgässner, G., 2000. *Income Tax Competition at the State and Local Level in Switzerland*. CESifo Working Paper No. 238, January 2000.
- Garrett, G. and Rodden, J., 2000. *Globalization and Decentralization*. Paper prepared for delivery at the 2000 Annual Meeting of the American Political Science Association, Washington, D.C., 31 August – 3 September 2000.
- Grewal, B.S. and Mathews, R.L., 1977. Intergovernmental Tax Competition and Co-ordination. In: R.L. Mathews, ed. *State and Local Taxation*. Canberra: Australian National University Press, 83-93.
- Mintz, J. and Smart, M., 2001. *Income Shifting, Investment, and Tax Competition: Theory and Evidence from Provincial Taxation in Canada*. Paper presented to Conference on World Tax Competition, Institute of Fiscal Studies, London, May 2001.
- Musgrave, R., 1959. *The Theory of Public Finance*. New York: McGraw Hill.
- Musgrave, R., 1961. Approaches to a Fiscal Theory of Political Federalism. In: NBER. *Public Finance: Needs, Sources and Utilization*. Princeton: Princeton University Press, 97-133.
- Oates, W., 1968. The Theory of Public Finance in a Federal System. *Canadian Journal of Economics*, 1, 37-54.
- Oates, W., 1972. *Fiscal Federalism*. New York: Harcourt Brace.
- Oates, W., 1999. An Essay on Fiscal Federalism. *Journal of Economic Literature*, 37, 1120-1149.

- Oates, W.E. and Schwab, R., 1988. Economic Competition among Jurisdictions: Efficiency-Enhancing or Distortion-Inducing? *Journal of Public Economics*, 35, 333-354.
- OECD, 1998. *Concurrence fiscale dommageable: un problème mondial*. Paris: OECD.
- Shah, A., 1997. *Fiscal Federalism and Macroeconomic Governance: For Better or For Worse?* Keynote paper for the International Conference on Decentralization, Intergovernmental Fiscal Relations and Macroeconomic Governance, Brasilia, Brazil, 16-17 June 1997, sponsored by the Government of Brazil and the OECD.
- Shah, A., 1998, Indonesia and Pakistan: Fiscal Decentralization – an Elusive Goal? *In: R.M. Bird and F. Vaillancourt, eds. op. cit.*, 1998, 115-151.
- Sinn, S., 1992. The Taming of Leviathan: Competition among Governments. *Constitutional Political Economy*, 3, 177-196.
- Ter-Minassian, T., ed., 1997. *Fiscal Federalism in Theory and Practice*. Washington, D.C.: International Monetary Fund.
- Tiebout, C., 1956. A Pure Theory of Local expenditures. *Journal of Political Economy*, 64, 416-424.
- Tiebout, C.M., 1961. An Economic Theory of Decentralization. *In: NBER. Public Finance: Needs, Sources and Utilization*. Princeton: Princeton University Press, 79-96.
- Wasylenko, M., 1996. The Role of Fiscal Incentives in Economic Development: How Ohio Stands Relative to its Competitor States. *In: R. Bahl,*

ed. *Taxation and Economic Development: A Blueprint for Tax Reform in Ohio*. Columbus: Batelle Press, 467-510.

Webb, S., Perry, G. and Dillinger, W., 2001. *Developing Hard Budget Constraints in Decentralized Democracies of Latin America*. Paper presented to Conference on Public Finance in Developing and Transitional Countries, Stone Mountain, Georgia, April 2001.

Wildasin, D.E., 1997. *Fiscal Aspects of Evolving Federations*. Cambridge: Cambridge University Press.

Wilson, J.D., 1999. Theories of Tax Competition. *National Tax Journal*, 52, 269-304.

Wiseman, J., 1989. The Political Economy of Federalism: A Critical Appraisal. *In: J. Wiseman. Cost, Choice and Political Economy*. Aldershot: Edward Elgar, 71-111.

Wiseman, J., 1990. Principles of Political Economy: An Outline Proposal, Illustrated by Application to Fiscal Federalism. *Constitutional Political Economy*, 1/1, 101-124.

WBI: World Bank Institute, ed., 2001, *Intergovernmental Fiscal Relations and Local Financial Management Program*. Washington, D.C.: World Bank Institute.