

Fiscal Decentralization in Developing and Transition Economies

Progress, Problems, and the Promise

By

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1. Introduction

During the past half century, by subscribing to various central planning paradigms of development, developing and transition economies (hereafter referred to as DTEs) by and large followed a path of centralization. As a result, they are more centralized today than industrial countries were in their early stages of development. A number of recent developments, discussed below, are prompting most DTEs to re-examine the respective roles of levels of government, the private sector and the civil society as partners in development². This paper examines the reasons for the rekindling of interest in fiscal rearrangements in DTEs and reviews the progress to-date by 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. An overall conclusion of the paper is that citizen voice, choice and exit options are critical to the success of decentralized decision making. These areas require significant attention in the on-going reform efforts.

The paper is organized as follows. Section 2 provides a discussion of the motivation behind the mega change. Section 3 provides a simple framework to evaluate and cope with the forces of change. Section 4 reviews the broad trends in the division of powers in DTEs and their implications for public sector governance. Section 5 reviews the operational capacity and orientation of the public sector in support of the reform efforts. Finally, Section 6 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. Nevertheless, generic catalysts for change include: (i) the

² This rethinking has caused much heated controversy and debate in development policy fora. Regrettably, this debate has focused on straw men of “centralization” vs “decentralization”. Contrary to focus in this debate, the fiscal federalism literature is concerned with clarifying assignment of responsibilities among different levels of government in support of good governance.

collapse of economies with collective ownership and control; (ii) desire to breakaway from the vestiges of colonialism and ethnic strife as in Africa; (iii) central government failures in securing national objectives; (iv) beggar-thy-neighbor and fend-for-yourself federalism policies of sub-national governments; (v) assertion of basic rights of citizens by the courts; (vi) globalization of economic activities; and (vii) the demonstration effects of the European Union and Latin America. The demise of the collective ownership model prompted a major change in government organization and geographical boundaries of some countries, especially in Eastern Europe and former Soviet Union. 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 centralized systems of governance geared toward 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. Political reforms in Latin America 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-neighbor policies, sought free ridership with no accountability and, in pursuit of narrow self-interest, undermined national unity. The judicial systems in some countries are also providing stimuli for change by providing a broader interpretation of basic rights and requiring that national and sub-national legislation conform to the basic rights of citizens.

The emergence of a new "borderless" world economy complicates this picture by bringing new challenges to constitutional federalism (see Courchene 1995). These challenges arise from the decline of nation-states in carrying out regulation of certain economic activities as borders have become more porous and information technology has weakened their ability to control information flows. With globalization, it is increasingly becoming apparent that nation-states are too small to tackle large things in life and too

large to address small things. More simply nation states are fast losing control of some of their areas of traditional control and regulation such as regulation of external trade, telecommunications, and financial transactions. National governments are experiencing diminished control in their ability to control the flow of goods and services, ideas and cultural products. These difficulties are paving way for the emergence of specialized institutions of global governance such as the World Trade Organization, Global Environment Facility with many more to follow especially institutions to regulate information technology, satellite communications, and international financial transactions. Thus nation states would be confederalizing in the coming years and relinquishing responsibilities in these areas to supranational institutions. This trend, however, contributes to a democracy deficit as citizens do not have the possibility of direct input in vital decision making by supranational institutions.

The European Union's policies and principles regarding subsidiarity³, fiscal harmonization and stabilization checks are also having demonstrable effects on DTEs' policies. Similarly the success of decentralization 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 inspired other countries to have a review of own fiscal arrangements (see Wiesner, 1994). Finally, resurgence of interest in the new public management and federalism principles and practices has served as a powerful basis to restructure and re-orient the public sector.

Emerging Governance Structure

This re-examination has resulted in a silent revolution sweeping the globe. This silent revolution is slowly but gradually bringing about rearrangements that embody diverse features of supra-nationalization, confederalization, centralization, provincialization and localization. Nevertheless, the vision of a governance structure that is slowly taking hold through this silent revolution is the one that indicates a gradual shift from *unitary* constitutional structures to *federal* or *confederal* form of governance for a

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.

large majority of people⁴. It implies that we are likely to move from a centralized to a globalized and localized world⁵. The role of the central governments in such a world would change from that of a managerial authority to a leadership role in a multi-centered 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 that of intolerance for risk to allowing freedom to fail or succeed. Financial crises around the world encouraging protectionist policies are hampering this change and as a result the new vision will take some time to shape in the 21st century (see Table 1) and in many DTEs as this vision may not actually materialize for some time due to the institutional impediments noted in the following sections.

Table 1: Governance Structure—20th Versus 21st Century

<i>20th Century</i>	<i>21st Century</i>
◆ Unitary	◆ Federal/confederal
◆ Centralized	◆ Globalized and localized
◆ Center manages	◆ Center leads
◆ Bureaucratic	◆ Participatory
◆ Command and control	◆ Responsive and accountable to citizens
◆ 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 manifest a trend toward either devolution (empowering people politically) and/or localization (decentralization of decision making

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 multilayered 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 European Union 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 have 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 are 24 federal countries with 25.4% of the world population with another 20 decentralized unitary countries with some federal features having 35% of world population (see also Watts, 1999). The World Bank has had programs in support of decentralization in 74 countries during 1986-2001.

to the local level). Localization has been pursued through varying combinations of political, administrative and fiscal decentralization initiatives. *Political or democratic decentralization* implies directly elected local governments thereby making elected officials accountable to citizens. *Administrative decentralization* empowers these governments to hire and fire local staff (thereby making local officials accountable to elected officials) without any reference to higher level governments. *Fiscal decentralization* ensures that all elected officials weigh carefully the joys of spending some one else's money as well as pains associated with raising revenues from the electorate and facing the possibility of being voted out. *Administrative deconcentration*, where decision making is shifted to regional and local offices of the central government, would not be consistent with administrative decentralization. Similarly *administrative delegation* where local governments undertake activities on behalf of the higher level governments falls short of administrative decentralization. Thus, localization of authority is intended to bring decision making closer to the people being served by the public sector. This change has proven to be a controversial proposition in DTEs. This is because localization is being perceived both as a solution to problems such as a dysfunctional public sector and lack of voice and exit, as well as a source of new problems such as capture by local elites and aggravation of macroeconomic management due to lack of fiscal discipline and perverse fiscal behavior by sub-national units. There are also conceptual difficulties in making choices on the right balance. (see Shah, 1994 and Boadway, Roberts and Shah, 1994). Beyond these conceptual issues, a number of practical considerations have a bearing on the quest for balance within a nation. 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.

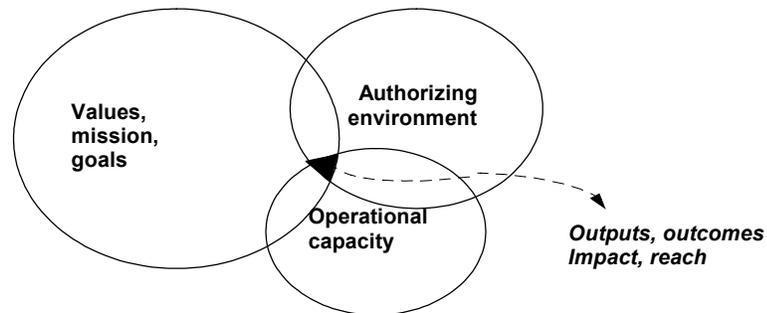
3. Leading Change: Developing a Vision and a Strategy

Coping with or adapting to this 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's mission and values, its authorizing environment and its operational

capacity in DTEs yields important insights in understanding the dysfunctionality of public governance.

- (a) *Public sector vision or public sector mission and values.* Societal mission and values as embodied in the constitution or in annual budget policy statements, may be useful points of reference for public sector mandates and the values inherent in these mandates
- (b) *Authorizing environment.* The authorizing environment represents the institutional mechanisms to translate constitutional mission to concrete objectives and actions. These include societal norms, formal and informal rules, procedures and organizations dealing with participation, consultation, policy making, and accountability. Legislative, coordination and oversight bodies are important elements of the authorizing environment. These institutions ensure that the public sector is solely focused on citizen aspirations. In Switzerland, legislative bodies, fiscal rules and popular referenda on major budgetary proposals ensure that citizens preferences are respected.
- (c) *Operational capacity and constraints.* The skills, motivations and commitment of the executive branch represents the operational capacity. What is authorized is not necessarily what will get done as the available operational capacity may not be consistent with the task at hand. Further, even the operational capacity that is available may be circumvented by the bureaucratic culture or incentives that reward command and control, and corruption and patronage.

Figure 1: Public Sector Institutional Environment
in Transition Economies and Developing Countries



The challenge of public sector reform in any country is to harmonize the public sector’s mission and values, its authorizing environment and its operational capacity so that there is a close, if not perfect, correspondence among these three aspects of governance (see Figure 1). The intersection of these three elements has a bearing on the public sector performance in the delivery of its mandate. Thus the goal is to maximize this intersection. Such a task is daunting for many DTEs since they often have lofty goals, but lack an authorizing environment that is capable of translating these goals into a policy framework. This problem is often compounded further by bureaucratic incentives that make any available operational capacity to implement such a framework dysfunctional.

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

Various levels of government will have a greater focus on societal goals if they and the citizens knew with some clarity 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. This 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 European Union. 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 literature has also provided principles which broadly support the subsidiarity principle. *Stigler's menu* (Stigler, 1953) identifies two principles of jurisdictional design: (a) representative government works best closer it is to the people; and (b) people should have the right to vote for the kind and amount of public services they want. Olson (1969) proposed “*fiscal equivalency*” as the criterion for jurisdictional design. According to this principle, political jurisdiction and the benefit area for public services must overlap to ensure that marginal benefit of provision equals its marginal costs and that there is no free ridership. Oates refines these ideas further. The *decentralization theorem* advanced by Oates states that “each public service should be provided by the jurisdiction having control over the minimum geographical area that would internalize benefits and costs of such provision” (Oates 1972, p.55). This would imply assignment of functions such as national security and defense to the center and garbage collection and fire protection to the local level. In a related idea, the so-called “*correspondence principle*”, Oates (1972) has argued that the jurisdiction determining the level of provision of each public good should include precisely the set of individuals that consume it. Application of these principles to achieve the right balance in the number and size of jurisdictions require operations of *voting with feet* (Tiebout, 1956), voting by ballots or other community formation processes (Buchanan, 1965) or redrawing of jurisdictional boundaries.

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

a. Clarifying Roles of Various Governments in Public Service Delivery

Conceptually, central government expenditure responsibilities should include: (a) 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; (b) those 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; and (c) stabilization 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 oversight or the conditional transfer of funds (see Appendix Table 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. The assignment of public services to various types of local and regional authorities requires 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) and 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.

Special challenges in expenditure assignment from globalization

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 localization and regionalization of public decision making to better safeguard their interests. With greater mobility of capital, and loosening of the 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 transnational economic alliances as 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. Education and training typically however is a 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 polarize the distribution of income in favor of skilled workers, accentuating income inequalities and possibly eliminating lower-middle-income classes. Since the national governments may not have the means to deal with this social policy fallout, sub-national governments working in tandem with national governments would have to devise strategies in dealing with the emerging crisis in social policy.

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 for conflict among different levels of government. To avoid these conflicts, a guiding principle should be that to the extent these agreements embody social policy provisions they must be subject to ratification by sub-national governments as is currently the practice in Canada.

In macroeconomic governance, supranational institutions such as the IMF and the World Bank are assuming ever larger 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 stabilization and macroeconomic control. The federal government's role in coordination and oversight, however, will increase⁶.

⁶ Macroeconomic management under decentralized decision making is the subject of an on-going debate. An overall conclusion from this controversy is that, contrary to common misconception, decentralized fiscal systems offer a greater potential for improved macroeconomic governance than centralized fiscal systems (see Shah, 1998 for a summary of the debate and Shah, Thompson and Zou, 2004, for empirical evidence).

Emerging Jurisdictional Realignments

Box 1 presents a newer federalism 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, the global environment, and international migration will gradually pass upwards (centralized) beyond nation states, some sub-national functions such as training will have greater central government inputs (centralization) and local functions would gradually be completely decentralized and would involve greater participation by civil society and the private sector. In general, globalization and localization trends reinforce each other while diminishing the relative importance and centrality of central governments.

Box 1. Emerging Rearrangements: Globalization, Centralization and Localization

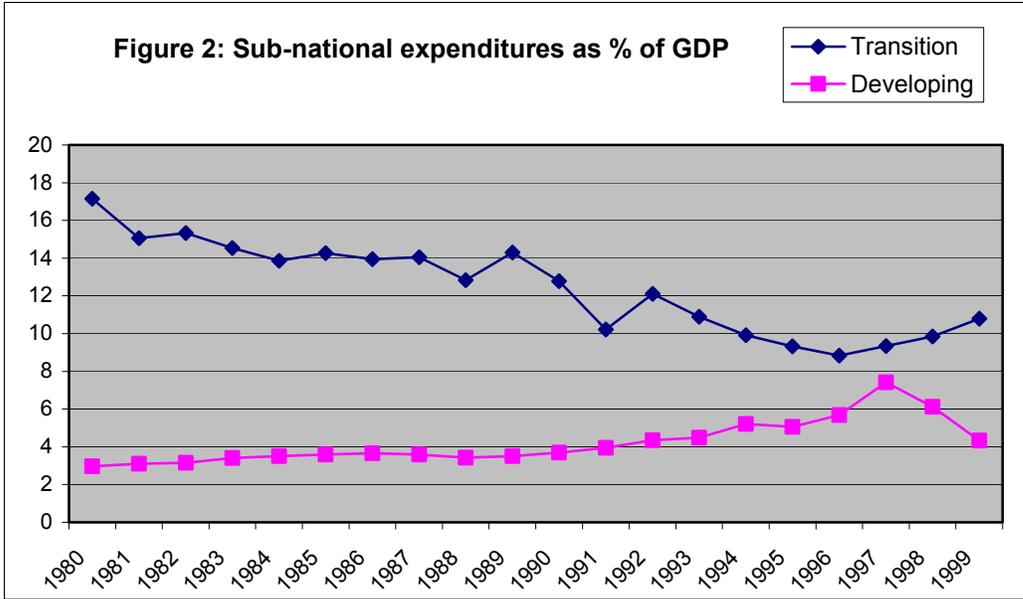
Beyond Nation States: International conflict resolution, stabilization, regulation of financial transactions, corporate taxation, international trade, global environment, telecommunications, international standards, international migration, surveillance of governance conditions, global security and risk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

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

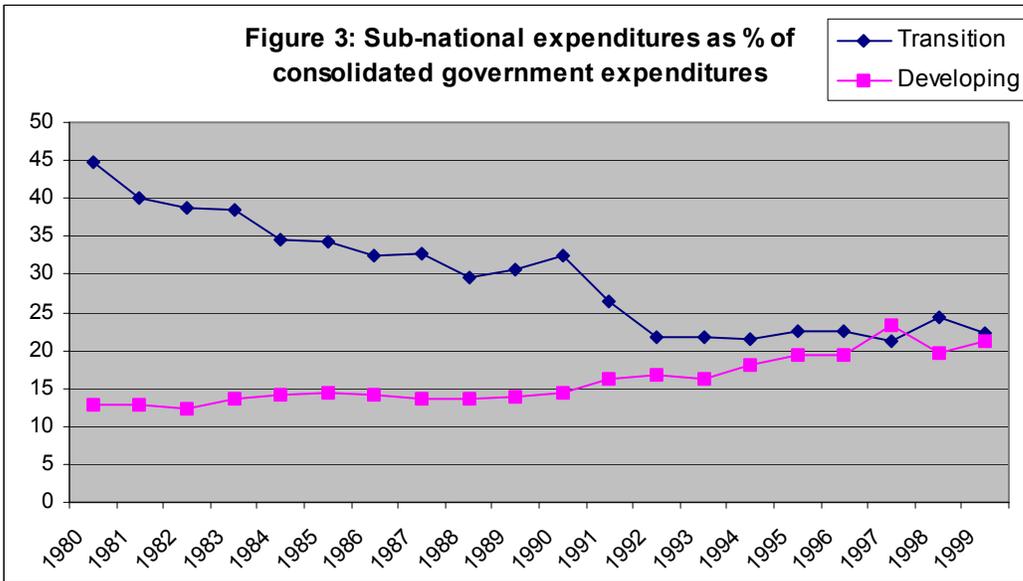
Regionalization/Localization/privatization: All regional/local functions.

Expenditure re-assignment – progress so far

Expenditure assignments in DTEs have undergone significant changes in the past two decades. In transition economies such changes reflected a new role for the public sector in support of a market economy. As a consequence sub-national expenditures contracted as a percent of GDP from about 17.2% in 1980 to 10.8% in 1999 (see Figure 2). Sub-national expenditures in transition economies as a proportion of total public sector expenditures experienced even a sharper decline during the same period from 44.9% to 22.3% (see Figure 3).

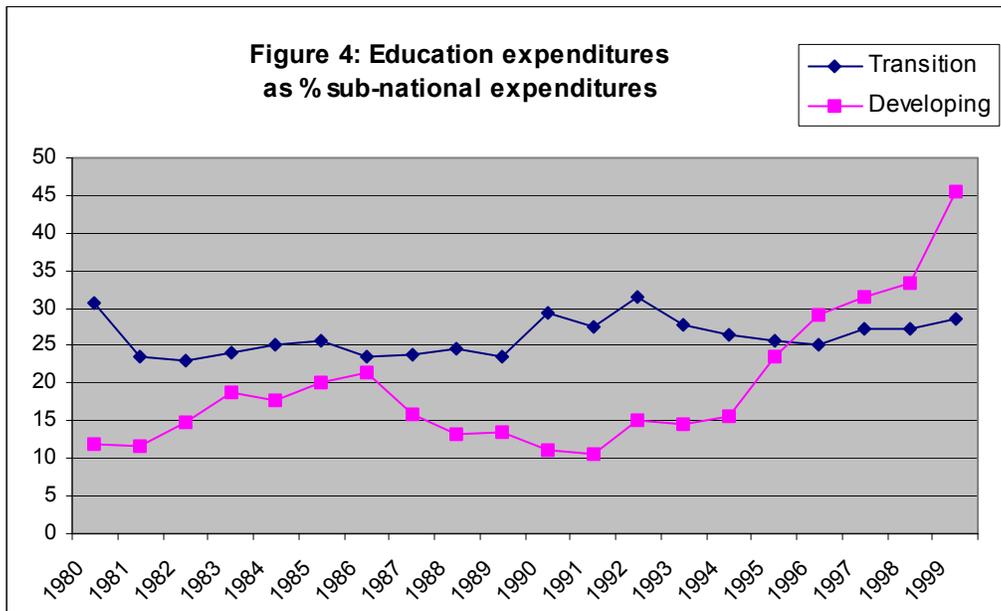


Source: IMF Government Finance Statistics (various years) and World Bank Fiscal Indicators.
 (<http://www1.worldbank.org/publicsector/decentralization/fiscalindicators.htm>)



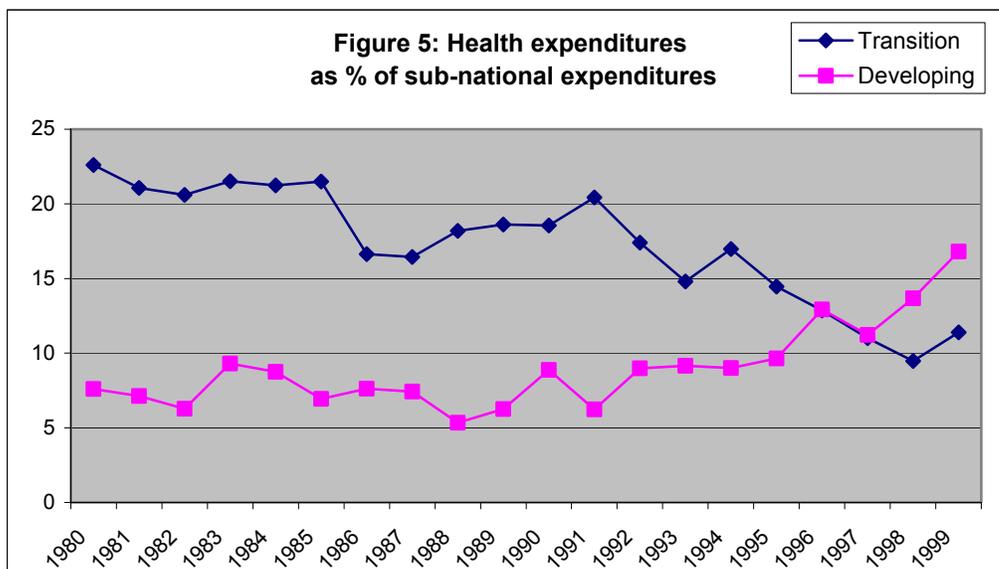
Source: IMF Government Finance Statistics (various years) and World Bank Fiscal Indicators.
 (<http://www1.worldbank.org/publicsector/decentralization/fiscalindicators.htm>)

In developing countries, on the other hand, there has been a gradual, generally piecemeal yet persistent decentralization of expenditure responsibilities. Sub-national expenditures in developing countries as a percent of GDP rose from 3% of GDP in 1980 to 6.1% of GDP in 1997. Sub-national expenditures as a percent of total public sector expenditures increased from 12.7% of total expenditures in 1980 to about 19.6% of total in 1998. Sub-national government's role in education and health spending show divergent trend in transition economies and developing countries (see Figures 4 and 5).



Source: IMF Government Finance Statistics (various years) and World Bank Fiscal Indicators.

(<http://www1.worldbank.org/publicsector/decentralization/fiscalindicators.htm>)



Source: IMF Government Finance Statistics (various years) and World Bank Fiscal Indicators.

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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. In developing countries, on the other hand, such expenditures have risen from 21% of total public sector education expenditures in 1980 to 40% of the same 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. In developing countries, the same role expanded from about 22% of total education expenditures to 57% of the same in 1999. These trends, however, hide the wide variations in such ratios across countries as shown in Table 2.

On the high side, in China (56%), India (46%) and Argentina (40%) are noteworthy for the relative importance of sub-national expenditures in total public expenditures. Moldova (18%) and South Africa (18%) have the highest percentage of these expenditures with respect to their GDP. Slovak Republic (8%), Dominican Republic (2.6%) are noted for the lowest share of sub-national expenditures in total public sector expenditures in transition and developing countries respectively. As a percentage of GDP, Croatia (0.01%), Dominican Republic (0.4%), Costa Rica and Bahrain (less than 1% of GDP) are noteworthy.

Table 2. Decentralization Indicators for Developing and Transition Economies

		Transition (1999)			Developing (1997)		
		Average	Max	Min	Average	Max	Min
<i>Sub-national expenditures</i>							
	As % of GDP	10.8	20.4	5.8	7.4	18.3	0.8
	As % of public sector expenditures	22.3	38.8	7.3	23.3	45.2	3.5
	Sub-nat'l education expenditures, as % of public sector education expenditures	55.9	91.4	0.2	49.8	97.5	0.2
	Sub-nat'l health exp., as % of public sector health expenditures	41.9	95.9	0.3	60.2	98.1	13.7
<i>Sub-national revenues</i>							
	As % of GDP	7.9	17.1	2.9	5.3	12.5	0.5
	As % of public sector revenues	18.4	36.0	5.6	16.6	39.8	2.2
<i>Fiscal transfers</i>							
	As % of sub-national revenues	24.0	50.4	4.1	42.2	80.8	5.0
<i>Sub-national autonomy</i>							
	Tax autonomy	55.1	91.0	29.1	40.1	76.5	7.6
	Expenditure autonomy	74.0	96.2	49.6	58.0	95.0	23.4

Source: Author's calculations based on IMF Government Finance Statistics, various years and World Bank Fiscal Indicators.

(<http://www1.worldbank.org/publicsector/decentralization/fiscalindicators.htm>)

Many central governments play a larger direct role in service provision than the theory would recommend. For example, in India, Indonesia, South Africa and Mexico, the central government accounts for more than two-thirds of total expenditures. Even in countries where the de jure assignment of expenditures agrees with theoretical principles, practices can differ. Brazil and Pakistan are the cases in point. In Brazil, the central government has found it difficult to withdraw from some purely local functions such as public markets, local schools, and local bridges more than a decade after the adoption of the 1988 constitution. In Pakistan, central and provincial governments have a prominent role in local functions. In Mexico, the dominance of the central government results from both the direct assignment of functions to the federal level and the supposed inability of lower governments to assume delegated responsibilities. In China, Russia and other transition economies, state enterprises continue to have a role in local government functions. Their redistributive role associated with consumer and producer subsidies especially in the housing market is large and threatens the fiscal health of local governments.

Table 3: Central Involvement in Local Functions Remains Extensive

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	<i>Service</i>	<i>Number of Countries</i>			Sample Size
		Purely Central Function:	Central Government Involvement (Other):	Purely Local Function	
	Public Service				
Social Services	Primary and Preschool Education	12	9	12	33
	Secondary Education	13	8	10	31
	Public Health	9	14	8	31
	Hospitals	11	12	4	27
Transportation	Urban Highways	7	5	17	29
	Urban Transportation	6	4	12	22
Utility Services	Drinking Water and Sewerage	8	16	6	30
	Waste Collection	0	2	27	29
	Electric Power Supply	8	13	4	25
Other Services	Fire Protection	0	5	4	9
	Public Order and Safety	1	1	0	2
	Police	14	10	5	29

Source: Author's calculations based on World Bank Qualitative Decentralization Indicators.

<http://www1.worldbank.org/publicsector/decentralization/qualitativeindicators.htm>

Quite a large number of central governments are involved in 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 center in 12 countries and in additional 9 countries central government is involved in this service along with local governments (see Table 3 for details on central government involvement in local functions).

In areas of shared responsibility such as education, health and social services, policies of various levels of government are typically uncoordinated. While social services expenditures tend to be less important in developing countries than industrial countries, the local government role in these functions is more important in the latter. These are also the functions that are in some countries mandated by the constitution to be provided universally and free. In transition economies the central governments have often attempted to shift social expenditures downward to regional and local governments without providing additional finances. These largely unfunded mandates have therefore

been seen as attempts by national governments to shift deficits downward, creating disharmony and conflicts among governments at different levels. The division of expenditure responsibilities within nations have been further complicated by the role of external donors. External donors in their attempt to create “islands of integrity” associated with the use of their funds have often supported creation of parallel structures of decision making that bypass local government institutions.

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

b. Taxing Choices: Determining Who Taxes What, At What Rate and How

Four general principles require consideration in 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 center. Sub-national assignment of taxes on mobile factors may facilitate the use of socially wasteful beggar-thy-neighbor policies to attract resources to own areas by regional and local governments. In a globalized world even central assignment of taxes on mobile capital may not be very effective in the presence of tax havens and difficulty in tracing and attributing incomes from virtual transactions to various physical spaces. Second, national equity considerations warrant that progressive redistributive taxes should be assigned to the center. This limits the possibility of regional and local governments following perverse redistribution policies using both taxes and transfers to attract high income persons and repel low income ones. Third, taxes should be assigned to the jurisdiction with the best ability to monitor relevant assessments. This minimizes the administration costs as well as potential for tax evasion. For example property and land taxes are good candidates for local assignment as local governments would be in a better position to assess market values of such properties. 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 table 2 for a representative assignment of taxing responsibilities).

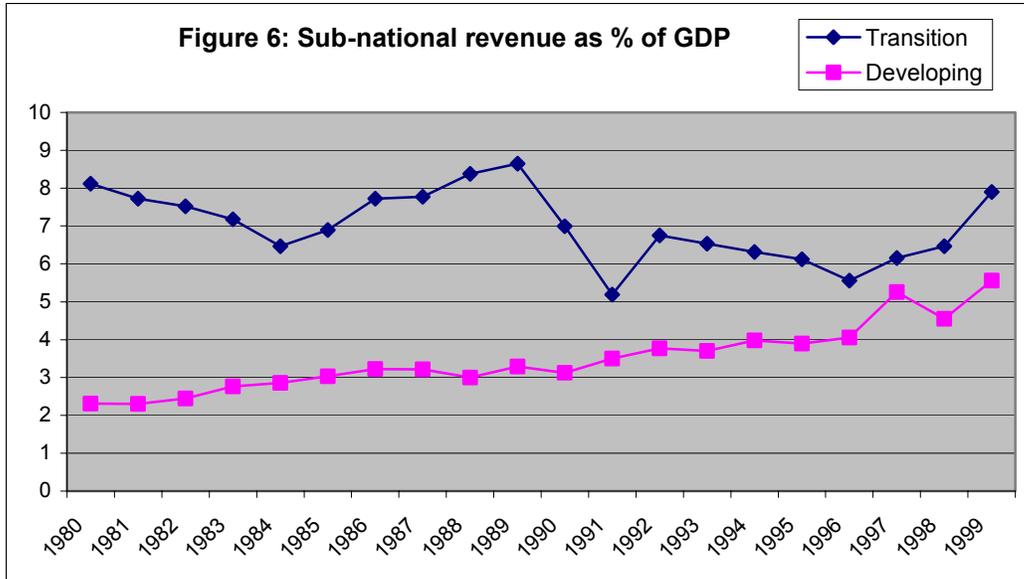
The above principles suggest that the case for decentralizing taxing powers is not as compelling as that for decentralizing public service delivery. This is because lower level taxes can introduce inefficiencies in the allocation of resources across the federation and cause inequities among persons of 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 decentralize must be done with care balancing the need to achieve fiscal and political accountability at the lower levels of government against the disadvantages of having a fragmented tax system. The trade-off between increased accountability and increased economic costs from decentralizing taxing responsibilities can be mitigated by fiscal arrangements that permit joint occupation and harmonization of taxes to overcome fragmentation and fiscal equalization transfers to reduce fiscal inefficiencies and inequities that arise from different fiscal capacities across regional and local governments.

Re-assigning taxing powers – An Update

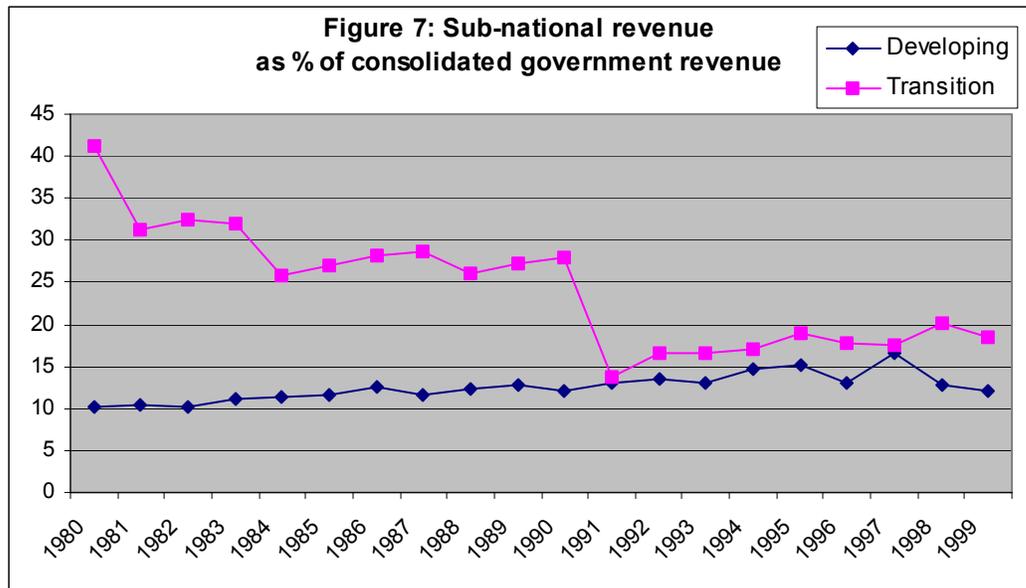
The above discussion suggests that decentralization of taxing powers may not fully match the decentralization of expenditure and regulatory functions. However, in developing and transition economies centralization of taxing responsibilities is much more pronounced than would be based on economic considerations. In some countries such as Mexico and Pakistan, the national government raises more than 90% of consolidated public sector revenues. Revenue systems in developing and transition economies are typically characterized by a large and dominant central government role and a heavy reliance on indirect taxes such as VAT, excises, taxes on external trade and fuel taxes. Sub-national sales taxes are permitted in a number of countries including Brazil, India, Russia and Kyrgyz Republic. Sub-national level VAT is vogue only in Brazil (see Shah 2001, 1988, 1994 for practical difficulties with a sub-national VAT) but several Indian states have introduced multi-stage sales taxes. Local governments have very limited access to own source revenues such as property taxes and user charges and even for these limited tax bases, they typically have autonomy only with respect to rate

setting within limits. Even the property related taxes in some countries are under central control. In China and Indonesia, the central government levies taxes on land, property and housing, and in India state governments levy an urban property tax and taxes on property transactions. In Brazil the rural property tax is in the federal domain, in Nigeria state governments tax non-agricultural land and in Pakistan provincial governments are empowered to tax agricultural land. Private sector participation in collecting taxes and user fees on behalf of local governments is practiced in some countries. For example, tax farming whereby rights for revenue collection are auctioned, is practiced by local governments in Pakistan for collecting taxes and user fees.

Sub-national own revenues constitute about 7.9% of GDP in transition economies (11% in Moldova, 10% in Belarus and 0.01% in Croatia) and 5.5% of GDP in developing countries (8% in Argentina, less than 1% in Bahrain, Indonesia and Mauritius and 0.1% in Dominican Republic) in 1999 (see Figure 6). In transition economies, on average sub-national governments raise 18.4% of revenues of public sector revenues (52% in China, and 3% in Albania) and in developing countries they raise slightly less – about 16.6% (39% in Argentina and India and 0.8% in Dominican Republic) in 1997 (see Figure 7). During the past two decades, transition economies have shown a decline in these revenues as tax collection was centralized whereas in developing countries, there has been a modest increase due to small degree of tax decentralization. Sub-national revenues financed 55% of sub-national operating expenditures in transition economies (71% in Lithuania and 70% in Moldova, and 2% in Albania) and 40% of the same in developing countries (78% in Argentina, 63% in Costa Rica and 7% in Peru and South Africa) in 1999. The rest of the financing comes from shared taxes, transfers and borrowing. Overall tax decentralization remains an unfinished agenda for DTEs.



Source: IMF Government Finance Statistics (Various years) and World Bank Fiscal Indicators
<http://www1.worldbank.org/publicsector/decentralization/fiscalindicators.htm>



Source: IMF Government Finance Statistics, various years and World Bank Fiscal Indicators

<http://www1.worldbank.org/publicsector/decentralization/fiscalindicators.htm>

The above discussion implicitly assumes that assignment of taxes entails control over the tax base, tax rates and collection authority. This need not be the case and higher level governments may instead, in the interest of harmonization and minimizing collection and compliance costs, allow lower level governments to either levy a supplementary rate on own base (tax base sharing) or agree to share the proceeds from specific taxes in a pre-determined way (shared taxes). Under such arrangements, tax base determination usually rests with the higher-level government with lower levels of government levying supplementary rates on the same base. Tax collection is by one level of government, generally the central government in market economies and the local government in transition economies with proceeds shared downward or upward depending upon revenue yields. Only a handful of developing and transition economies have adopted tax base sharing. A sub-national surcharge on the personal income tax is permitted in Brazil and Croatia. Russia allows a surcharge on the corporate income tax. Provincial governments in Pakistan allow local governments to have a supplementary rate on property transfer taxes. While the practice of tax base sharing is uncommon, sharing the proceeds of various taxes on a tax by tax basis is frequently practiced in DTEs. In transition economies, in 1999, 49.3% of sub-national government revenues

were obtained from shared taxes (see 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.

c. Designing Fiscal Transfers: Dividing the spoils or creating an enabling framework for innovative and competitive service delivery

Intergovernmental transfers are the dominant source of revenues for sub-national governments in most DTEs. In 1999, they constituted on average 24% of total revenues for transition economies (93% in Albania and 4% in Croatia) and 42% (81% in South Africa, 75% in Peru and 7% in China) of the same (in 1997) for developing countries. This ratio ranges from 4% to 81% for individual countries. The transfers constituted 75-95% of sub-national revenues in Indonesia, Nigeria, Mexico, Pakistan and South Africa. The design of these transfers is of critical importance for efficiency and equity of local service provision and fiscal health of sub-national governments (see Appendix table 3 for general principles and better practices in grant design). For enhancing 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 needed to fulfill own direct service responsibilities so that they are able to use their spending power through fiscal transfers to fulfill 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.

i. To bridge a fiscal gap

An imbalance between the revenue-raising ability of regional and local governments and their expenditure responsibilities might arise for three reasons. For one, there may be inappropriate assignment of taxing and spending responsibilities such that expenditure needs of sub-national governments exceed their revenue means. Second, it may be more efficient for the national government to collect tax revenues on behalf of the states and turn

the funds over to them to allow them to carry out their expenditure responsibilities to avoid the tax competition, interregional tax distortions and beggar thy neighbor policies that might otherwise exist which would preclude the states from raising the optimal amount of revenues on their own. Third, a fiscal gap may come about endogenously because it is necessary for the national government to occupy more tax room than it needs in order to be able to undertake a number of its fiscal responsibilities, including managing the macro-economy, maintaining a harmonized tax system, and making the fiscal transfers that it needs to make to satisfy the objectives of such transfers. To correct problems associated with the first two kinds of imbalances, joint occupancy of some tax fields or decentralization of some taxes are advocated. Unconditional grants or revenue sharing based on the origin/derivation (point of collection) principle are also appropriate solutions to these problems. To deal with tax competition, higher revenue effort by the national government and unconditional grants are required. Finally, to deal with the last type of imbalance some form of tax abatement by the national government is necessary to provide more tax room in fields jointly occupied with the lower levels of government. This would, however, imply scaling back national role in some expenditure areas.

In DTEs, general revenue sharing are typically used to deal with fiscal gap. A number of countries including China, India, Malaysia, Pakistan, South Africa have in the past tried deficit grants to fill fiscal gaps at sub-national levels with unwelcome results in terms of mushrooming of sub-national deficits. These grants are still in vogue in China, Hungary and South Africa.

ii. To correct fiscal inequities and fiscal inefficiencies arising from differentials in regional fiscal capacities

Decentralized decision making results in differential net fiscal benefits (imputed benefits from public spending minus tax burden) being realized by citizens depending upon the fiscal capacities of their place of residence. A rich jurisdiction can provide a higher level of public services at a lower tax rate. It is argued that such differential net fiscal benefits (NFBs) would lead to unequal treatment of citizens with identical private incomes depending on their place of residence. This is because their after tax income inclusive of

NFBs would be vary by place of residence. Such NFBs also encourage people to move to a resource rich area, although appropriate economic opportunities may not exist. Thus resource allocation would be inefficient, because people in their relocation decisions would compare gross income (private income plus net benefits minus cost of moving) at new locations whereas economic efficiency considerations warrant comparing private income minus moving costs. Thus a nation which 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 which naturally arise in a decentralized government. As argued earlier, regional governments with their own expenditure and taxation responsibilities will be able to provide their residents different NFBs from their differing fiscal capacities. In a centralized unity country, they would not arise as the central government would provide comparable services to all citizens using a national tax system. Central-state grants can eliminate these differences in NFBs 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 decentralized the tax system is, the greater the need for equalizing transfers.

Most transition economies have equalization 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 equalization concerns. In developing countries, programs using an explicit standard of equalization are untried, although equalization 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 on individual objectives. Because the formulae lack explicit equalization standards, they fail to address regional equity objectives satisfactorily.

iii. To compensate 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

which yield 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 the 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 not been implemented in developing countries with the single exception of South Africa. South Africa provides a closed-ended matching grant to teaching hospitals based upon an estimate of benefit spillovers associated with enrollment of non-local students and use of hospital facilities by non-residents.

iv. 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 these will contribute to the free flow of goods and services, labor and capital and reduce wasteful inter-jurisdictional expenditure competition, and will therefore improve 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 redistributive 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 – create 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 to 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 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.

Source: Shah (1998)

Conditional non-matching transfers to ensure national minimum standard are rarely used in DTEs. Central government transfers to provincial and local governments in Indonesia (the former roads and education grants), 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.

v. To influence 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, the so-called spending power. Matching transfers are often used to influence lower level priorities. Both the national and intermediate level governments could legitimately pursue such policies.

Open-ended matching transfers with matching rate (percent of expenditures financed from own sources by the recipient) to vary 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 behavioral 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 program in midstream as it could not meet its obligations under the program.

vi. To create macroeconomic stability in depressed regions

Fiscal transfers can be used to serve central government objectives in regional stabilization. For this purpose capital grants would be appropriate provided funds for 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 a regular upkeep. 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 by providing political and policy risk guarantees.

Capital grants are pervasive in DTEs and most countries have complex processes for initiation and approval of submissions for financing capital projects. These processes are greatly susceptible to lobbying, political pressures and grantmanship and favor projects that give the central government greater visibility. The projects typically lack citizen and stakeholder participation and often fail due to proper local ownership, interest and oversight. The requirement for matching funds helps in monitoring and evaluation of projects and in building local ownership.

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 vs rural. In view of this, it would be advisable to classify local governments by population size, municipality type, and urban/rural distinction and have a separate formula for each class of municipalities. 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.

d. Facilitating Responsible Credit Market Access

Needs for capital finance to overcome infrastructure deficiencies are of astronomical proportions in DTEs and could not be financed from current revenues and

transfers. Facilitating local credit market access can also reduce the need for beggar-thy-neighbor policies by local governments. Local access to credit requires well functioning financial markets and credit worthy local governments. These pre-requisites 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 have also 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, Thailand (see World Bank, 1999/2000 and World Bank, 2001). Almost all DTEs with the exception of South Africa and Hungary do not have a regulatory framework for declaring local government bankruptcy. In a few countries such assistance is available through specialized institutions and central guarantees to jump start municipal access to credit. The menu of choices available to local governments for financing capital projects are 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 centralization. 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 decentralization is also important to establish private sector confidence in lending to local governments and sharing in the risks and rewards of such lending.

e. Oversight of Local Governments: Freedom and Responsibility within Boundaries

Monitoring and oversight of local governments is an area of concern in both federal and unitary countries alike. For example, the Republic of South Africa Constitution Act 1996 (Section 139(1) (b)) provides for a disbandment of local government in the event of failure to (i) “maintain national standards or meet minimum standards of service”; (ii) “prevent actions prejudicial to the interests of another municipality or the nation as a whole”; and (iii) “maintain economic unity.” It further provides for withholding of tax shares and transfers for non-compliance with tax effort (Section 227(2)). 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 oversight include fiscal rules for expenditure and debt creation and management, requirement of annual commercial corporate audit of local governments; fiscal capacity measurement using a common yardstick i.e. equalization 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; and performance ratings of local governments based upon outputs, outcomes and citizen satisfaction.

Oversight of local governments is typically exercised through process and input controls in DTEs. 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 over nearly half of the same in developing countries (see Figure 8). Local autonomy accompanied by accountability to citizens for service delivery offers a better alternative in local government oversight. 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 organizations in six developing countries, Grindle (1999) found that where decentralization was matched by such local autonomy and oversight, governments were “good performers” (achieving high levels of capacity, completed tasks, responsiveness and effectiveness).

As an alternative to centralized 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 decentralization for health care 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 institutionalizes greater autonomy for local governments than do other decentralization 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 constituted from representatives of civil society organizations and are charged with monitoring performance of local governments in fulfilling their mandates in service delivery and achieving local citizens’ satisfaction and reporting the results to central authorities.

f. Ensuring a fair suck of the sauce bottle: institutional considerations

Adherence to federalism principles or “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 decentralized decision making. Complementary formal and informal institutions are needed to ensure that all players in the game adhere to agreed upon set of ground rules and deviant behavior is properly dealt with. In the following, we discuss selected aspects of this consideration.

Institutions and processes of intergovernmental coordination

Federal countries require both formal and informal institutions of intergovernmental coordination. In some federal countries, areas of potential conflict among different levels of government are minimized through clear separation of national and sub-national responsibilities (the so-called layer-cake model of federalism as practiced in Australia, Canada, India and Pakistan) and the two levels interact through meetings of officials and ministers (executive federalism) and in Australia, India and Pakistan through federal unilateralism. 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 intergovernmental coordination. In countries with overlapping responsibilities (the so-called marble cake model of federalism), such as United States and Brazil, state lobby of Congress and interstate relations serve coordinating roles. In China, where growth concerns have imposed a federalism structure on a unitary country, regional communist party officials/ governors exercise a moderating influence on the otherwise monolithic orientation of the State Council.

Constitutional provisions per se can also provide coordinating influences. For example, in some federal countries, constitutional provisions require that all legislation recognize that ultimate power rests with the people. For example, all legislation in Canada must conform to the Canadian Charter of Rights. In Switzerland, a confederation by law but a federal country in practice, major legislative changes require approval by referenda. In Switzerland, there is also a strong tradition of coordination through consensus initiatives by cantons.

Institutional arrangements for fiscal relations

The structure of intergovernmental fiscal relations, especially the system of grants, must be determined by some body. 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, whose purpose 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 done in Canada. The fourth alternative is to have a joint intergovernmental cum inter-legislative commission such as the Finance Commission in Pakistan and the fifth alternative is to have an intergovernmental legislative body such as the upper house of the German Parliament (Bundesrat) as in Germany. The latter three systems allow for explicit

political inputs from the jurisdictions involved, and therefore likely to opt for simple and feasible but less than ideal (compromise) solutions.

Institutions of accountability

Institutions of accountability hold the key to the success of decentralized decision-making. This entails institutions and mechanisms for citizens voice and exit, norms and networks of civic engagement (“social capital” according to Putnam), social consensus (Williamson, 1994 and Weingast, 1993), preservation instinct of a “stationary bandit” who monopolizes and rationalizes theft in the form of taxes (Olson, 1993), judicial accountability, and vertical and horizontal accountability. Citizen voice and exit require institutions of democratic participation and accountability provisions for elected officials. The origins and success of decentralization programs in Latin America is traceable to the democratic traditions that emerged across the continent in late 1980s. In the Philippines, recently enacted local government legislation, while empowering these governments, has provided for regular elections and recall of elected officials for a breach of public trust (see the Republic of Philippines Act No. 7160, the Local Government Code, 1991). While norms and networks of civic engagement were reasonably well developed in the pre-colonial traditionalist societies found in many developing countries, such as the Panchayat Raj in Pre-British India, these institutions withered away either under the colonial rule or subsequently under centralized 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 failures share this common underpinning.

Societal consensus on economic and political rights is also conducive to accountability at all levels. According to Weingast (1993), this consensus need not take any formal expression but would work so long as a majority of people share a common belief as to the limits of government intervention and are willing to police those limits by withdrawing their support from a government that fails to abide by them (see Weingast, 1993, p. 306). Preservation instincts of a stationary bandit also respect accountability (see Olson, 1993). This is because the stationary bandit strengthens his grip on power, 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/Southeast Asian regimes. The latter regimes were controlled by “roving bandits” whose main aim was to pad their overseas bank accounts and then disappear in a foreign haven.

Judicial accountability strengthens the credibility of public commitments. This is particularly important for transition economies, where framework laws on property rights, corporate legal ownership and control, bankruptcy, and financial accounting and control are not fully developed. Interestingly enough, judicial accountability is much more difficult to enforce in a parliamentary democracy than in a presidential system that respects separation of the legislative and executive functions. This is because under a parliamentary democracy, the executive branch can override judicial accountability by amending the legislation - a game played ad infinitum in Pakistan to undermine a decentralized federal constitution. Judicial accountability is further compromised under a British style civil service organization as in India and Pakistan (until 2001), where divisional and district commissioners hold simultaneously executive, legislative and judicial powers. As noted by Montesquieu (1970), such a situation is ripe for the abuse of powers as “ ... When the legislative and executive powers are united in the same body of magistrates, there can be no liberty;... Again, there is no liberty, if the judiciary power is not separated from the legislative and executive” (Montesquieu, 1970, p. 397).

Traditional channels of accountability

The audit, inspection and control functions should be strengthened, since they tend to be quite weak in transition and developing economies. The auditor-general should be given greater authority and autonomy in exercising his mandate. At the same time, a case can be made for loosening the constraints of the central planning process in developing countries. Central plans lead to a centralization of authority; reductions in flexibility, innovation and autonomy at the local level; and delays in private sector activity.

5. Aligning Operational Capacity with the Authorizing Environment

In DTEs operational capacity for local governance is deficient. However, this deficiency can be overcome in the short run by borrowing such capacities from the national government, other local governments and the private sector and civil society. In the long run, training staff and creating 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 DTEs is that the available capacity is not geared toward serving the citizen-voters. A similar bureaucratic culture prevailed in Western Europe not long ago. German philosopher Nietzsche characterized the government as “coldest of all cold monsters – whatever it says it lies – and whatever it has – it has stolen.” 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 to citizens at large. This was done by creating a political-legal-fiscal framework for citizen-centric governance (see Andrews and Shah, 2003). The elected representatives made a commitment along the lines of the oath required of the members of the city of Athens which stated that:

“We will strive increasingly to quicken the public sense of public duty;
That thus...we will transmit this city
Not only not less, but greater, better and more beautiful
Than it was transmitted to us.”

In modern times, such a commitment to accountability for results got firmly grounded in the political culture of industrial countries. This accountability for results was further strengthened by accountability of the executive to the legislature branch and through creation of charter of rights for individuals to demand accountability from their governments. An important element of these systems of accountability has been to bring about a change in both the bureaucratic culture and the incentives public employees face. This is done by steering attention away from internal bureaucratic processes and input controls (hard controls) to accountability for results (soft controls). While various

countries have followed diverse policies to achieve this transformation, the underlying framework driving these reforms is uniform and firmly grounded in a citizen-centered governance framework. The results oriented management and evaluation framework (ROME) serves to operationalize elements of this broader framework of bottom-up accountability. Under ROME, a results based chain provides a yardstick for measuring public sector performance.

Results Oriented Management and Evaluation (ROME) Chain:

Program/project => inputs=> activities=> outputs=>reach (stakeholders positively or adversely affected)=> outcome (purpose) => impact (goal)=> citizen feedback and evaluations=>program design => program/project

Most ROME related approaches have the following common elements: (a) Contracts/work programs based upon pre-specified output and performance targets and budgetary allocations; (b) Managerial flexibility but accountability for results; (c) Subsidiarity principle; (d) Incentives for cost efficiency and (e) Citizen charter, bottom-up accountability.

ROME provides a coherent framework for strategic planning and management based upon learning and accountability in a decentralized environment. As the focus of the approach is on learning, failure to meet commitments in the short run may be tolerated but a failure to share values and persistent failure to meet commitments invite severe sanctions. The ROME framework calls for competitive wages and task specialization and lack of formal tenures for public personnel. Public providers are given the freedom to succeed or fail. Instead public employees hold the jobs so long as they are able to fulfill the terms of their contracts. Persistent failures initiate the exit process. Responsiveness to citizenry and accountability for results are the cornerstone of this approach. A recent empirical study by Gurgur and Shah (1999) supports this view as it shows that political and bureaucratic culture and centralization of authority represent the most significant determinants of corruption in a sample of 30 countries. In view of this evidence, the ROME framework offers a great potential in developing countries to improve public sector governance by nurturing a responsive and accountable governance.

6. Adapting to a Changing World with Learning From and Inspiring Each Other

The DTEs have undergone a major transformation of their public sector in the last decade. The transition economies have rapidly moved from central planning to market dominated economies whereas the progress in developing countries to move decision making closer to the people remains painfully slow and modest. The DTEs have also attempted to forge a new partnership within and beyond governments with varying degrees of commitment and success. Argentina, Brazil, Chile, Czech Republic, Hungary, India, Malaysia and Poland represent examples of achieving a stable authorizing environment - where there is a significant degree of societal consensus on the roles and responsibilities of various levels of government and their partnership with civil society. 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, and Central and East Asia, these issues have not yet received the political attention they deserve. Thus for a large number of DTEs, the quest for the right balance remains largely elusive. Further progress on this agenda requires learning from past experiences of industrial countries as well as more recent experiences of DTEs. In this paper, we have reviewed the DTE experiences while using an analytical framework that draws on experiences in both industrial and non-industrial countries. The following important lessons can be distilled from this review.

- *Periodic review of jurisdictional assignments is essential to realign responsibilities with changing economic and political realities.* With globalization and localization, the national government's direct role in stabilization and macroeconomic control is likely to diminish over time, but its role in social protection, education, training, skills enhancement, coordination and oversight is expected to increase as regimes and sub-national governments assume enhanced roles in some of its areas of traditional responsibility. Constitutional and legal systems and institutions must be amenable to timely adjustments to adapt to changing circumstances.

- *An enabling environment for decentralization, 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.
- *Civil service reform is critical to the success of a decentralization program.* Such a reform must ensure that the center has no direct say in the recruitment and promotions of civil servants, other than overseeing that standards of transparency and fairness are met at the sub-national levels and that wages of sub-national services must be competitive with the central government. Further, the civil service incentive structure should reward service orientation and performance and discourage command and control and rent seeking. This can be accomplished through performance contracts, stay-with-it culture, recognition of specialized skills and evaluation systems that link performance, rewards and budgeting.
- *Traditional administrative capacity matters but should not be considered as an impediment to decentralization.* Administrative capacity to develop and maintain modern organizational practices such as budgeting, auditing and accounting systems is no doubt important but should not be considered as a barrier to decentralization provided citizen participation and transparency in decision making is ensured. This is because technical capacity can be borrowed from supportive higher-level governments and elsewhere.
- *Asymmetric decentralization as provided under the Indonesian decentralization program and under provincial local government ordinances in Pakistan offers a thoughtful approach to decentralization.* Regardless of the availability of help from higher level governments, lack of institutional capacity should never be considered as an excuse not to decentralize. Instead, an objective program of decentralization that recognizes the nature and type of local government, its clientele and its fiscal capacity can be developed and various local governments can 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.* In the event of such de-linking, the role of conditional (conditional on standards of services and access to such services and not on expenditures) block transfers is worth examining to enhance accountability.

- *Intergovernmental transfers in developing countries undermine fiscal discipline and accountability while building transfer dependencies that cause a slow economic strangulation of fiscally disadvantaged regions.* Properly designed intergovernmental transfers on the other hand can enhance competition for the supply of public goods, fiscal harmonization, sub-national government accountability and regional equity.
- *The role of fiscal transfers in enhancing 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 the public sector and the not-for-profit private sector on an equal basis using as criteria the demographics of the population served, school age population and student enrollments, etc. This would promote 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” intergovernmental councils/committees provide a useful framework for fiscal discipline and fiscal policy coordination.* In this context, one can draw on industrial countries’ experiences with “golden rules”, Maastricht type guidelines and “common budget directives” to develop country specific guidelines. To ensure voluntary compliance with the guidelines, an appropriate institutional framework must be developed. Transparency of the budgetary processes and institutions, accountability to the electorate and general availability of comparative data on fiscal positions of all levels of government further strengthen fiscal discipline.
- *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 act as a lender of last resort 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 governments and limits to their authority are vital for the success of decentralized decision making.* In the

absence of such norms and consensus, direct central controls do not work and intergovernmental gaming leads to dysfunctional constitutions.

- *Tax decentralization is a pre-requisite for sub-national credit market access.* In countries with highly centralized tax bases, unrestrained credit market access by sub-national governments poses a risk for macro stabilization 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 credit worthiness.
- *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 institutional environment calls for a greater degree of decentralization than needed for an industrial country.* For an efficient working of a centralized bureaucracy, advanced information gathering and transmittal networks, an efficient and dedicated civil service, and well developed institutions of citizen participation and accountability are needed. This is possible in the setting of an industrial country environment. A more primitive public sector environment is more suited to a decentralized form of governance. This is because information requirements and transaction costs are minimized by moving the 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 Table 1 . A Representative Assignment of Expenditure Responsibilities

<i>Function</i>	<i>Policy, standards & oversight</i>	<i>Provision/ administration</i>	<i>Production/ Distribution</i>	<i>Comments</i>
Interregional & International conflicts resolution	U	U	N,P	Benefits & costs international in scope
External trade	U	U,N,S	P	“ “
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
Defense	N	N	N,P	Benefits & costs national in scope
Foreign Affairs	N	N	N	“ “
Monetary policy, currency, banking	U, ICB	ICB	ICB, P	Independence from all levels essential. Some international role for common discipline
Interstate commerce	Constitution, N	N	P	Constitutional safeguards important for 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 & 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 & Recreation	N,S,L	N,S,L	N,S,L,P	“ “ “
Police	S, L	S,L	S,L	Primarily local benefits
Water, sewer, refuse, fire protection	L	L	L,P	“ “ “

Note: U is supranational 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. Source: Shah (1994).

Appendix Table 2: A representative assignment of taxing powers

<i>Types of Tax</i>	<i>Determination of Base</i>	<i>Collection and Rate</i>	<i>Administration</i>	<i>Comments</i>
Customs	F	F	F	International trade taxes.
Corporate income	F, U	F,U	F,U	Mobile factor, stabilization 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 local environment.
Personal income	F	F,S,L	F	Redistributive, mobile factor, stabilization tool.
Wealth taxes (taxes on capital, wealth, wealth transfers, inheritances, and bequests)	F	F,S	F	Redistributive.
Payroll	F,S	F,S	F,S	Benefit charge, e.g., social security coverage.
Multi-stage sales taxes (value-added tax, [VAT])	F	F	F	Border tax adjustments possible under federal assignment; potential stabilization tool.
Single stage sales taxes (manufacturer/wholesale/retail)				
Option A	S	S,L	S,L	Higher compliance cost.
Option B	F	S	F	Harmonized, lower compliance cost.
"Sin" taxes				
Excises on alcohol and tobacco	F,S	F,S	F,S	Health care 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 interstate, intermunicipal 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.
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 supranational agency, F is federal, S is state or province, L is municipal or local.

Source: Shah (1994).

Appendix Table 3. Principles and Better Practices in Grant Design

<i>Grant Objective</i>	<i>Grant Design</i>	<i>Better Practices</i>	<i>Practices to avoid</i>
To bridge fiscal gap	<ul style="list-style-type: none"> • Reassign responsibilities • Tax abatement • Tax base sharing 	Tax abatement in Canada and tax base sharing in Canada, Brazil and Pakistan	Deficit grants Tax by tax sharing as in India
To reduce regional fiscal disparities	General Non-matching Fiscal capacity equalization transfers	Fiscal equalization programs of Australia, Canada and Germany	General revenue sharing with multiple factors
To compensate for benefit spillovers	Open-ended matching transfers with matching rate consistent with spillover of benefits	RSA grant for teaching hospitals	
Setting national minimum standards	Conditional non-matching block transfers with conditions on standards of service and access	Indonesia 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
Stabilization	capital grants provided maintenance possible	Limit use of capital grants and encourage private sector participation by providing political and policy risk guarantee	stabilization grants with no future upkeep requirements

Source: Shah (1994), Boadway, Roberts and Shah (1994)