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Fiscal Decentralisation in Transition Economies and Developing Countires

Progress, Problems and the Promise

1. Introduction

During the past 50 years, by subscribing to different variants of central planning paradigms of development, developing and transition economies have by and large followed a path of centralisation, and as a result they are more centralised than industrialised countries were in their early stages of development. A number of recent developments, discussed below, are prompting most developing and transition economies to re-examine the respective roles of various levels of government, the private sector and civil society as partners in development.[2] This paper examines the reasons for rekindling of interest in fiscal rearrangements in developing and transition economies, and reviews the progress to date using a systemic framework. It draws general and institutional lessons to advance the agenda for creating an enabling environment for responsive and accountable local governance. The overall conclusion of the paper is that citizens' voice, choice and exit options are critical to the success of decentralised decision making. These areas require significant attention in ongoing reform efforts.

The paper is organised as follows. Firstly there follows a discussion of the motivation behind the mega change. Secondly comes a simple framework to evaluate and cope with the forces of change. The next section reviews the broad trends in the division of powers in developing and transition economies and their implications for public sector governance. The following section reviews the operational capacity and orientation of the public sector in support of the reform efforts. The final section draws general lessons from experience in adapting to a changing world.

2. The quest for the right balance

The reasons for rethinking fiscal arrangements are manifold, and the importance of each factor is country specific. The demise of the collective ownership model prompted a major change in government organisation and geographical boundaries of some countries, especially in Eastern Europe and the former Soviet Union (Horvath, 2000). These countries sought guidance from the principles and practices pursued in industrial countries where market preserving systems of public decision making have evolved over a long period of time. In Africa, both former French and English colonies inherited highly centralised systems of governance geared towards command and control, with little concern for citizens' preferences. Resolution of ethnic conflicts required greater protection of minority rights in politically disenfranchised and fragmented societies in Africa (Bird and Stauffer, 2001). In Latin America, political reforms empowered people who in turn demanded greater accountability from their governments. In most countries, national governments have failed to ensure regional equity, economic union, central bank independence, a stable macroeconomic environment or local autonomy. The record of sub-national governments is also not very commendable. Sub-national governments have often followed beggar-thy-neighbour policies, sought free rider-ship with no accountability, and have often undermined national unity in pursuit of narrow self-interest. The judicial systems in some countries are also providing stimuli for change by giving a broader interpretation of basic rights, and requiring national and sub-national legislation to conform to the basic rights of the citizens.

The emergence of a new “borderless” world economy complicates this picture by bringing new challenges to constitutional federalism (Courchene, 1995; Shah, 2002). These challenges arise from the reduced role of nation states in carrying out the regulation of certain economic activities as borders have become more porous, and information technology has weakened their ability to control information flows. With globalisation, it is becoming increasingly apparent that nation states are too small to tackle the large things in life and too large to address the small things. More simply nation states are fast losing control of some traditional areas of control and regulation, such as regulation of external trade, telecommunications, and financial transactions. National governments are experiencing diminished ability to control the flow of goods and services, ideas, and cultural products. These difficulties are paving the way for the emergence of specialised institutions of global governance, such as the World Trade Organization (WTO) and the Global Environmental Facility, with many more to follow, especially institutions regulating information technology, satellite communications, and international financial transactions. Thus nation states may well be confederalising in the coming years, and relinquishing responsibilities in these areas to supra-national institutions. However, this trend contributes to a democracy deficit, as citizens do not have the possibility of direct input in vital decision making by supra-national institutions.

The European Union's (EU) policies and principles regarding subsidiarity,[3] fiscal harmonisation and stabilisation checks are also having demonstrable effects on the policies of developing and transition economies. Similarly the success of decentralisation in improving public participation, efficiency and equity of public provision, and accountability of the public sector in some Latin American countries, especially Brazil, Chile and Colombia, has encouraged other countries to review their own fiscal arrangements. Finally, resurgence of interest in new public management and federalism principles and practices, has served as a powerful basis from which to restructure and reorient the public sector.

2.1. Emerging governance structure

This re-examination has resulted in a silent revolution sweeping the globe. This is slowly but gradually bringing about rearrangements that embody diverse features of supra-nationalisation, confederalisation, centralisation, provincialisation and localisation. Nevertheless, the vision of governance structure that is slowly taking hold through this silent revolution is one that indicates a gradual shift from unitary constitutional structures to federal or confederal forms of governance for a large majority of people.[4] It implies that we are likely to move from a centralised to a globalised and localised world.[5] In such a world, the role of the central government changes from that of a managerial authority to that of a leader in a multi-centred government environment. The culture of governance is also slowly changing from a bureaucratic to a participatory mode of operation; from command and control to accountability for results; from being internally dependent to being competitive and innovative; from being closed and slow, to being open and quick; and from being intolerant of risk, to allowing freedom to fail or succeed. Financial crises around the world are hampering this change by encouraging protectionist policies. As a result, the new vision will take some time to shape in the twenty-first century (Table 1), and in many developing and transition economies, it may not actually materialise for some time due to the institutional impediments noted in the following sections.

Table 1 Governance structure – twentieth versus twenty-first century

20th Century	*21st Century*
Unitary	Federal/confederal
Centralised	Globalised and localised
Centre manages	Centre leads
Bureaucratic	Participatory
Command and control	Responsive and accountable to citizens
Civil service with life-long tenures	Civil service with contractual employment
Input controls	Results matter
Top down accountability	Bottom-up accountability
Internally dependent	Competitive
Closed and slow	Open and quick
Intolerance of risk	Freedom to fail/succeed

The overall thrust of these changes is a trend towards either devolution (empowering people politically) and/or localisation (decentralisation of decision making to the local level). Localisation has been pursued through varying combinations of political, administrative and fiscal decentralisation initiatives.

- Political or democratic decentralisation implies directly elected local governments, thereby making elected officials accountable to citizens.
- Administrative decentralisation empowers these governments to hire and fire local staff (thereby making local officials accountable to elected officials) without any reference to higher-level governments.
- Fiscal decentralisation ensures that all elected officials weigh the joy of spending someone else's money carefully against the pain associated with raising revenues from the electorate, and the possibility of being voted out.
- Administrative de-concentration, where decision making is shifted to regional and local offices of the central government, would not be consistent with administrative decentralisation.
- Similarly administrative delegation, where local governments undertake activities on behalf of the higher level governments, falls short of administrative decentralisation.

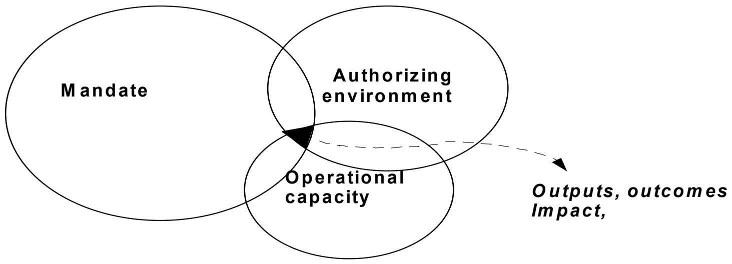
Thus, localisation of authority is intended to bring decision making closer to the people being served by the public sector. This change has proved to be a controversial proposition in developing and transition economies. This is because localisation is being perceived both as a solution to problems such as dysfunctional public sector, lack of voice and exit, as well as source of new problems such as capture by local elites, aggravation of macroeconomic management due to lack of fiscal discipline, and perverse fiscal behaviour by sub-national units. There are also conceptual difficulties in making choices with the right balance (Shah, 1994). Beyond these conceptual issues, a number of practical considerations have a bearing on a nation's quest for balance. These include the level of popular participation in general elections, feudal politics, civil service culture and incentives, governance and accountability structure, and capacities of local governments.

3. Leading change: developing a vision and a strategy

Coping with or adapting to the silent revolution requires a vision and a strategy in the absence of which a nation may not have full control of its destiny. A closer look at the public sector mandate, its authorising environment (institutional mechanisms/rules of the game, and organisational structures to translate constitutional mandates or societal objectives to concrete policies and programs, and make the public sector responsive and accountable to citizens),[6] and its operational capacity (determined by skills and bureaucratic culture) in developing and transition economies, yields important insights into the dysfunctionality of public governance.

The challenge of public sector reform in any such country is to harmonise the public sector mandate, its authorising environment, and its operational capacity so that there is a close if not perfect correspondence between these three aspects of governance (Figure 1). The intersection of these three elements has a bearing on public sector performance in the delivery of its mandate. Thus the goal is to maximise this intersecting space. Such a task is daunting for many developing and transition economies since they often have lofty goals, but lack an authorising environment capable of translating these goals into a policy framework. This problem is often compounded further by bureaucratic incentives making any available operational capacity to implement such a framework dysfunctional.

Figure 1 Public sector institutional environment in developing and transition economies



4. Realigning the authorising environment to a focus on societal goals

Certain levels of government will have a greater focus on societal goals if they and the citizens understand clearly their respective roles in public service delivery. This “assignment problem”, or the division of powers among various levels of government, has been the most fundamental issue in public governance from time immemorial. It remains a central concern in the literature of federalism. The Maastricht Treaty introduced a guiding principle, the “principle of subsidiarity”, for assignment of responsibilities among members of the EU. According to this principle, taxing, spending and regulatory functions should be exercised by the lowest levels of government, unless a convincing case can be made for assigning the same to higher levels of government. Fiscal federalism's literature has also provided principles that broadly support the subsidiarity principle (Oates, 1999). The application of these principles to achieve the right balance in the number and size of jurisdictions requires voting with feet, voting by ballots or other community formation processes, or redrawing of jurisdictional boundaries.

In applying principles of jurisdictional design, the literature of fiscal federalism argues that the assignment of responsibility for spending must precede or at least take place at the same time as, the assignment of responsibility for taxation. This helps to ensure a better match between taxing and spending powers for better accountability, and to avoid over-reliance on transfers in financing own expenditures. In the following, conceptual guidance and the practice on allocation of responsibilities are reviewed briefly.

4.1. Clarifying roles of various governments in public service delivery

Conceptually, central government expenditure responsibilities should include: (i) functions to preserve national efficiency objectives such as the maintenance of the internal common market, provision or finance of efficient levels of public goods and services whose benefits transcend sub-national borders; (ii) those expenditures needed to safeguard national equity objectives such as vertical equity based upon incomes and other characteristics, horizontal or fiscal equity across regions, and equality under the law through the legal framework; (iii) stabilisation programs. Responsibilities for all other functions are best exercised by regional and local governments. The national government can ensure attainment of minimum standards of public services through regulatory supervision or the conditional transfer of funds (see Appendix 1 for a representative assignment of expenditure responsibilities).

Asymmetric arrangements may be useful if regions are heterogeneous in terms of population, skills, culture, size and economic base. Assignment of public services to various types of local and regional authorities necessitates taking into consideration factors such as economies of scale, economies of scope (proper bundling of local public services to improve efficiency through information and coordination economies, and enhanced accountability through voter participation and cost recovery), cost/benefit spillovers, proximity to beneficiaries, consumer preferences, and flexibility in budgetary choices on composition of spending. The particular level of government to which a service is assigned determines the public and/or private production and distribution of the service based upon considerations of efficiency and equity. As local governments' financial capacities are quite limited in most developing and transition economies, fostering private sector participation in the delivery of local public services assumes a greater significance. Such participation enhances voice, choice and exit options for citizens.

4.1.1. Special challenges in expenditure assignment from globalisation

In the emerging borderless world economy, interests of residents as citizens are often at odds with their interests as consumers. In securing their interests as consumers in the world economy, individuals are increasingly seeking localisation and regionalisation of public decision making to better safeguard their interests. With greater mobility of capital, and loosening of regulatory environment for foreign direct investment, local governments, as providers of infrastructure-related services, would serve as more appropriate channels for attracting such investment than national governments. As borders become more porous, cities are expected to replace countries in trans-national economic alliances. People across Europe are already discovering that national governments have diminishing relevance in their lives. They are increasingly more inclined to link their identities and allegiances to cities and regions.

With mobility of capital and other inputs, skills rather than resource endowments will determine international competitiveness. Typically however, education and training is sub-national government responsibility. Therefore, there would be a need to realign this responsibility by giving the national government a greater role in skills enhancement through education and training. The new economic environment will also polarise the distribution of income in favour of skilled workers, accentuating income inequalities, and possibly wiping out lower-middle income classes. Since national governments may not have the means to deal with this social policy fallout, sub-national governments will have to devise strategies for dealing with the emerging crisis in social policy, working in tandem with national governments.

International trade agreements typically embody social policy provisions. But social policy is typically an area of sub-national government responsibility, as in Canada, Brazil, India, Pakistan and the United States. This is an emerging area of conflict among different levels of government. To avoid these conflicts, a guiding principle should be that to the extent that these agreements embody social policy provisions, they must be subject to ratification by sub-national governments, as is currently the case in Canada.

In macroeconomic governance, supra-national institutions such as the International Monetary Fund and the World Bank are assuming ever more important roles. Within the nation, independent central banks and sub-national governments are seeking enhanced roles in macroeconomic management, leading to a diminished direct role of federal government in stabilisation and macroeconomic control. However, federal governments' role in coordination, support and supervision will increase.[7]

4.1.2. Emerging jurisdictional realignments

Box 1 presents a newer federalist perspective on the assignment of responsibilities by taking into account the considerations noted above. This box shows that functions such as regulation of financial transactions, international trade, global environment and international migration will gradually pass upwards (centralised) beyond nation states. Some sub-national functions such as training will have greater central government inputs (centralisation), and local functions would gradually be completely decentralised and involve greater participation by civil society and the private sector. In general, globalisation and localisation trends reinforce each other, diminishing the relative importance and centrality of central governments.

Box 1 Emerging rearrangements: globalisation, centralisation and localisation

Beyond Nation States: International conflict resolution, stabilisation, regulation of financial transactions, corporate taxation, international trade, global environment, telecommunications, international standards, international migration, surveillance of governance conditions, global security and risk management, trans-national production, investment and technology transfer, suppression of money laundering, drug smuggling and terrorism.

Centralisation: Social and environmental policy through international agreements, skills enhancement for international competitiveness, social safety nets, macroeconomic coordination, supervision and technical assistance to sub-national governments.

Regionalisation/Localisation/Privatisation: All regional/local functions

(Shah, 1998)

4.1.3. Expenditure reassignment: progress so far

Expenditure assignments in developing and transition economies have undergone significant changes during the past two decades. In transition economies such changes reflect a new role for the public sector in support of a market economy. As a consequence, sub-national expenditures contracted as a percentage of Gross Domestic Product (GDP) from about 17.2% in 1980 to 10.8% in 1999. Sub-national expenditures in transition economies, as a proportion of total public sector expenditures, experienced even an even sharper decline during the same period from 44.9% to 22.3%. In developing countries on the other hand, there has been a gradual, generally piecemeal, yet persistent decentralisation of expenditure responsibilities. Sub-national expenditures in developing countries as a percentage of GDP rose from 3% of

GDP in 1980 to 6.1% of GDP in 1997. Sub-national expenditures as a percentage of total public sector expenditures increased from 12.7% of total expenditures in 1980 to about 19.6% of total in 1998 (Ebel and Yilmaz, 2001). Sub-national government roles in education and health spending show divergent trends in transition economies and developing countries. In transition economies, sub-national educational expenditures, as a percentage of public sector education expenditures, have declined from 71% in 1981 to 55% in 2000, while in developing countries such expenditures have risen from 21% in 1980 to 40% in 2000. In health, the role of sub-national governments in total public sector health expenditures in transition economies declined from about 92% in 1977 to 39.2% in 2000, while in developing countries the same role expanded from about 22% to 57% in 1999. In transition economies the central governments have often attempted to shift social expenditures downwards to regional and local governments without providing additional finances. These largely un-funded mandates have therefore been seen as attempts by national governments to shift deficits downwards, creating disharmony and conflict among governments at different levels.

Quite a large number of central governments are involved in purely local functions. Out of a sample of 33 countries for which details on the assignment of local functions are available, primary education is the sole responsibility of the centre in 12 countries, and in an additional nine countries, central government is involved in this service together with local governments.

Division of expenditure responsibilities within nations has been further complicated by the role of external donors. In their attempts to create islands of integrity associated with the use of their funds, external donors have often supported creation of parallel structures of decision making, which bypass local government institutions.

Finally expenditure autonomy (percentage of own expenditure under effective control of sub-national governments) is on average higher (74% overall, but 96% in Croatia and 7% in Albania) in transition economies than developing countries (58% overall, but 95% in Dominican Republic and 23% in South Africa).

4.2. Taxing choices: determining who taxes what, at what rate and how?

Four general principles require consideration when assigning taxing powers to various governments. First, taxes on mobile factors and tradable goods that have a bearing on the efficiency of the internal common market should be assigned to the centre. Sub-national assignment of taxes on mobile factors may facilitate the use of socially wasteful beggar-thy-neighbour policies by regional and local governments to attract resources to their own areas. In a globalised world, even central assignment of taxes on mobile capital may not be very effective in the presence of tax havens, and because of the difficulty in tracing and attributing incomes from virtual transactions to various physical spaces. Second, national equity considerations warrant that progressive re-distributive taxes should be assigned to the centre. This limits the possibility of regional and local governments following perverse redistribution policies, which use both taxes and transfers to attract high-income persons and repel low-income ones. Third, taxes should be assigned to the jurisdiction most capable of monitoring relevant assessments. This minimises administration costs as well as potential for tax evasion. For example, property and land taxes are good candidates for local assignment, as local governments are in a better position to assess the market value of such things. Fourth, to ensure accountability, revenue means (the ability to raise revenues from own sources) should be matched as closely as possible to expenditure needs (see Appendix 2 for a representative assignment of taxing responsibilities).

The above principles suggest that the case for decentralising taxing powers is not as compelling as that for decentralising public service delivery. This is because lower-level taxes can introduce inefficiencies in the allocation of resources across the federation, and cause inequities among citizens of different jurisdictions. In addition, collection and compliance costs can increase significantly. These problems are more severe for some taxes than others, so the selection of which taxes to decentralise must be made with care. A balance should be found between need to achieve fiscal and political accountability at the lower levels of government, and the disadvantages of having a fragmented tax system. These trade-offs can be mitigated by fiscal arrangements that permit joint occupation and harmonisation of taxes to overcome fragmentation, and fiscal equalisation transfers to reduce fiscal inefficiencies and inequities arising from different fiscal capacities.

4.2.1. Reassigning taxing powers – an update

The above discussion suggests that decentralisation of taxing powers may not fully match the decentralisation of expenditure and regulatory functions. However, in developing and transition economies, centralisation of taxing responsibilities is much more pronounced than it would be if based on economic considerations. In 1999, sub-national own revenues constituted about 7.9% of GDP in transition economies and 5.5% of GDP in developing countries. In transition economies in 1997, sub-national governments raised 18.4% of public sector revenues on average, and in developing countries they raised slightly less – about 16.6%. During the past two decades, transition economies have shown a decline in these revenues as tax collection was centralised, whereas in developing countries, there has been a modest increase due to a small degree of tax decentralisation. In 1999, sub-national revenues financed 55% of sub-national operating expenditures in transition economies, and 40% of the same in developing countries. The rest of the financing came from shared taxes, transfers and borrowing. Overall tax decentralisation remains an unfinished agenda for developing and transition economies. In 1999, in transition economies 49.3% of sub-national government revenues were obtained from shared taxes (World Bank, 2001). In developing countries, the role of shared taxes in financing sub-national governments is of lesser significance as general revenue sharing is widely practiced.

4.3. Designing fiscal transfers: dividing the spoils, or creating an enabling framework for innovative and competitive service delivery

Inter-governmental transfers are the dominant source of revenues for sub-national governments in most developing and transition economies. The design of these transfers is of critical importance for the efficiency and equity of local service provision and the fiscal health of sub-national governments (see Appendices C and D for criteria, general principles and better practices in grant design). To enhance accountability, it is desirable to match revenue means (the ability to raise revenues from own sources) as closely as possible with expenditure needs at all levels of government. However, higher-level governments must be allowed greater access to revenues than they need to fulfil their own direct service responsibilities, so that they are able to use their spending power through fiscal transfers to fulfil national and regional efficiency and equity objectives. We can identify six broad objectives for national fiscal transfers, each of which may apply to varying degrees in different countries, and each of which calls for a specific design of fiscal transfers.

4.3.1. Bridging the fiscal gap

A fiscal gap is defined as an imbalance between the revenue-raising ability of regional and local governments, and their expenditure responsibilities. To deal with a fiscal gap, it is important to deal with the causes of this gap through reassignment of responsibilities, tax decentralisation, tax abatement by the centre, and tax-base sharing (allowing sub-national governments to levy supplementary rates on a national tax base). Only as a last resort should unconditional formula-based transfers, or revenue sharing based on the origin/derivation (point of collection) principle, be considered as options to deal with this gap. This is because such transfers weaken accountability to local taxpayers. In developing and transition economies, general revenue sharing is typically used to deal with the fiscal gap. A number of countries, including China, India, Malaysia, Pakistan and South Africa, have previously tried deficit grants to fill fiscal gaps at sub-national levels, with unwelcome results in terms of mushrooming sub-national deficits. These grants are still in vogue in China, Hungary and South Africa.

4.3.2. Correcting fiscal inequities and fiscal inefficiencies arising from differentials in regional fiscal capacities

Decentralised decision making results in net fiscal benefits (imputed benefits from public spending minus tax burden), which vary according to place of residence, due to variations in fiscal capacities of local and regional governments. This leads both to fiscal inequity and fiscal inefficiency in resource allocation. Fiscal inequity arises as citizens with identical incomes are treated differently, depending on their place of residence. Fiscal inefficiency in resource allocation results from people comparing gross income at new locations (private income plus net public sector benefits, minus cost of moving) when making their relocation decisions, whereas economic efficiency considerations warrant comparing private income minus moving costs. Thus a nation that values horizontal equity (i.e. the equal treatment of all citizens nationwide) and fiscal efficiency will need to correct the fiscal inequity and fiscal inefficiency that naturally arise in a decentralised government. Central-state grants can eliminate these differences in net fiscal benefits if the transfers to each region depend upon the tax capacity of the region relative to others, and upon the relative need for and cost of providing regional public services. The more decentralised the tax system is, the greater the need for equalising[8] transfers.

Most transition economies have equalisation components in their grant programs to sub-national governments. Latvia, Lithuania, Poland, Romania, Russia and Ukraine have adopted transfer formulae that explicitly incorporate either fiscal capacity and/or expenditure need equalisation concerns. In developing countries, programs using an explicit standard of equalisation are untried, although equalisation objectives are implicitly attempted in the general revenue-sharing mechanisms used in Argentina, Brazil, Colombia, India, Nigeria, Mexico, Pakistan and South Africa. These mechanisms typically combine diverse and conflicting objectives into the same formula, and fall significantly short of individual objectives. Because the formulae lack explicit equalisation standards, they fail to address regional equity objectives satisfactorily (Shah, 1996, 2000; Shankar and Shah, 2001).

4.3.3. Compensating for benefit spillovers

This is the traditional argument for matching conditional grants. Regional and local governments will not have the proper incentive to provide the correct levels of services yielding spillover benefits to residents of other jurisdictions. A system of open-ended matching grants, based on the expenditures giving rise to the spillovers will provide an incentive to increase expenditures. Typically, the extent of the spillover will be difficult to measure, so the correct matching rate to use will be somewhat arbitrary.

Although benefit-cost spill-out is a serious factor in a number of countries, such transfers have typically not been implemented in developing countries. Among the few countries that do, South Africa provides a closed-ended matching grant to teaching hospitals, based upon an estimate of benefit spillovers associated with enrolment of non-local students, and use of hospital facilities by non-residents.

4.3.4. Setting national minimum standards to preserve the internal common market and attain national equity objectives

Setting national minimum standards in regional-local services may be important for two reasons. The first is that there is an advantage to the nation as a whole from such standards, as they contribute to the free flow of goods and services, labour and capital, and reduce wasteful inter-jurisdictional expenditure competition, improving the gains from trade from the internal common market. Second, these standards serve national equity objectives. Many public services provided at the sub-national level, such as education, health, and social welfare, are re-distributive in their intent, providing in-kind redistribution to residents. In a federal system, lower-level provision of such services – while desirable for efficiency, preference matching, and accountability – creates difficulty in fulfilling federal equity objectives. Factor mobility and tax competition create strong incentives for lower-level governments to under-provide such services, and to restrict access for those most in need, such as the poor and the old. This is justified by their greater susceptibility to disease and potentially greater risks for cost curtailment. Such perverse incentives can be alleviated by conditional non-matching grants, where the conditions reflect national efficiency and equity concerns, and where there is a financial penalty associated with failure to comply with any of the conditions. Thus, conditions will not be on the specific use of grant funds, but on attainment of standards in quality, access and level of services. Such grants do not affect local government incentives for cost efficiency, but do encourage compliance with nationally specified standards for access and level of services. Properly designed conditional non-matching transfers can create incentives for innovative and competitive approaches to improved service delivery (see Box 2 for an example of such a grant).

Box 2 An example of a performance-oriented grant: education grant to set minimum standards, while encouraging competition and innovation

Allocation basis among local governments: school age population.

Distribution to providers: equal per pupil to both government and private schools.

Conditions: universal access to primary and secondary education regardless of parents' income; improvements in achievement scores; no condition on the use of grant funds.

Penalties for non-compliance with standards: public censure, reduction of grant funds.

Incentives for cost efficiency: retention of savings.

Conditional non-matching transfers to ensure national minimum standards are rarely used in developing and transition economies. However, central government transfers to provincial and local governments in Indonesia, central per capita transfers for education in Colombia and South Africa, and the capitation grant to Malaysian states come close to the concept of such a transfer.

4.3.5. Influencing local priorities in areas of high national but low local priority

In a federation, there is always some degree of conflict among priorities established by various levels of government. One way to induce lower-level governments to follow priorities established by the higher-level government is for the higher-level government to use its powers of the purse, or so-called spending power, by using matching transfers. Open-ended matching transfers, with matching rate (percentage of expenditures financed from own sources by the recipient) varying inversely with fiscal capacity, would be consistent with this use. The use of ad hoc grants or open-ended matching transfers for local tax effort would be inadvisable. The former is unlikely to have behavioural responses consistent with grantor's objectives, and the open-ended nature of the latter may create budgetary difficulties for the grantor. India, Malaysia, and Pakistan use conditional closed-ended matching programs. Pakistan in late 1990s got into serious difficulty by offering open-ended matching transfers for provincial tax effort. Central government had to abandon this scheme in mid-flow as it could not meet its obligations under the program.

4.3.6. Creating macroeconomic stability in depressed regions

Fiscal transfers can be used to serve central government objectives in regional stabilisation. For this purpose capital grants would be appropriate, provided that funds for the future upkeep of facilities were available. Experience with capital grants shows that such grants often create facilities that are later not maintained by sub-national governments, as they either remain unconvinced of the utility of such facilities or do not have the means to provide for their regular upkeep.

Capital grants are pervasive in developing and transition economies, and most countries have complex processes for initiation and approval of submissions for financing capital projects. These processes are highly susceptible to lobbying, political pressures and grantsmanship, and often favour projects that give the central government greater prominence. The projects typically lack citizen and stake-holder participation, and often fail due to lack of proper local ownership, interest and supervision. In view of this difficulty, it may be best to limit the use of capital grants by requiring matching funds from recipients, and by encouraging private sector participation in infrastructure through provision of political and policy risk guarantees.

4.3.7. Special issues in state/province-local transfers

General purpose transfers to local governments require special considerations as local governments vary in population size, area served, and the type of services offered (e.g. urban versus rural). In view of this, it would be advisable to classify local governments by population size, municipality type, and urban/rural distinction, and to have a separate formula for each class of municipality. Some common useful components in these formulae are: equal per-municipality component, equal per capita component, service area component, and fiscal capacity component. The grant funds should vary directly with service area, but inversely with fiscal capacity.

4.4. Facilitating responsible credit market access

The need for capital finance to overcome infrastructure deficiencies is of astronomical proportions in developing and transition economies, and cannot be financed from current revenues and transfers. Facilitating local credit market access can also reduce the need for beggar-thy-neighbour policies by local governments. Local access to credit requires properly functioning financial markets and creditworthy local governments. These pre-requisite s are easily met in industrial countries. In spite of this, traditions for assisting local governments by higher-level governments are well established in these countries.

In developing countries, undeveloped markets for long-term credit, and weak municipal creditworthiness limit municipal access to credit. Nevertheless, the predominant central government policy emphasis is on central controls, and consequently less attention has been paid to assistance for borrowing. Argentina, Bolivia, Brazil, Chile and Colombia have cooperative controls on domestic borrowing, and administrative controls on foreign borrowing. Ethiopia, India, Indonesia Korea, Mexico and Peru have administrative controls on domestic borrowing. India, Indonesia, Korea and Peru also have administrative controls on foreign borrowing. Foreign borrowing is prohibited in Thailand, Pakistan, Armenia, Czech Republic, Kazakhstan, Kyrgyz Republic, Lithuania, Poland, Russia and Slovenia. Domestic borrowing is prohibited in Ethiopia, Mexico and Thailand (World Bank, 2000 and 2001). Almost no developing and transition economies, with the exception of South Africa and Hungary, have a regulatory framework for declaring local government bankruptcy. In a few countries, such assistance is available through specialised institutions and central guarantees to jump-start municipal access to credit. The menu of choices available to local governments for financing capital projects is quite limited, and available alternatives are not conducive to developing a sustainable institutional environment for such finance. This is because macroeconomic instability, and lack of fiscal discipline and appropriate regulatory regimes have impeded the development of financial and capital markets. In addition, revenue capacity at the local level is limited due to tax centralisation. A first transitory step to provide limited credit market access to local governments may be to establish municipal finance corporations run on commercial principles, and to encourage the development of municipal rating agencies to assist in such borrowing. Tax decentralisation is also important to establish private sector confidence in lending to local governments and sharing the risks and rewards of such lending.

4.5. Supervision of local governments: freedom and responsibility within boundaries

Monitoring and supervision of local governments is an area of concern in both federal and unitary countries alike. The constitutional obligations regarding these provisions require a significant and superior evaluation capacity at provincial and national levels. Evaluative measures that can assist in this supervision include fiscal rules for expenditure and debt creation and management, requirement of annual commercial corporate audits of local governments; fiscal capacity measurement using a common yardstick (i.e. equalisation of municipal assessments); greater emphasis on formula grants over project grants in provincial-local transfers; greater emphasis on public-private/civil society partnership in public provision; opinion polls on service standards and citizen satisfaction; performance ratings of local governments based upon outputs, outcomes and citizen satisfaction.

In developing and transition economies, supervision of local governments is typically exercised through process and input controls. Such controls compromise local autonomy without advancing national objectives. In 1999, central governments exercised some control over 25% of sub-national expenditures in transition economies, and nearly half of the same in developing countries. Local autonomy, accompanied by accountability to citizens for service delivery, offers a better alternative in local government supervision. Thus local governments should have the freedom to raise money from local residents and spend as they wish, and also to hire and fire personnel as they please. In a study of 29 public organisations in six developing countries, Grindle (1997) found that where decentralisation was matched by such local autonomy and supervision, governments were “good performers” (achieving high levels of capacity, completed tasks, responsiveness and effectiveness).

As an alternative to centralised controls, some governments have developed ways of relating higher- to lower-level governments through results-oriented lines of accountability that do not stifle performance. The model of decentralisation for healthcare in Brazil is an example. Results-oriented contracts are developed between central government (providing funds) and local clinics (providing services), ensuring accountability between levels of government without a process bias. The contract system institutionalises greater autonomy for local governments than do other decentralisation regimes, holding them accountable for their results – and not binding their processes. The creation of “vigilance committees” in Bolivia follows the same principle. These committees are made up of representatives from civil society organisations. They are charged with monitoring performance of local governments in fulfilling their mandates in service delivery and satisfying local citizens, and reporting the results to central authorities.

4.6. Institutional considerations

Adherence to federalism principles, “getting prices right” or even “getting the rules of the game right” as discussed earlier, is a necessary but not a sufficient condition for the success of decentralised decision making. Complementary formal and informal institutions are needed to ensure that all players in the game adhere to a set of ground rules that has been agreed on, and that deviant behaviour is properly dealt with. In the following, we discuss selected aspects of this consideration.

4.6.1. Institutions and processes of inter-governmental coordination

Federal countries require both formal and informal institutions of inter-governmental coordination. In some federal countries, areas of potential conflict among different levels of government are minimised through clear separation of national and sub-national responsibilities (the so-called layer-cake model of federalism, practiced in Australia, Canada, India and Pakistan). In this model, the two levels interact through meetings of officials and ministers (executive federalism), and in Australia, India and Pakistan through federal unilateral actions. Some countries place a greater premium on a common response through shared or joint tasks, such as Germany (a federal country) and the Republic of South Africa (a pseudo-federal country). In these countries, in addition to executive federalism, the upper houses of parliament (Bundesrat and the Council of Provinces) play a key role in inter-governmental coordination. In countries with overlapping responsibilities (the so-called marble cake model of federalism), such as the United States and Brazil, state lobby of Congress and inter-state relations serve coordinating roles. In China, where growth concerns have imposed a federalist structure on a unitary country, regional communist party bosses/governors exercise a moderating influence on an otherwise monolithic orientation of the State Council. In Switzerland, there is also a strong tradition of coordination through consensus initiatives by cantons.

4.6.2. Institutional arrangements for fiscal relations

The structure of inter-governmental fiscal relations, especially the system of grants, must be determined by somebody. There are five main alternatives. The first is for the federal government alone to decide on it. This alternative negates federalism and would not be acceptable in many countries. The second is to set up a quasi-independent body, such as a grants commission, the purpose of which is to design and reform the system, as practiced in Australia, India and the Republic of South Africa. This alternative is prone to more ideal solutions rather than pragmatic approaches, and therefore runs the risk of presenting complex solutions and recommendations that may not be politically palatable. The third alternative is to use federal-state committees to negotiate the terms of the system, as in Canada. The fourth alternative is to have a joint inter-governmental cum inter-legislative commission, such as the Finance Commission in Pakistan, and the fifth alternative is to have an inter-governmental legislative body, such as the upper house of the German parliament (Bundesrat) in Germany. The last three systems allow for explicit political inputs from the jurisdictions involved, and are therefore likely to opt for simple and feasible, but less than ideal (compromise) solutions.

4.6.3. Institutions of accountability

Institutions of accountability hold the key to the success of decentralised decision making. These entail institutions and mechanisms for citizens' voice and exit norms and networks of civic engagement ("social capital" according to Putnam, 1993), social consensus (Williamson, 1994; Weingast, 1993), the preservation instinct of a "stationary bandit" who monopolises and rationalises theft in the form of taxes (Olson, 1993), judicial accountability, and vertical and horizontal accountability. The citizens' voice and exit requires institutions of democratic participation, and accountability provisions for elected officials. The origins and success of decentralisation programs in Latin America are traceable to the democratic traditions that emerged there during late 1980s. While norms and networks of civic engagement were reasonably well developed in pre-colonial traditionalist societies found in many developing countries, such as the Panchayat Raj in pre-British India, these institutions withered away either under colonial rule, or subsequently under centralised bureaucratic governance structures. The net result has been the rise of opportunism and social distrust, culminating in dysfunctional societies when formal institutions of governance failed. The African and the South Asian development fiascos share this common underpinning. Societal consensus on economic and political rights is also conducive to accountability at all levels. This consensus need not take any formal expression, but can work so long as a majority of people shares a common belief as to the limits of governmental intervention, and are willing to police those limits by withdrawing their support from a government that fails to abide by them (Weingast, 1993, 306). Preservation instincts of a stationary bandit also respect accountability (Olson, 1993), because the stationary bandit strengthens his grip on power only so long as economic performance is strong and citizens see their well-being improved. This partly explains the success of the Asian Tigers and the failure of some South/South East Asian regimes. The latter were controlled by “roving bandits”, whose main aim was to collect the loot to pad their overseas bank accounts, and then disappear to a foreign haven.

5. Aligning operational capacity with the authorising environment

In developing and transition economies operational capacity for local governance is deficient. This deficiency, however, can be overcome in the short term by borrowing such capacities from the national governments, from other local governments, from the private sector, and from civil society. In the long term, training of staff and the creation of an enabling environment for competitive service delivery, through partnership with the private sector and civil society, can augment operational capacity. A matter of greater concern in developing and transition economies is that the available capacity is not geared towards serving the citizen-voters. A similar bureaucratic culture prevailed in Western Europe not long ago. Over the years, industrial countries have shown a remarkable change in the performance of their public sectors. It is interesting to note that this change was brought about not through a system of hierarchical controls, as is the focus in most developing countries, but more through strengthened accountability for results to citizens at large. A recent empirical study by Gurgur and Shah (2002) supports this view, showing that in a sample of 30 countries, political and bureaucratic culture, and centralisation of authority represent the most significant determinants of corruption. In view of this evidence, a management framework where the public service is held accountable for delivery of public services consistent with citizen preferences offers great potential in developing countries for improving public sector governance, by nurturing responsive and accountable governance (Shah, 1999, for details and implications of civil service reform).

6. Adapting to a changing world by learning from each other

The developing and transition economies have undergone a major transformation of their public sector in the last decade. The transition economies have moved rapidly from central planning to market-dominated economies, whereas in developing countries the process of moving decision making closer to the people remains painfully slow and modest. Developing and transition economies have also attempted to forge new partnerships within and beyond governments, with varying degrees of commitment and success. Brazil, Chile, Czech Republic, Hungary, India, Malaysia and Poland are examples where a stable authorising environment, with a significant degree of societal consensus on the roles and responsibilities of various levels of government and their partnership with civil society, has been achieved. Other countries, such as China, Indonesia, Nigeria, Pakistan, South Africa, Russia and Uganda, are still groping for a consensus on the right balance. In some other countries in Africa, Central and East Asia, these issues have not yet received the political attention they deserve. Thus for a large number of developing and transition economies, the quest for right balance remains largely elusive. Further progress on this agenda requires learning from the experiences of industrial countries as well as the more recent experiences of developing and transition economies. Important lessons that can be distilled from these experiences are listed below.

- Periodic review of jurisdictional assignments is essential to realign responsibilities with changing economic and political realities.
- An enabling environment for decentralisation (i.e. institutions of citizen participation and accountability) must be addressed in any serious reform of fiscal systems. These elements have not been sufficiently addressed in most reform efforts. The charter of rights in Canada and Malaysia, and the Swiss requirement of approval of major legislative changes by referendums are helpful in enhancing accountability and bringing about a consensus.
- A decentralised civil service with task specialisation and performance contracts is critical to the success of a decentralisation program.
- Traditional administrative capacity matters, but should not be considered as an impediment to decentralisation; such capacity can be borrowed from supportive higher-level governments and elsewhere.
- An asymmetric program of decentralisation which recognises the nature and type of local government, its clientele, and its fiscal capacity should be developed, and various local governments should be assigned differential powers by taking into account the above-mentioned factors.
- A major separation of spending and taxing decisions leads to lack of accountability in the public sector.
- The role of performance-oriented fiscal transfers in enhancing accountability and competition for the supply of public goods should not be overlooked. For example, transfers for basic health and primary

education could be made available to both public and the not-for-profit private sector on an equal basis, using as criteria the demographics of the population served, school-age population, student enrollments etc. The continuation of the grant in future years would be conditional on achievement of service delivery performance goals. This would promote accountability for results, and competition and innovation as both public and private institutions would compete for public funding. Such financing options are especially attractive for providing greater access to public services in rural areas.

- Fiscal rules accompanied by “gate keeper” inter-governmental councils/committees provide a useful framework for fiscal discipline and fiscal policy coordination.
- To ensure fiscal discipline, governments at all levels must be made to face the financial consequences of their decisions. This is possible if the central government does not backstop state and local debt, and the central bank does not, in the last resort, act as a lender to the central government. In addition, ownership and preferential access to the financial sector should not be available to any level of government. In such an, environment capital markets and bond rating agencies would provide an effective fiscal policy discipline.
- Societal norms and consensus on the roles of various levels of government, and limits to their authorities are vital for the success of decentralised decision making. In the absence of such norms and

consensus, direct central controls do not work and inter-governmental gaming leads to dysfunctional constitutions.

- Tax decentralisation is a pre-requisite for sub-national credit market access. In countries with highly centralised tax bases, unrestrained credit market access by sub-national governments poses a risk to macro-stabilisation policies of the national government, as the private sector anticipates a higher-level government bailout in the event of default, and does not discount the risks of such lending properly.
- Higher-level institutional assistance may be needed for financing local capital projects. This assistance can take the form of establishing municipal finance corporations run on commercial principles to lower the cost of borrowing by using the superior credit rating of the higher-level government and municipal rating agencies to determine creditworthiness.
- An internal common market is best preserved by constitutional guarantees. National governments in developing countries have typically failed in this role.
- Finally, contrary to a common misconception, a developing country's institutional environment calls for a greater degree of decentralisation than that of an industrialised one. This is because information requirements and transaction costs are minimised by moving decision making closer to people who are affected by those decisions. Closeness also serves to enhance better participation, preference matching for public services, transparency, and greater accountability.

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Appendix A Representative assignment of expenditure responsibilities

Function	***Policy, standards and oversight***	***Provision/ administrati on***	***Production/ Distribution***	***Comments***
Inter-regional 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	" "
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
Defence	N	N	N,P	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
Inter-state commerce	Constitution, N	N	P	Constitutional safeguards important for factors and goods mobility
Immigration	U,N	N	N	U due to 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-neighbour 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	Transfers in kind
Highways	N,S,L	N,S,L	S,L,P	Benefits and costs of various roads vary in scope
Parks and Recreation	N,S,L	N,S,L	N,S,L,P	Benefits and costs vary in scope
Police	S, L	S,L	S,L	Primarily local benefits
Water, sewer, refuse, fire protection	L	L	L,P	Primarily local benefits

Note: U is supra-national responsibility, ICB is independent central bank, N is national government, S is state/provincial government, L is local government and P is non-government sectors/civil society

Appendix B A representative assignment of taxing powers

Types of Tax	*Determination of Base*	*Collection and Rate*	*Administration*	*Comments*
Customs	F	F	F	International trade taxes
Corporate income	F, U	F,U	F,U	Mobile factor, stabilisation tool
Resource taxes				
Resource rent (profits/income) tax	F	F	F	Highly unequally distributed tax bases
Royalties, fees, charges; severance taxes; production, output, and property taxes	S,L	S,L	S,L	Benefit taxes/charges for state-local services
Conservation charges	S,L	S,L	S,L	To preserve the local environment
Personal income	F	F,S,L	F	Re-distributive, mobile factor, stabilisation tool
Wealth taxes (taxes on capital, wealth, wealth transfers, inheritances, and bequests)	F	F,S	F	Re-distributive
Payroll	F,S	F,S	F,S	Benefit charge, e.g. social security coverage
Multistage sales taxes (Value Added Tax, [VAT])	F	F	F	Border tax adjustments possible under federal assignment; potential stabilisation tool
Single stage sales taxes (manufacturer/wholesale/retail)				
Option A	S	S,L	S,L	Higher compliance cost
Option B	F	S	F	Harmonised, lower compliance cost
"Sin" taxes				
Excises on alcohol and tobacco	F,S	F,S	F,S	Healthcare a shared responsibility
Betting, gambling	S,L	S,L	S,L	State and local responsibility
Lotteries	S,L	S,L	S,L	State and local responsibility
Race tracks	S,L	S,L	S,L	State and local responsibility
Taxation of "Bads"				
Carbon	F	F	F	To combat global/national pollution
BTU taxes	F,S,L	F,S,L	F,S,L	Pollution impact may be national, regional, or local
Motor fuels	F,S,L	F,S,L	F,S,L	Tolls on federal/provincial/local roads
Effluent charges	F,S,L	F,S,L	F,S,L	To deal with inter-state, inter-municipal or local pollution issues
Congestion tolls	F,S,L	F,S,L	F,S,L	Tolls on federal/provincial/local roads
Parking fees	L	L	L	To control local congestion
Motor vehicles				
Registration, transfer taxes, and annual fees	S	S	S	State responsibility
Driver's licenses and fees	S	S	S	State responsibility
Business taxes	S	S	S	Benefit tax

Types of Tax	***Determination of Base***	***Collect-ion and Rate***	***Administration***	***Comments***
Excises	S,L	S,L	S,L	Residence-based taxes
Property	S	L	L	Completely immobile factor, benefit tax
Land	S	L	L	Completely immobile factor, benefit tax
Frontage, betterment	S,L	L	L	Cost recovery
Poll	F,S,L	F,S,L	F,S,L	Payment for local services
User charges	F,S,L	F,S,L	F,S,L	Payment for services received

Note: U is supra-national agency, F is federal, S is state or province, L is municipal or local

Source: Shah, 1994

Appendix C Criteria for the design of inter-governmental fiscal transfers

Autonomy: sub-national governments should have complete independence and flexibility in setting priorities, and should not be constrained by the categorical structure of programs and uncertainty associated with decision making at the centre. Tax-base sharing – allowing sub-national governments to introduce their own tax rates on central bases, formula-based revenue sharing, or block grants – is consistent with this objective.

Revenue Adequacy: sub-national governments should have adequate revenues to discharge designated responsibilities.

Equity: allocated funds should vary directly with fiscal need factors and inversely with the taxable capacity of each jurisdiction.

Predictability: the grant mechanism should ensure predictability of sub-national governments' shares by publishing five-year projections of funding availability.

Efficiency: the grant design should be neutral with respect to sub-national government choices of resource allocation to different sectors or different types of activity.

Simplicity: grant 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.

Incentive: the design should provide incentives for sound fiscal management and discourage inefficient practices. There should be no specific transfers to finance sub-national government deficits.

Safeguard of grantor's objectives: this is best done by having grant conditions specify results to be achieved and giving the recipient flexibility in the use of funds.

Singular focus: each grant should be focused on a single objective.

The various criteria specified above could be in conflict with each other and therefore a grantor may have to assign priorities to various factors in comparing design alternatives.

Source: Shah, 1994

Appendix D Principles and better practices in grant design

Grant Objective	***Grant Design***	***Better Practices***	***Practices to avoid***
To bridge fiscal gap	• Reassign responsibilities • Tax abatement • Tax-base sharing	Tax abatement and tax-base sharing in Canada	Deficit grants Tax-by-tax sharing
To reduce regional fiscal disparities	General non-matching fiscal capacity equalisation transfers	Fiscal equalisation 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 spill-out of benefits	Republic of South Africa grant for teaching hospitals	
Setting national minimum standards	Conditional non-matching block transfers with conditions on standards of service and access	Indonesia pre-2000 roads and primary education grants Colombia and Chile education transfers	Conditional transfers with conditions on spending alone *ad hoc* grants
Influencing local priorities in areas of high national but low local priority	Open-ended matching transfers (with preferably matching rate to vary inversely with fiscal capacity)	Matching transfers for social assistance as in Canada	*ad hoc* grants
Stabilisation	Capital grants provided maintenance possible	Limit use of capital grants and encourage private sector participation by providing political and policy risk guarantee	Stabilisation grants with no future upkeep requirements

Source: Shah, 1994, 1998.

[1] The author is grateful to Professors Richard Bird, Bernard Dafflon and Claude Jeanrenaud for comments.

[2] This rethinking has caused much heated controversy and debate in the development policy forum. Regrettably, this debate has focused on straw men of "centralisation" *versus* "decentralisation". Contrary to focus in this debate, the literature of fiscal federalism is concerned with clarifying the assignment of responsibilities among different levels of government in support of good governance (Bird and Vaillancourt, 1998; Shah, 1994; Boadway and Shah, (forthcoming).

[3] The subsidiarity principle states that public service responsibilities must be exercised by the lowest level of government unless a convincing case can be made for higher-level assignment.

[4] A unitary country has a single or multi-tiered government in which effective control of government functions rests with the central government. A federal form of government has a multi-layered structure with decision making shared by all levels of government. In a confederal system of government, the central government serves as the agent of member units, usually without independent taxing and spending powers. The EU is an important example of a confederal form of government. Switzerland has a confederal constitution but is considered a federal country in practice.

[5] The total number of countries has risen from 140 in 1975 to 192 in 2001, and of these 25% were democracies in 1975 compared to 60% in 2001. In 2001 there were 24 federal countries with 25.4% of the world population, and another 20 decentralised unitary countries with some federal features, containing 35% of world population (Watts, 1999).

[6] In Switzerland, legislative bodies, fiscal rules and popular referendums on major budgetary proposals ensure that citizens' preferences are respected.

[7] Macroeconomic management under decentralised decision making is the subject of an ongoing debate. An overall conclusion from this controversy is that contrary to common misconception, decentralised fiscal systems offer a greater potential for improved macroeconomic governance than centralised fiscal systems (see Shah (1998) for a summary of the debate).