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Intergovernmental Fiscal Relations in a Macroeconomic Perspective: An Overview

TERESA TER-MINASSIAN

Over the past few decades a clear trend has emerged worldwide toward the devolution of spending and, to a lesser extent, revenue-raising responsibilities to subnational levels of government (state and local).[1] This trend is evident not only in federal, but also in many unitary countries, including some that have had a long tradition of centralist government. This trend is partly a reflection of the political evolution toward more democratic and participatory forms of government, seeking to improve the responsiveness and accountability of political leaders to their electorate, and to ensure a closer correspondence of the quantity, quality, and composition of publicly provided goods and services to the preferences of their beneficiaries.

The view that decentralization of spending responsibilities can entail substantial gains in terms of efficiency and welfare has long been held in the economic literature, Tiebout (1961), Musgrave (1969), and Oates (1972). Also common in the literature is, however, the view that decentralization can entail significant costs in terms of distributional equity and macroeconomic management (see, for exam-

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[1]In this chapter state refers to the regional level (encompassing states, regions, or provinces) and local to the municipal level (including counties, towns, and villages).

ple, Prud'homme, 1995; Tanzi, 1996). This chapter examines the validity of these views, in the light not only of theoretical considerations, but also of the experience of a number of countries worldwide, which are discussed in detail in Chapter 8 through Chapter 28 of this book. A major conclusion of this analysis is that substantial decentralization is indeed likely to make it more difficult to carry out both redistribution and macroeconomic management through the budget. It does not, however, make it impossible. The specific design of intergovernmental fiscal relations, as well as of institutional arrangements within and among the various tiers of government, plays a crucial role in this respect.

This chapter briefly reviews and discusses the main issues to be faced in the design of various aspects of intergovernmental fiscal relations: expenditure assignment, revenue assignment, intergovernmental transfers, tax administration, budgeting and financial management in a multilevel government setting, and the control of subnational government borrowing. These topics are developed in greater depth in subsequent chapters (Chapter 2 through Chapter 7) of the book. In this chapter, emphasis is placed on the implications that different choices in the design of intergovernmental fiscal relations have for macroeconomic management.

Expenditure Assignment

As indicated above, there is broad consensus in the literature that decentralization of spending responsibilities can entail substantial welfare gains. According to this view, efficiency in the allocation of resources is best served by assigning responsibility for each type of public expenditure to the level of government that most closely represents the beneficiaries of these outlays. In this perspective, a clear case for centralized provision can be made—at least on allocative grounds—only for national public goods, that is, goods whose benefits extend nationwide or whose provision is subject to substantial economies of scale. Defense, foreign affairs, and infrastructures for interstate transport and telecommunications are the categories of expenditure that most closely fit these criteria.

Proponents of centralization argue, however, that allocative considerations can come into conflict with distributional and macroeconomic management objectives. Especially in large countries characterized by substantial regional disparities in the distribution of productive resources and incomes, the ability of subnational governments to provide public goods and services to their residents can vary widely, leading to undesirable internal migrations, as well as, in some cases, to unsustainable social and political pressures. To the extent that substandard levels of provision of certain public goods (for instance, primary education or basic health care) affect adversely the stock of human capital of the country (and, thereby, the prospects for long-term growth of the economy), there can be even significant efficiency costs from the decentralization of these types of expenditures.

While these are certainly valid points, they do not necessarily imply that the provision of public goods and services—other than those of a clearly national nature—should be administered centrally. The central government can influence the decentralized delivery of such goods and services through the setting of policy guidelines (or mandates) for this delivery; a transfer of resources to the subnational governments to equalize their capacity to meet these mandates; and the ex post control of the use of the transfers and of the level and quality of the services provided by the lower levels of governments.

The decentralization of a large share of public expenditure can have significant implications for macroeconomic management. Even if the overall level of expenditures of subnational governments is effectively constrained by limits on their taxation and borrowing powers, changes in the composition of their expenditures can affect aggregate demand in ways which may run counter to the stabilization objectives of the central government. This may be the case, for example, if the composition of subnational expenditures shifts in favor of items that have a relatively large impact on demand (such as transfers to individuals with a high propensity to consume). Even a balanced budget expansion by subnational governments could boost aggregate demand, and worsen the balance of payments, if the average multiplier of their expenditures exceeded significantly that of their revenues. Purely from a macroeconomic management perspective, therefore, central governments should retain responsibility for expenditures that have a particularly strong impact on demand or that are particularly sensitive to changes in the cycle, such as unemployment benefits. More broadly, it is clear that the greater the share of public expenditure that is assigned to the subnational levels of government, the greater the need to involve the latter (especially the states or provinces and large municipalities) in the pursuit of any needed fiscal adjustment. The section on Administrative Aspects of Fiscal Decentralization will discuss some possible mechanisms of such coordination, referring in particular to the experience of some large federations like Germany and Australia.

It is important to recognize that the theoretical efficiency gains from decentralization can be significantly undermined in practice by institutional constraints (Tanzi, 1996). First, the administrative capacity of subnational governments may be quite weak. Overstaffing, poor technical skills and training of employees, and the inability to formulate and implement effective spending programs to fully exploit potential financing sources characterize many regional and local jurisdictions in a number of countries worldwide. The incidence of corruption at the local level is not negligible either.[2] Second, subnational governments often have not been able to develop modern and transparent public expenditure management systems, including adequate mechanisms of financial control, reporting and accounting, and evaluation of expenditure programs. Third, the size of local jurisdictions (which is often the result of historical developments or political factors) is not always consistent with the full realization of potential efficiency gains from decentralization.

Against the background of these considerations, it is not surprising that country experiences regarding expenditure assignments vary widely. As indicated in Chapter 2, during the 1980s the shares of state (provincial) governments in total expenditures of the general government ranged from less than 8 percent (in Mexico) to over 40 percent (in Australia, Canada, and India). The corresponding shares of local governments ranged from 2 percent (in Mexico) to over 50 percent (in Denmark).

These differences reflect varying practices with respect to the choice of functions to be covered by each level of government. Most countries assign such functions as defense, foreign affairs, foreign trade, and regulation of immigration to the central (federal) level. At the other end of the spectrum, services such as local police, fire prevention, sanitation, transportation, and certain utilities are typically assigned to the municipal or county level. For the other expenditure functions, however, which account for the bulk of government noninterest spending, there is no uniform pattern of assignments. Moreover, the legal framework regulating these assignments is not always clear, allowing the persistence of ambiguities regarding the respective roles of the various levels of government in the formulation of policies, the financing, and the delivery of shared expenditures (see, for example, the cases of Italy (Chapter 11) and Brazil (Chapter 18)).

A prevalent tendency is to reserve to the central or federal level the intervention in, and regulation of, strategic sectors of industry, as well as of interstate transport and telecommunications. The central government is also generally responsible for the promotion of research and development. State or provincial governments tend to share responsibility with the central government in the areas of agriculture, forestry,

[2]See, however, Huther and Shah (1996) for an empirical analysis suggesting that decentralization promotes accountability and strengthens governance.

fishing, and environmental protection. They are generally responsible for regional infrastructures, notably the road network. Local governments tend to regulate locally based businesses.

Substantial diversity can be found in the assignment of responsibilities within the broad area of social spending. There is a case for the assignment to the central level of responsibilities for social insurance mechanisms against life-cycle and economic contingencies (such as old age, disability, and unemployment), since a main rationale for the setting up of such mechanisms is a pooling of risks. This case is reinforced by the desire in most societies to ensure nationwide standards for social insurance. Indeed, this is the prevailing pattern in the countries surveyed in this book, at least as far as old age and disability pensions are concerned. The provision of unemployment benefits, however, which is a federal function in most countries, is a responsibility of the states in the United States (although the federal government contributes to its financing through grants). As regards social assistance, for administrative efficiency reasons, its delivery is frequently devolved to the local level, but the federal and/or regional level generally plays a role in setting standards for, as well as in funding, local programs.

In the area of education, the most frequent pattern is the assignment of responsibility for the primary and secondary levels to local governments and for the postsecondary level to the national or regional governments. In a number of unitary states, however, education at all levels remains a central government responsibility. Even in countries that decentralize expenditures on education to the state and/or local levels, the central government generally maintains a significant role in shaping nationwide education policies and standards, and in funding various education programs.

Concurrent responsibilities are also frequent in the area of health expenditures. Local governments are often responsible for basic and preventive health care provision. The states, or, in unitary countries, the central government, are generally responsible for the prevention of communicable diseases, more advanced curative facilities, such as hospitals, and the funding of medical research. In some cases, there is overlapping and even duplication of services in this area, leading to inefficiencies and waste of resources. In some countries, particularly developing and transition economies (for example, China, Russia), the devolution of health expenditure responsibility to lower levels of government, in the absence of adequate equalization transfers, has led to increased regional discrepancies in the level and quality of public health care services, with adverse effects especially on the lower income groups in the poorer regions, which cannot substitute private health care for the deteriorating public services.

The Assignment of Revenue-Raising Responsibility

There is a degree of consensus in the public finance literature on a number of desirable criteria to guide the assignment of revenue-raising responsibilities across the various levels of government. Nevertheless, country experiences do not always conform to those criteria and exhibit a fairly wide range of variation.

It is generally recognized that both distributional and, especially, macroeconomic management considerations argue against arrangements (such as the ones in the former Yugoslavia and, until recently, in China) that would assign all or most taxing powers to subnational governments, with upward revenue sharing, especially if the sharing formulas were to be renegotiated frequently. Such arrangements deprive the central government of tax instruments for macroeconomic management. Moreover, they do not facilitate a redistributive role for the central government budget, either across regions or across income groups. Therefore, upward revenue-sharing arrangements can only be viable in countries (such as Germany) with a long-established tradition of close policy coordination among different government levels and relative homogeneity of economic conditions across regions, or in loose confederations, or common economic areas, in which the responsibility for redistribution and stabilization policies continues to rest primarily with the member states. Moreover, since substantial regional variations in the bases and/or rates of certain taxes would tend to lead, in an integrated economic space, to distortions in the flow of goods and factors of production, even in common economic areas efforts have to be made to achieve a degree of harmonization of national tax policies, to avoid such allocative distortions. This is illustrated by the experience of the European Union, especially since the beginning of the single market in 1993.

Arrangements that assign all or most taxing powers to the central government are undesirable as well. By separating spending authority from revenue-raising responsibilities, these arrangements obscure the link between the benefits of public expenditures and their price, namely, the taxes levied to finance them. Thus, they do not promote fiscal responsibility in subnational politicians and their electorate.[3]

Therefore, the alternative favored in the literature and most frequently observed in countries around the world is one that provides for

[3]In Italy recognition of the shortcomings of a system (enacted after the tax reform of 1973) that concentrated all the major taxes at the central government level—making both the regions and the local authorities highly dependent on transfers from the central government—has led to reforms that in the last few years have increased significantly the share of own revenues for the lower levels of government (see Chapter 11 for details).

the assignment of own sources of revenue to each level of government, in combination with various types of intergovernmental transfers, to bridge any resulting gap between revenue and expenditure assignments. There is, however, wide variation in the forms of both revenue assignments and intergovernmental transfers.

Some countries espouse a principle of complete separation of the tax bases for the different levels of government. Others allow different levels to tap the same tax base. Examples of tax separation can be found in, among others, India, Australia, and, for nonshared taxes, Germany. By contrast, there is a considerable degree of tax overlapping in the United States and Canada.

There is broad consensus in the literature that the central government should be assigned taxes that have certain characteristics (see Chapter 3):

(1) They are levied on the more mobile tax bases. This is necessary to avoid tax-induced movements of factors of production, and also to avoid tax competition driving down revenues excessively.

(2) They are more sensitive to changes in income, that is, they have higher income elasticity. This is to provide the central government with stabilization instruments, and also to shelter to the extent possible the budgets of subnational governments from cyclical fluctuations.

(3) They are levied on tax bases that are distributed unevenly across regions.

These criteria would argue for the assignment to the central government of income taxes on enterprises (criteria (1) and (2)) and of taxes on natural resources (criterion (3)). For the latter, however, a plausible case can be made for a sharing of the base between the federal and the relevant subnational governments, especially in view of the impact that the exploitation of these resources might have on the local environment. There is also general consensus that taxes on foreign trade should be assigned to the central government.

Since the mobility of individuals and households tends to be less than that of businesses, the personal income tax appears more suitable for partial assignment—through tax overlapping—to the subnational (especially state or provincial) level.[4] However, to minimize distortions and tax-induced movements of labor and capital, it is preferable that the definition of the tax base be homogeneous throughout the country and also that rate differentials among subnational jurisdictions be kept relatively small. Since this tax should be levied on the basis of the res-

[4]In Canada, the provinces levy a personal income tax, which is calculated as a surcharge on the federal income tax.

idence principle, including in the base income from out-of-state sources, its administration would be carried out most effectively by the central government. If it is carried out at the state level, it is crucial that there be adequate and systematic exchange of information among the states, to permit the identification of out-of-state incomes.

As regards multistage sales taxes, such as the value-added tax (VAT), the difficulties of coordinating and administering such taxes, if levied at the subnational level, are frequently pointed out in the literature, and are exemplified by the case of Brazil where the state-level VAT on interstate transactions is levied on an origin basis—at a lower rate than on transactions within the state—giving rise to significant distortions and administrative difficulties (see Chapter 18 for details). Although in principle a destination-based VAT could be levied at different rates in different regions of a common economic area (with a deferred payment mechanism) without allocative distortions (along the current model of the European Union), the requirements for its effective administration (including exchange of relevant information among the regional tax administrations) are substantial, making it a difficult option for most countries.

By contrast, single-stage sales and excise taxes are generally considered good candidates for assignment to the regional governments, provided that the rates do not differ excessively among the regions. Property taxes, business license taxes, and various types of user fees for local services are generally regarded as ideal candidates for local taxation, since their base is relatively immobile.

As indicated above, country experiences conform only partially to these recommended criteria for revenue assignment. In some countries, state-level taxation of corporate profits, in the absence of a coordinated approach, has been accompanied by strong competition (tax wars), leading to distortions in enterprises' location decisions, tax avoidance through transfer pricing by enterprises operating in multiple areas, and erosion of revenues. Compliance costs for enterprises have also been substantially increased by regionally differentiated corporate tax regimes and by having to deal with multiple tax administrations. Also, in contrast with recommended principles of tax assignment, natural resources are assigned in some federations wholly to the region in which the resources are located. This arrangement, which reflects economic and political power balances, tends to exacerbate horizontal imbalances among regions. This is, for example, the case in Canada.

The substantial variation across countries of arrangements for revenue assignment is reflected in wide disparities in the shares of own revenues in total revenues of regional and local governments. These shares provide an indication of the degree of dependence of subnational governments on financial support from the central government. Rough calculations suggest that for regional governments these shares ranged from 4 percent in Italy, prior to the 1992 reform mentioned above, to over 80 percent in the United States and Canada. Comparable data are not available for the local governments in all countries. Those available point to a variation from about 17 percent in Germany and the United Kingdom to about 70 percent in the United States and Australia.

Intergovernmental Transfers

Since most major taxes are typically assigned to the central government, while substantial and growing expenditure responsibilities are devolved to regional and local governments, sizable vertical imbalances (that is, pre-transfer fiscal deficits) frequently emerge at the subnational government level. There are also horizontal imbalances, because the capacity to raise own revenues differs across jurisdictions, depending on the distribution of their assigned tax bases, and also because different regions may face different costs and demand pressures in meeting their assigned expenditure responsibilities.

These imbalances must be addressed through intergovernmental transfers, or borrowing by deficit jurisdictions, or a combination of the two. The design of an appropriate system of intergovernmental transfers is crucial not only to promote any desirable redistribution of resources among subnational jurisdictions, but also to ensure that effective limits can be set, and enforced on a sustained basis, on the borrowing of subnational governments. The design of intergovernmental transfers is also one of the more complex aspects of fiscal federalism, as demonstrated by the wide range of country experiences in this area. Intergovernmental transfer mechanisms can be broadly grouped into two main categories, revenue-sharing arrangements and grants.

Revenue-Sharing Arrangements

Revenue-sharing arrangements of various types are quite common in the international experience, and tend to be primarily geared to correcting, to varying degrees, the vertical imbalances generated by revenue and expenditure assignments. Sharing of tax revenues can be arranged on a tax-by-tax basis, with different coefficients of distribution among levels of government for each tax or on the entire pool of central government tax revenues. Examples of tax-by-tax sharing can be found in a number of countries, including Argentina, Brazil, Germany, Hungary, India, and Russia.[5] A disadvantage of this type of arrangement is the fact that it may provide an incentive for the tax administration at the federal level to concentrate its collection and enforcement efforts on the taxes that are not shared or are shared to a lesser degree. Moreover, the central government has also an incentive to concentrate on those taxes in any tax reforms (base broadening or rate increases) that may be needed for stabilization purposes, with possible distortive effects on the structure of the tax system. For these reasons, it would be preferable that revenue sharing be applied on the entire pool of central government revenues.

Revenue-sharing arrangements with coefficients set in law, or in the constitution (as in Brazil or Colombia), provide the subnational governments a degree of predictability of revenues, which is important for their budgetary planning. However, they impart considerable rigidity to the central government budget. In particular, they can substantially dilute the impact of a fiscal tightening by the central government, as tax increases by the latter also boost the capacity of the subnational governments to spend. This shortcoming could be avoided if the portion of revenues going to the subnational governments was determined by applying a constant rate to the shared tax base. Fixed revenue-sharing arrangements can also have pro-cyclical effects, as increases in shared revenues during periods of boom increase the capacity to spend of the subnational governments, while declines in revenues during economic downturns force them to cut back spending. To address this problem, elements of flexibility could be introduced in these sharing arrangements, for instance, by relating the transfers to a moving average over a few years of central government revenues, or by requiring subnational governments to constitute revenue stabilization funds,[6] to even out cyclical fluctuations in the shared taxes.

The distribution of shared revenues among subnational jurisdictions is often made on a derivation basis, with each jurisdiction getting the share of the revenue collected in its territory.[7] This is, for example, the principle used in Germany for the sharing of revenues from the personal and corporate income taxes (Chapter 10). Revenue-sharing arrangements based on a derivation principle cannot be used to correct hori-

[5]See relevant chapters for details.

[6]In the United States, most states have constituted so-called rainy day funds, which are drawn down during cyclical downturns and reconstituted during the subsequent recovery (see Chapter 15).

[7]Specific rules have to be defined for the apportionment of revenues from incomes generated by companies operating in different jurisdictions, or by individuals working and residing in different states.

zontal imbalances since, under these arrangements, the level of the transfer from the center to each subnational government is positively correlated with the taxing capacity of the latter. To promote horizontal balance, in allocating shared revenues among regions or localities, some countries utilize formulas based on redistributive criteria. For example, in Germany shared revenue from the VAT is apportioned on a per capita basis, which entails a degree of redistribution to the less affluent states. India utilizes formulas that combine population, income per capita, indicators of backwardness, and the state's own tax effort (Chapter 21). Brazil utilizes a set of coefficients agreed among the states in 1988, which are only loosely linked to relative per capita income levels of the states. Hungary distributes the local governments' share of the personal income tax partly on a derivation and partly on an equalization basis (Chapter 27).

Grants

Besides revenue sharing, the main mechanism for intergovernmental transfers are grants from higher (federal or state) to lower (state or local, respectively) levels. Grants can be grouped into the following main categories:

- *General purpose grants*. These are unconditional transfers, aimed at addressing vertical and horizontal imbalances.
- *Specific purpose grants*. These grants carry more or less tight conditions regarding the use of the funds and/or the performance achieved in the program or programs financed through them. They may be open-ended or subject to a cap. They may or may not have matching requirements for the recipient government. Specific purpose grants may be of a recurrent nature, if used to finance current expenditures, or of a once-off nature, if used to finance investment projects.

In between these two categories fall the so-called block grants, which are earmarked for the financing of broad areas of expenditure (such as education) rather than of specific programs.

The choices between conditional and unconditional transfers should be based on a number of considerations. On the one hand, the imposition of conditions clearly detracts from the autonomy of subnational governments, partly negating the welfare (efficiency) arguments for decentralization. On the other hand, the imposition of conditions may be justified by distributional considerations (for example, ensuring the observance of minimum nationwide standards for the provision of services of national concern, such as primary education and health care, or pollution control). Whether or not desirable in theory, the design and enforcement of appropriate conditions for grants is not easy in practice, and controls on the use of grants often end up being more formal than substantive. Even more difficult is to specify and enforce conditionality on the performance of the programs supported by the grants.[8]

The amounts transferred under open-ended, specific purpose grants can often be influenced by the recipient institution (for example, by unnecessarily admitting patients to hospitals, if the size of the grant is based on the number of inpatients). Moreover, these types of grants may create opportunities for corruption. Therefore, it is important that the norms regulating them be specified with care, to avoid inappropriate incentives and minimize the scope for abuse.

Within conditional grants, the choice of whether or not to impose matching requirements has also to take into account various considerations. Matching requirements may induce a redirection of resources of subnational governments to the areas of spending considered of priority by the central government, but obviously at a cost for the local provision of other services. Also, matching requirements may place poorer, resource-constrained, regions at a disadvantage vis-à-vis the richer ones in the utilization of federal grants. Finally, budgetary and, more broadly, macroeconomic management considerations clearly argue against open-ended grants.

A brief review of grant mechanisms in a number of countries indicates that combinations of different types are used in most cases, with special purpose grants generally predominating over general purpose ones. The two main federal countries that use general purpose equalization schemes are Canada and Australia. Equalization mechanisms are also used in a number of unitary countries (notably the Scandinavian countries). The Australian system can be viewed as the most comprehensive effort at equalization, but it is also very complex, and demanding in terms of information requirements. The system is aimed at ensuring equal ability of the states to provide a standard level of public services at an average level of taxation. Other countries (including Denmark, Japan, and Korea) use simpler indicators of expenditure needs, such as demographic characteristics, population density, and length of roads, information on which is more easily available.

In Canada, equalization transfers to provinces are based only on their relative taxing capacities; they do not take into account relative expenditure needs. Equalization payments are complemented by block grants for the financing of health care and postsecondary education, which ini-

[8]See Chapters 4 and 6, and the case study of Italy (Chapter 11), in particular, for an illustration of these difficulties.

tially were open-ended, but more recently have been capped, as part of the effort to reduce the overall government deficit (Chapter 9).

Block grants are also extensively used in the United States, in combination with a large number of special purpose grants. These latter grants currently account for almost 90 percent of total federal transfers to state and local governments in the United States. About 70 percent of such grants are project-specific. Concern over the escalating costs of some of the programs supported by these grants (for example, Medicaid and the Aid to Families with Dependent Children), and dissatisfaction with the effectiveness of the federal government control over the use of these funds, has led to proposals for reform, and to initial steps in the direction of reducing the linkage of the grants to specific projects, and allowing greater responsibility (and hopefully political accountability) to the states in their management (Chapter 15).

In Germany, central government grants to the states are essentially an instrument for the former to influence specific state programs in areas that are defined as of common interest. These transfers have acquired greater importance, especially vis-à-vis the constituent states of the former east Germany, in the aftermath of unification. Equalization objectives are pursued in Germany through direct horizontal redistribution among the states, without participation of the central government. Interstate "solidarity" came under severe stress in the years following unification, given the enormous disparities in taxing capacity and expenditure needs of the eastern states vis-à-vis the western ones (see Chapter 10 for details).

Administrative Aspects of Fiscal Decentralization

The fiscal federalism literature has focused to date much more on policy than administrative issues. There is little doubt, however, that substantial devolution of revenue raising and expenditure responsibilities poses new challenges for tax administration and for public expenditure management. These aspects are discussed in some detail at a theoretical level in Chapters 5 and 6 and, to the extent that information is available on individual countries' practices in these areas, in the case studies (Chapter 8 through Chapter 28). This section highlights some main conclusions of these analyses.

Tax Administration

The assignment of certain taxes to subnational governments need not involve a decentralized administration of these taxes. In principle, especially if the definition of the base of some taxes assigned to the states is uniform, or nearly uniform, across the nation—with the states deciding only the rate or rates—those taxes could be administered by the central government. A centralized administration would have certain advantages, notably a uniformity of procedures, which would promote consistency of treatment of taxpayers across the country and reduce compliance costs, especially for enterprises conducting business in, and individuals receiving income from, more than one subnational jurisdiction. It would also permit economies of scale, in particular in the utilization of computer hardware and systems. A decentralized administration, on the other hand, would entail greater responsibility and accountability of the subnational authorities for the performance of taxes assigned to them, as well as greater flexibility in adapting systems and procedures to local needs and conditions.

Decentralized administration is more likely to be effective for local taxes, such as property taxes, business licence fees, user fees, and other minor levies. Decentralized administration of state-level taxes, such as personal or company income taxes, or even a general sales tax, may require, to be carried out effectively, a systematic exchange of relevant information among state administrations (especially on cross-border transactions). More generally, if devolution of revenue-raising responsibilities is to be accompanied by decentralization of the tax administration, substantial efforts have to be made to ensure that subnational tax administrations are equipped—through the development of their systems and procedures, technology, and human resources—to carry out the basic functions of collection and enforcement effectively. In this effort, the central government can play an important role, by providing guidance and technical support. This support may extend, for instance, to the carrying out of joint audits for the more complex taxes, and/or to the monitoring of large taxpayers who operate in several states.

Public Expenditure Management

Substantial decentralization of expenditure responsibilities also poses new challenges for public expenditure management by the various levels of government. These challenges relate to

- The need to coordinate the budgetary policies of the central and subnational governments, to ensure their consistency with national macroeconomic objectives (for example, for growth, inflation, and the external accounts).
- The need to promote responsiveness of all levels of government to the preferences of their constituents in both the allocation of bud-

getary resources and the delivery of goods and services assigned to them, in as efficient and cost-effective a manner as possible.
- The need to ensure sound financial management of the operations of each level of government.

These objectives should be pursued through all aspects of the public expenditure management process: planning and budget preparation, budget implementation and revisions, financial planning and cash management, debt management, accounting, and audit and evaluation.

Especially in federal countries, the objective of macroeconomic coordination could be pursued through the creation of an institutional forum—such as the Premiers' Conference and the Loan Council in Australia (Chapter 8) or the Financial Planning Council in Germany (Chapter 10).[9] In such a forum, the main lines of budgetary policy would be discussed each year—preferably within the framework of medium-term rolling budget plans—in advance of the preparation of national and subnational budgets; agreement would be reached on the major budgetary aggregates for the central and state governments, and at least for the larger municipalities; and a common set of procedures and assumptions would be adopted for the preparation of those budgets. The same forum should monitor the implementation of agreed plans during the year and approve any significant modifications that may be required in the light of changing circumstances.

In unitary countries, the central government needs to provide adequate and timely guidance to the local governments for their budget preparation. The creation of institutional forums for promoting frequent dialogue between the central and local authorities can be also useful in this respect. Examples of such an approach can be found in a number of European countries, such as the United Kingdom (Chapter 14), Denmark, and Sweden.

The steps to promote sound expenditure choices and a cost-effective delivery of public goods and services, as well as to strengthen financial management, are not dissimilar at the central and the subnational government levels.

- A clear definition of respective expenditure assignments is crucial, in particular to avoid duplication and waste of public resources.
- It is important that the system of intergovernmental transfers be also clearly defined, so that each level of government can anticipate the level and timing of these transfers as much as possible. In

[9]A high-level forum of this type would need, of course, to be supported by a similar committee at a more technical level, to prepare relevant analysis.

this respect—as noted in the section on Intergovernmental Transfers—open-ended, matching, and conditional grants, which inherently entail significant uncertainty for both donor and recipient governments, are clearly inferior to formula-based general purpose grants.

- Effective budgeting and accounting can be greatly helped by the adoption by all levels of government of modern, comprehensive, standardized, and transparent budget classifications, and accounting rules.
- Each level of government should prepare, and update frequently, rolling financial plans, and exchange relevant information about them with other levels of government.
- The development and implementation by subnational, as well as the central, governments of modern, integrated, computerized and accounting-based information systems, allowing the monitoring and control of all phases of the public expenditure process, would greatly facilitate effective financial management and control and help prevent the accumulation of budgetary arrears.
- Finally, the improvements in audit and evaluation that have occurred, or are occurring, at the central government level in many countries (for example, the United Kingdom, New Zealand, and Australia), need to be disseminated and replicated at the subnational level.

The Control of Subnational Government Borrowing

A review of country experiences with the control of subnational government borrowing shows considerable diversity in approaches. These indicate, among other things, the legal or constitutional status of subnational governments, the degree of political and administrative controls of the central government over them, the country's overall tradition of financial discipline, the presence or absence of serious fiscal and macroeconomic imbalances, and the state of development of the country's financial market.

Country approaches to the control of subnational borrowing can be grouped into four broad categories, although most countries utilize a mix of them. The four "stylized" categories are

(1) sole or primary reliance on market discipline;
(2) cooperation by different levels of government in the design and implementation of debt controls;
(3) rules-based controls; and
(4) administrative controls.

Examples of the first model can be found in Canada, and in Brazil until recent years. Notable examples of the second model are the Scandinavian countries, Australia, and Germany, although in the latter country subnational governments have also to follow the golden rule, which prohibits borrowing to fill current budgetary deficits. Other types of rules prevailing in different countries stipulate limits to the absolute level of subnational indebtedness, or allow new borrowing up to a level of debt consistent with maximum debt service ratio, or ban or restrict certain types of borrowing that involve greater macroeconomic risks (including borrowing from the central bank or from abroad). Examples of a rules-based approach can be found in, among others, the United States, Switzerland, and Spain (see Chapter 7 for details).

Finally, in a number of countries, the central government is empowered with direct control over the borrowing of subnational governments. This control may take various forms. These include the setting of annual (or more frequent) limits on the overall debt of individual subnational jurisdictions (or some of its components, such as external borrowing); the review and authorization of individual borrowing operations (including approval of the terms and conditions of the operation); and/or the centralization of all government borrowing, with on-lending to subnational governments for approved purposes (generally investment projects). Control powers generally encompass not only the ex ante authorization of proposed borrowing, but also the ex post monitoring, on a more or less detailed and timely basis, of the financial operations of subnational governments. Direct central government controls are, of course, more common in unitary states (such as the United Kingdom (Chapter 14), France, Japan (Chapter 12), and Korea (Chapter 22)) than in federations. One example for the latter is India, where federal government approval is required for borrowing by the states if they have outstanding debt to the federal government—which is currently the case for virtually all the states (Chapter 21).

Each of these models of control presents advantages and disadvantages, the balance of which would make it more or less suitable to a particular country's circumstances. Moreover, as these circumstances evolve—for example, as fiscal and macroeconomic imbalances improve or worsen—the preferable model may change over time. The review of country experiences presented in Chapter 7 would appear to justify the following main conclusions:

- Although appealing in principle, sole reliance on market discipline for government borrowing is unlikely to be appropriate in many circumstances. This is so, because one or more of the conditions for its effective working frequently are not realized in any particular country. However, market discipline can be a useful complement to other forms of borrowing controls, in particular to help contain resort by subnational governments to practices aimed at circumventing those controls. In this respect, greater transparency and dissemination of information on recent and prospective developments in the finances of subnational governments are highly desirable, and governments should be encouraged to make any necessary changes in the legal and institutional framework to promote these objectives. In countries with a history of bailouts of insolvent subnational governments by the central government, a firm and sustained refusal to engage in further operations of this kind will be necessary to change expectations and behaviors of market participants vis-à-vis subnational government borrowing. It must be recognized that this may be a prolonged process, the more so the longer the previous history of bailouts.

- The ongoing decentralization trend seems likely to come into growing conflict with systems of administrative controls by the central government on subnational borrowing (involving, for instance, a centralization of borrowing or approval of individual loan operations). It would not be surprising to see administrative controls on domestic subnational borrowing decline in importance in the years ahead.
- Rules-based approaches to debt control would appear preferable, in terms of transparency and certainty, to administrative controls and also to statutory limits defined in the context of the annual budget process, the outcome of which may be unduly influenced by short-term political bargaining. There is a clear macroeconomic rationale for barring all levels of government from borrowing from the central bank (or, at a minimum, for severely restricting this type of borrowing). Borrowing abroad by subnational governments should also be strictly limited, in accordance not only with the debt-servicing capacity of the subnational jurisdiction involved, but also with macroeconomic (especially monetary and balance of payments) considerations.
- In principle, a good case can be made for limiting all borrowing to investment purposes. However, the so-called golden rule may not be sufficiently restrictive in countries that need to generate government savings to finance at least a part of public investment. Moreover, it may not be desirable to allow government borrowing to finance investments that do not have adequate rates of economic and social return. Indeed, in many countries, efficient current expenditures on health and education may have higher rates of return than many capital projects. Finally, in practice, it may be

difficult to avoid circumvention of the golden rule through the labeling of certain current expenditures as investments.

- These considerations would seem to argue for setting global limits on the debt of individual subnational jurisdictions on the basis of criteria that mimic market discipline, such as the current and projected levels of service of the debt in relation to the jurisdictions' revenues. It is crucial that the projection of the debt service and of revenues, utilized in testing compliance with the ceiling, be realistic, and indeed preferably conservative. It is equally important that a comprehensive definition of the debt subject to the ceiling be adopted (including, to the extent feasible, extrabudgetary operations, suppliers' credits, and guarantees to credits contracted by the subnational governments' enterprises).
- Finally, even in the context of rules-based approaches, there seems to be scope for increased cooperation for all levels of government in containing (or reversing, if needed) the growth of the public debt. Enhanced involvement of the subnational governments (especially at the regional or state level) in formulating and implementing medium-term fiscal adjustment programs (along the lines discussed in the previous section) should result in greater responsibility of these governments in the conduct of their budgetary affairs, facilitate the recognition of any need for reforms of the existing system of intergovernmental fiscal relations, and help muster adequate political consensus for such reforms.

Concluding Remarks

This chapter has provided a broad survey of the theory and practice of intergovernmental fiscal relations, focusing on key issues and selected country experiences. From this review, a few major conclusions emerge:

- As is well known, the design of intergovernmental fiscal relations is importantly influenced by noneconomic (political, social, and cultural) factors, as well as by economic considerations. Therefore, the limitations of a purely economic analysis of intergovernmental fiscal arrangements should be kept in mind. Within the narrower economic context, the design of these arrangements reflects a balance among different (and not always easily reconcilable) objectives, namely allocative efficiency, income redistribution, and macroeconomic management. The specific balance of these objectives in different countries, and its evolution over time, tend also to reflect the country's social and political history and current conditions, and the presence or absence of serious macroeconomic imbalances.

- There is broad consensus in the literature that a decentralization of expenditure responsibilities should in principle lead to allocative efficiency gains, by promoting a closer correspondence of expenditure priorities with the preferences of affected citizens. However, it is also increasingly recognized that these theoretical efficiency gains may be negated in practice (or substantially reduced) by administrative weaknesses at the subnational level, especially the lack of modern and transparent public expenditure management systems.
- Country experiences, by and large, bear out the need to accompany a decentralization of spending responsibilities with the assignment to subnational governments of significant own sources of revenue. This is necessary to promote fiscal responsibility by subnational government officials, and their political accountability to the electorate. The best candidates for assignment to the subnational level are taxes characterized by relatively low mobility, a fairly even distribution of the base over the national territory, and relative stability over the cycle. These criteria would tend to argue for total or partial assignment to the regional governments of the personal income tax, general retail sales taxes, and certain excises; and to the local governments of the property tax, business license fees, and user fees. In general, harmonization of the definition of tax bases across the national territory and a not excessive variance of the rates are desirable, to avoid tax-induced distortions.
- As in the case of expenditures, administrative weaknesses may also impair the effectiveness of revenue decentralization. In countries characterized by weak and inexperienced subnational tax administrations, a determined effort to strengthen these entities should be given high priority by the central, as well as the subnational, authorities, and preferably should precede a decentralization of the administration of the taxes devolved to the subnational governments, to safeguard the revenue performance.
- It must be recognized that a high degree of decentralization may come in serious conflict with distributional objectives. This is especially the case, of course, in countries characterized by large regional disparities in income. In these cases, a system of equalization-oriented vertical transfers from the center (as in Australia) or a horizontal redistribution mechanism (as in Germany) are likely to be necessary, to preserve adequate economic and social cohesion in the country. It is important that such mechanisms be

designed, however, so as not to discourage tax effort and cost-effectiveness by the subnational governments.

- Substantial decentralization is also likely to make it more difficult for the central government to carry out macroeconomic stabilization through budgetary policies, for the reasons outlined earlier. Therefore, ceteris paribus, decentralization should progress more slowly in countries facing acute fiscal or macroeconomic imbalances. In these countries, it is especially important that a hard budget constraint be imposed on the subnational governments, through a design of intergovernmental fiscal relations that ensures for the subnational jurisdictions an adequate ex ante balance between expenditure responsibilities and own revenues plus clearly defined transfers from the center; and which bars them from borrowing.
- In countries that do not face serious macroeconomic or fiscal imbalances, it should be recognized that substantial decentralization of revenues and expenditures entails the need for the central government to involve more actively the subnational governments, especially states and large municipalities, in macroeconomic management, and to make them share responsibility for the achievement of national economic objectives (for some suggestions in this respect, see section on Administrative Aspects of Fiscal Decentralization). In these countries, subnational governments can be allowed to borrow, but subject to clearly specified limits, relating to their prospective ability to service the debt. It is important that any such borrowing be carried out by the subnational governments in their own name, without central government guarantee, and that all efforts be made to promote adequate market discipline on such borrowing.

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