Making Fiscal Decentralization Work: Cross-Country Experiences

Annalisa Fedelino and Teresa Ter-Minassian
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Fiscal decentralization and reforms of existing intergovernmental fiscal arrangements remain high on the policy agenda of many countries, both advanced and developing. Decentralization is often driven by political pressures, which tend to be especially acute in countries with some combination of multiple ethnicities and wide regional disparities in incomes or resource endowments. More generally, pressures for increased decentralization often reflect a desire for more participatory government and greater voice of local constituents in the allocation of budgetary resources.

Regardless of its motivation, fiscal decentralization can have important macroeconomic implications. Depending on the design and implementation of critical intergovernmental fiscal arrangements, decentralization has the potential to hinder sound macroeconomic management and longer-term fiscal sustainability.

Therefore, IMF advice to its member countries (whether in the context of surveillance, the design of IMF-supported programs, or technical assistance) has often focused on intergovernmental fiscal arrangements. This is one of the more complex areas of public finance, given that it spans a number of policy and institution-building issues; requires careful coordination and sequencing; and is strongly influenced by historical, political, and social, as well as economic, factors. Accordingly, the IMF has recognized that there is no single “right” model in this area, and has strived to tailor its advice to each country’s specific circumstances, taking into account macroeconomic constraints, the need to strike a balance between efficiency and distributional considerations, and the need to reflect relevant institutional factors.

This occasional paper distills the main lessons from the IMF’s engagement with member countries on the issue of fiscal decentralization, in particular from the technical assistance provided by its staff to 10 countries: Bolivia, China, Colombia, the Democratic Republic of the Congo, Indonesia, Kosovo, Liberia, the former Yugoslav Republic of Macedonia (FYR Macedonia), Mexico, and Nigeria.

The provision of IMF advice on fiscal decentralization has taken different forms, including dedicated staff missions, the fielding of short- or long-term resident experts, seminars and other training events, and the preparation of a substantial number of research books and papers. As evidenced by the case studies, the advice has spanned virtually all areas of intergovernmental fiscal relations. Regardless of the specific areas and forms of involvement, IMF advice has typically focused on the macrofiscal aspects of decentralization, with the primary goal of safeguarding macroeconomic stability and fiscal sustainability. This focus has reflected the core mandate of the institution and the comparative expertise of its staff. In the provision of its advice on fiscal decentralization, the IMF has frequently cooperated with other multilateral (notably the World Bank) and national institutions active in this area.

Despite the differences in the form and coverage of IMF policy advice and the nature and circumstances of recipient countries, some general lessons can be drawn from the range of experience in this area. Based on some of these lessons, this occasional paper aims at making a contribution to sound and sustainable reforms in fiscal decentralization across the IMF membership.

1The main examples are the IMF volume on Fiscal Federalism in Theory and Practice (Ter-Minassian, 1997); the proceedings of a 2000 international conference on managing fiscal decentralization (Ahmad and Tanzi, 2002); and the Handbook of Fiscal Federalism (Ahmad and Brosio, 2006).
This occasional paper would not have been possible without the contributions of a number of current and former colleagues from the IMF Fiscal Affairs Department. In particular, we owe our thanks to the following authors and co-authors of the case studies: Alejandro Simone and Paulo Medas (Bolivia), Isabell Adenauer (Colombia), Andreas Westphal (Democratic Republic of the Congo, with input from Amine Mati and Oral Williams), Amine Mati and Eric Le Borgne (Indonesia), Pablo Lopez Murphy (former Yugoslav Republic of Macedonia), Mercedes Garcia-Escribano (Mexico), and Mauricio Villafuerte and Oral Williams (Nigeria).

We would also like to express our appreciation to Ehtisham Ahmad, who gave us the initial inspiration for this occasional paper and provided invaluable contributions through discussions. Sarah Buss and Nezha Khaneboubi worked ably on the original manuscript. Special thanks also go to Sean Culhane and Joanne Blake of the External Relations Department for their advice and coordination of this publication.
Abbreviations

CDF  County Development Fund (Liberia)
CSP  Comprehensive Settlement Proposal (Kosovo)
DAU  General Allocation Fund (Dana Alokasi Umum, Indonesia)
DAK  Special Allocation Grant (Indonesia)
DBH  Shared Revenue Fund (Indonesia)
DGI  Direction Générale des Impôts (Tax Collection Agency, Democratic Republic of the Congo)
EAD  Entités Administratives Décentralisées (Decentralized Administrative Entities, Democratic Republic of the Congo)
ETD  Entités Territoriales Décentralisées (Decentralized Divisional Entities, Democratic Republic of the Congo)
FAD  Fiscal Affairs Department
FYR  Former Yugoslav Republic (of Macedonia)
GDP  gross domestic product
GFMIS  Government Financial Management Information System
GFS  Government Finance Statistics
IDH  Direct Tax on Hydrocarbons (Bolivia)
IMF  International Monetary Fund
HIPC  Heavily Indebted Poor Countries
LFLSG  Law of Financing of Local Self Governments (FYR Macedonia)
LLGF  Law on Local Government Finance (Kosovo)
LLSG  Law of Local Self-Government (FYR Macedonia)
MoF  Ministry of Finance
MoHA  Ministry of Home Affairs (Indonesia)
OECD  Organization for Economic Cooperation and Development
PFM  public financial management
PIT  personal income tax
PPP  public-private partnership
SLG  state and local government
TA  technical assistance
TSA  treasury single account
VAT  value-added tax
Pressures to decentralize—that is, transfer authority and responsibility for public functions from the central government to subnational entities—have become more evident over the years. Typically a political phenomenon, decentralization frequently takes on a fiscal dimension (hence the term “fiscal decentralization”) when changes in a country’s system of intergovernmental fiscal relations take place.¹

Changes in the assignment of spending responsibilities and their financing (through taxes, transfers, or borrowing) across government levels can have important macroeconomic implications. It is from this perspective—that fiscal decentralization can significantly affect macroeconomic management and, more specifically, governments’ budgetary balances and debt positions—that the IMF has provided policy advice to member countries undertaking reforms in this area.²

This occasional paper presents an overview of advice provided by the IMF, in particular, its Fiscal Affairs Department (FAD), to member countries on intergovernmental fiscal relations. This advice, provided in the context of surveillance, use of IMF resources, or technical assistance, has spanned the gamut of issues involved in such relations (expenditure and revenue assignments, design of intergovernmental transfers, public financial management systems and revenue administration systems at the subnational level, subnational borrowing, and so on).

IMF advice has been tailored to countries’ specific circumstances. Recognizing the largely political nature of a country’s decentralization agenda, staff have not taken a position in favor of or against it, and have focused advice on the appropriate sequencing and design of decentralization, with a view to minimizing risks to macroeconomic stability and debt sustainability while safeguarding the provision of public services. This paper seeks to distill key lessons from advice on various aspects of intergovernmental fiscal relations, based primarily on staff engagement on this topic with 10 countries: Bolivia, China, Colombia, the Democratic Republic of the Congo, Indonesia, Kosovo, Liberia, FYR Macedonia, Mexico, and Nigeria. These countries were selected because of the significance of the IMF’s engagement with them on intergovernmental issues, but especially because they differ markedly in economic, institutional, and sociopolitical characteristics, thereby providing a representative sample of the range of countries receiving IMF advice on fiscal decentralization in recent years. Specifically, as shown in Table 1, the case-study countries vary significantly along a number of dimensions. Two countries have federal government structures (Nigeria and Mexico) while the others are unitary countries; some have limited area and population (Liberia, Kosovo, and FYR Macedonia), while others are much bigger or more populated (China, the Democratic Republic of the Congo, and Nigeria). They also differ in the number of levels of government: most have three, but the smaller ones (Kosovo and FYR Macedonia) have only two, and China has five.

The paper is structured as follow: Part I (Chapters 1–3) distills the lessons learned from the last two decades of IMF engagement on fiscal decentralization. Chapter 1 reviews key issues in intergovernmental fiscal relations, based on a brief review of the relevant literature. Chapter 2 focuses on the main building blocks of such relations: (1) defining spending assignments and strengthening their management and (2) designing financing mechanisms, consisting of revenue assignments, transfers, and borrowing arrangements. These building blocks

¹This paper does not make a distinction between different forms of government (unitary versus federal), and uses the term “subnational governments” for the levels of government below the central or federal government (states in a federation and other jurisdictions in unitary or federal countries).

²This publication looks at “downward” decentralization, that is, the arrangements between a sovereign or national state and its lower levels of governments. Because political and economic processes and activities are becoming global and require global action (Tanzi, 2008; Bordignon, 2006), examples of upward devolution of powers are increasing, raising issues of coordination, monitoring, and control of behavior of countries that are members of economic unions. The European Union, in its enlargement and the establishment of a monetary union, is one such example.
need to be coherently structured and managed so that subnational governments face credible "hard budget constraints" and respond to incentives to behave fiscally responsibly. The main lessons and future challenges for the IMF’s role in the fiscal decentralization policy debate are outlined in Chapter 3. Part II (Chapters 4–13) provides more depth to the fiscal decentralization experience in each of the case-study countries, casting the IMF staff advice against a brief historical, institutional, and political context in each country as of the end of the first decade of the 2000s.

Table 1. Comparative Indicators for Case-Study Countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Bolivia</th>
<th>China</th>
<th>Colombia</th>
<th>Congo, Dem. Rep. of</th>
<th>Indonesia</th>
<th>Kosovo</th>
<th>Liberia</th>
<th>Mexico</th>
<th>FYR Macedonia</th>
<th>Nigeria</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population (million, 2007)</td>
<td>9.4</td>
<td>1,307.6</td>
<td>46.0</td>
<td>57.5</td>
<td>231.6</td>
<td>2.2</td>
<td>3.5</td>
<td>103.1</td>
<td>2.0</td>
<td>136.3</td>
</tr>
<tr>
<td>Area (in km² million)</td>
<td>1.1</td>
<td>9.3</td>
<td>1.1</td>
<td>2.3</td>
<td>1.9</td>
<td>10.9</td>
<td>1.0</td>
<td>1.9</td>
<td>25.4</td>
<td>0.9</td>
</tr>
<tr>
<td>Type of government</td>
<td>unitary</td>
<td>unitary</td>
<td>unitary</td>
<td>unitary</td>
<td>unitary</td>
<td>unitary</td>
<td>unitary</td>
<td>federal</td>
<td>unitary</td>
<td>federal</td>
</tr>
<tr>
<td>Levels of government</td>
<td>3</td>
<td>5</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>2</td>
<td>3</td>
<td>2</td>
<td>3</td>
<td></td>
</tr>
<tr>
<td>Number of states or provinces¹</td>
<td>9</td>
<td>31</td>
<td>33</td>
<td>11</td>
<td>13</td>
<td>n.a.</td>
<td>15</td>
<td>32</td>
<td>n.a.</td>
<td>37</td>
</tr>
<tr>
<td>Number of lowest subnational government²</td>
<td>112</td>
<td>44,016</td>
<td>1,120</td>
<td>1,005</td>
<td>510</td>
<td>36</td>
<td>126</td>
<td>2,454</td>
<td>84</td>
<td>774</td>
</tr>
<tr>
<td>of which: minimum size (inhabitants)</td>
<td>1,287</td>
<td>...</td>
<td>242</td>
<td>...</td>
<td>14,065</td>
<td>5,000</td>
<td>...</td>
<td>102</td>
<td>1,331</td>
<td>19,710</td>
</tr>
<tr>
<td>Average size of municipality (inhabitants)</td>
<td>84,172</td>
<td>29,706</td>
<td>41,106</td>
<td>57,262</td>
<td>498,153</td>
<td>62,111</td>
<td>...</td>
<td>42,009</td>
<td>24,245</td>
<td>176,037</td>
</tr>
<tr>
<td>GDP per capita (US dollars, 2008)²</td>
<td>356</td>
<td>846</td>
<td>2,303</td>
<td>14</td>
<td>908</td>
<td>1,276</td>
<td>126</td>
<td>7,484</td>
<td>2,350</td>
<td>474</td>
</tr>
</tbody>
</table>

Sources: World Bank World Development Indicators; IMF World Economic Outlook; and administrative divisions of countries.


²Nominal GDP per capita for Kosovo. Real GDP per capita for all other countries.
Part I: Lessons
Fiscal Decentralization: Key Issues

A Brief Literature Review

Fiscal decentralization involves a redefinition of the roles and responsibilities of the various levels of government in the conduct of fiscal policy. Traditional theories of public finance provide a normative framework for assigning the government’s three fiscal functions—stabilization, redistribution, and resource allocation—across government levels (Musgrave, 1959; Tiebout, 1956; Oates, 1972). While the center should be assigned the first two functions (Table 1.1 briefly reviews the main rationale), there is scope to improve resource allocation in the public sector through decentralization. The basic tenet of these theories is that governments and politicians behave like benevolent welfare maximizers; when preferences differ, welfare gains are possible through diversification of local public outputs. Two reasons underpin the possibility of gains: first, local politicians know consumers’ preferences in their jurisdictions better than does the central government, and therefore can better align the provision of local outputs to those preferences (allocative efficiency); and second, consumers can move to jurisdictions that better satisfy their preferences (Tiebout’s [1956] argument of “voting with one’s feet”). Therefore, subnational governments face competitive pressures to attract consumers of their outputs, resulting in more efficient (and possibly more innovative) provision of public services (productive efficiency).

In practice, normative considerations seldom drive the assignment of functions. Experiences with fiscal decentralization lend little support to the welfare-maximizing predictions of these theories. In fact, fiscal decentralization is largely driven by political motives, and also reflects historical and cultural legacies. Fiscal decentralization has also shown a “dark side” in countries where subnational fiscal policies have played a large role in macroeconomic disruptions and debt crises—as, for example, in some Latin American countries during the 1980s. Fiscal decentralization can also enhance opportunities for corruption and abuse (Brennan and Buchanan, 1980; Prud’homme, 1995; Tanzi, 2001). The realization of the potential dangers of decentralization has called into question the relevance of traditional normative models, and has given way to a positive strand of literature, which attempts to understand the political and institutional conditions under which greater fiscal decentralization may enhance or undermine efficiency, when politicians behave as self-interested individuals with their own objective functions.

Two main sources of distortions might hinder the effectiveness of fiscal decentralization. First, local policymakers can fail to internalize fully the cost of local spending when they can finance their marginal expenditure with central transfers or shared revenue funded by taxpayers in other jurisdictions (that is, the marginal benefits of additional spending exceed their marginal costs). This “common pool” problem often results in overspending and deficit bias. Second, local politicians may expect the central government to bail them out whenever necessary, thus undermining their incentives to behave in a fiscally responsible manner. This “soft budget constraint”

These issues are further developed in the next section of this chapter.

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A crucial issue is how to design and manage policies and institutions to mitigate the distortions created by the common pool and soft budget constraint problems. This issue will be covered in more detail in the following sections.

**Macrofiscal Implications of Decentralization**

Empirical evidence on the impact of fiscal decentralization on macroeconomic performance is mixed. Empirical studies seeking to quantify the relationship between measures of fiscal decentralization and macroeconomic variables, such as growth and inflation, have yielded contradictory results. This situation can be attributed to difficulties in compiling comparable measures of fiscal decentralization across countries because available data suffer from a number of shortcomings (Box 1.1), and difficulties in controlling for other possible factors (beyond decentralization) affecting macroeconomic performance. Finally, the design of intergovernmental fiscal relations, more than the degree of decentralization, affects efficiency and growth, as well as macroeconomic stabilization. As discussed in the previous section, decentralization can enhance or reduce efficiency, depending on the ability of subnational governments to carry out their increased responsibilities effectively. Similarly, decentralization can, in certain circumstances, negatively affect the conduct of short-term fiscal stabilization, or medium-term fiscal sustainability. This section

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**Table 1.1. The Policy Rationale for Fiscal Decentralization**

<table>
<thead>
<tr>
<th>Objectives of fiscal policy</th>
<th>Rationale in favor of centralized government</th>
<th>Rationale in favor of decentralized government</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Stabilization</strong> (stability considerations)</td>
<td>• Stabilization policies could be undermined if a large share of taxes or spending is undertaken by subnational governments, or if policies across government levels differ. • Centralizing stabilization policies: – allows better, easier policy coordination, – exploits scale economies (access to larger tax base and better borrowing conditions), and provides risk-sharing opportunities.</td>
<td>• None</td>
</tr>
<tr>
<td><strong>Redistribution</strong> (equity considerations)</td>
<td>• In a decentralized framework, there may be insufficient federal or central funds for proper equalization to mitigate interregional inequalities. • If redistributive policies are decentralized, adverse selection may arise (net contributors move to areas with low tax and transfers, and net beneficiaries concentrate in areas with high tax and transfers).</td>
<td>• Better targeting of decentralized social services</td>
</tr>
<tr>
<td><strong>Allocation</strong> (efficiency considerations)</td>
<td>Decentralizing allocative functions may be detrimental when • Preferences are fairly homogeneous and basic, so the “informational advantage” argument may not apply; • Externalities arise (subnationals do not take into account the effects of their decisions on other jurisdictions, leading to inefficiencies); • Excessive competition among local jurisdictions becomes damaging; and • Corruption may prevail when decision making is removed from the center (elite capture).</td>
<td>• Local jurisdictions enjoy an informational advantage: politicians know consumers’ and voters’ preferences better, leading to optimal resource allocation (allocative efficiency). • Decentralization improves efficiency of public service delivery (productive efficiency), because local politicians respond to incentives to perform better (more accountability and less corruption) and compete to attract mobile labor and capital.</td>
</tr>
</tbody>
</table>

Sources: Based on Ter-Minassian (1997); and Shah (2008).

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6 For a review of the soft budget constraint literature, see Kornai, Maskin, and Roland (2003); and Rodden, Eskeland, and Litvak (2003).

7 Theoretical models in the literature seek to determine subnational budget shares that maximize output growth; for a comprehensive review, see Babold, Mati, and Thornton (forthcoming). Some scholars have posited that fiscal decentralization may actually be neutral in its impact. For example, Treisman (2006b) presents a simple model implying that decentralization neither promotes nor inhibits growth, because any positive effect of decentralization on local governments will be offset by its negative effect on central government, and vice versa. One issue in these studies is related to identification problems, for example, the direction of causality is not clear.
briefly discusses interactions between various aspects of intergovernmental fiscal arrangements and macroeconomic management.

When subnational governments hold the key to a large share of spending, the center is less able to conduct stabilization through fiscal policy. The center has limited room to carry out any needed fiscal adjustment when it only controls a small share of spending. Many countries, for instance, in Latin America, have experienced such difficul-
ties. Even when the overall level of subnational spending is constrained by taxation and borrowing arrangements, a budget-neutral shift in the composition of such spending can in principle affect aggregate demand counter to the center’s stabilization policies. This contrary result may happen, for example, when the share of subnational spending with relatively larger multiplier effects increases. At the opposite end of the spectrum, central governments’ efforts to inject stimulus into the economy may be partly offset by subnational procyclical fiscal retrenchment during downturns—as happened in a number of countries during the 2008–09 financial crisis.

Similarly, when a significant share of revenue is managed by subnational governments, the center may not have sufficient resources for stabilization and redistribution purposes, or even to carry out its own spending responsibilities. A large pool of central resources provides risk-sharing opportunities, while smaller central government taxes inevitably limit insurance in the face of region-specific shocks. Central revenue may also prove insufficient to cover the center’s spending responsibilities, especially for entitlement programs (such as health care and pensions) whose costs are set to increase as a result of population aging. Some industrial countries are facing rapidly rising aging-related spending needs, but existing revenue-sharing formulas do not take into account differential dynamics in the spending responsibilities of the central and the subnational governments.

In certain circumstances, fiscal decentralization can contribute to a weakening of fiscal discipline. The more decentralized spending and taxing decisions are, the more difficult it is for the central government to ensure compliance with fiscal targets for the general government as a whole—its policy instruments, and its capacity to offset slippages at the subnational level, are more limited. The experience of European Union countries, for which the Stability and Growth Pact requires compliance with fiscal targets for the general government, but central and federal governments are directly responsible for meeting them, is illustrative in this respect (Balassone and Franco, 2001; Balassone, Franco, and Zotteri, 2004).

In such settings, nationally binding rules, or effective intergovernmental cooperation mechanisms, are needed to promote both short-term fiscal stabilization and medium-term fiscal sustainability. Some countries (e.g., Austria, Germany, Switzerland, and some Northern European countries) have used cooperative arrangements between the center and the subnational governments to formulate shared economic and fiscal objectives. In such cases, the incentive problem is addressed through moral suasion and peer pressure; although forging an agreement may be complex and time-consuming, greater ownership and flexibility often result from the process. In other countries, fiscal rules for subnational governments are being used; for example, in some European countries, Domestic Stability Pacts—the subnational counterpart to the Growth and Stability Pact for central governments—are increasingly being applied (Belgium, Italy, Spain). Fiscal rules offer the advantage of direct and immediate applicability; still, they may give rise to creative accounting and may not be politically sustainable if too rigid. Overall, fiscal rules may be a useful device to address coordination problems, but not necessarily to solve them. Box 1.2 reviews issues with regard to subnational fiscal rules.

Lack of fiscal discipline at the subnational level—and related excessive borrowing—may result in unsustainable debt levels. Direct bailouts from the central government, which are financed through debt accumulation, can cause a protracted increase in debt, as can the creation of explicit or contingent liabilities at the subnational level that eventually add to government debt—as shown by the Latin

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8For a review of these issues, see also Pisaeuro (2001).
9The United States provides another example where fiscal rules are applied to the subnational (state) level; virtually all states apply some sort of balanced budget rule. However, these rules have been self-imposed by the states, and not by the federal government. It could still be said that their credibility is enhanced by an effective no-bailout policy on the part of the federal government.
10These issues are further explored in “Identifying Mechanisms to Control Borrowing” in Chapter 2. In practice, solutions are not as clear cut as described here, and eclectic approaches are applied; for example, fiscal rules may be formulated in a cooperative framework (Franco and Zotteri, 2008).
American debt crises in the 1980s, and by Argentina’s crisis in the late 1990s. Subnational governments are generally less exposed to the financial repercussions of excessive public debt accumulation, such as higher expected inflation and interest rates, and therefore, again, may be less concerned about it.

For these reasons, IMF conditionality has focused on the general government fiscal balance. The IMF has advised countries to seek mechanisms, appropriate to their political and legal environments, to promote adherence by the subnational governments to national fiscal objectives (e.g., through the enact-
ment of national or subnational fiscal responsibility laws). In some cases, however, the lack of timely and reliable data on subnational fiscal outturns has made the use of central government balances unavoidable as quantitative conditionality in IMF-supported programs.

Evidence also suggests that subnational fiscal policies tend to be procyclical, for various reasons (Wibbels and Rodden, 2006). First, subnationals may be heavily dependent on income-sensitive revenues. Second, the central government may play a limited role in stabilizing subnational fiscal positions through transfers over the cycle. In a normative world, a welfare-maximizing central government would strive to mitigate the procyclicality of subnational finances—as highlighted in Table 1.1, central or federal governments are typically better placed to conduct countercyclical policies and withstand the impact of cyclical shocks, relative to subnational governments, given their broader access to resources (larger tax base and better borrowing conditions) and their privileged role in policy coordination. However, the central government may face little incentive to do so; in fact, opportunistic central governments have an incentive to push the costs of adjustment onto subnationals, by cutting transfers in downturns—thus exacerbating procyclicality—or shifting spending (the so-called unfunded mandates). Indeed, in most federations, transfers are found to be procyclical, or at best acyclical. Finally, lack of access to borrowing may add to procyclicality, when subnationals cannot smooth spending through access to credit to offset lower revenue during downturns (and have not accumulated buffers as insurance for rainy days, as highlighted in Box 1.2).

Thus, not only the degree of fiscal decentralization, but also its design matter for macroeconomic management. The impact of subnational fiscal operations on fiscal discipline and procyclicality does not simply depend on the share of these operations in overall spending and revenue, but also on how they are financed. The discussion above has underlined the role that central transfers play in shaping incentives at the subnational level. This issue is relevant because in practically all countries, subnational spending shares are larger than revenue shares; thus, varying degrees of central transfers are required to cover the resulting vertical fiscal gaps (in Figure 1.1, all countries are located below the 45 degree line). In addition, these gaps appear to have been increasing over time, further highlighting the importance of establishing appropriate policies to deal with these issues (Figure 1.2).

The impact on fiscal discipline and the conduct of fiscal policy is the main macrofiscal issue confronting countries considering fiscal decentralization reforms. When the roles and responsibilities of government levels are modified, what expenditure and tax policies will appropriately ensure fiscal discipline and hard budget constraints? How should the transfer system be designed to provide appropriate funding for subnational operations, while ensuring an adequate level of equalization without blunting incentives to pursue sound policies? What supporting institutional mechanisms to ensure accountability for good results should be emplaced? Providing possible answers to these and related questions has been at the heart of the IMF’s work on fiscal decentralization, and in its policy dialogue with member countries, as explored in the next chapter.

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11A vast empirical literature finds that asymmetric shocks on regional incomes are managed through the tax-transfer system providing insurance mechanisms, as in Canada and the United States (Bayoumi and Masson, 1995); for Germany, von Hagen and Hepp (2001) find that the transfer system insures against revenue shocks, not shocks to regional incomes. Thus, the transfer system acts as a mechanism for insuring state budgets rather than regional economies. However, this literature has focused on the management of shocks, not the conduct of fiscal policy over the cycle.

12Wibbels and Rodden (2006) suggest that an independent agency with an explicit countercyclical mandate would ensure that transfers are countercyclical. They also conclude that the trend toward increasing decentralization, especially in European Monetary Union countries, will complicate attempts to avoid procyclicality.

13Stehn and Fedelino (2009) find that vertical transfers in Germany are procyclical.

14Treisman (2006a) finds a strong positive relationship between economic development (measured as increases in GNP per capita) and expenditure decentralization, while the relationship with revenue decentralization does not appear to be significant. This could further explain why vertical fiscal gaps tend to widen over time.
**Figure 1.1. Subnational Revenues and Expenditures as Shares of General Government, 2006**

Source: GFS data.

**Figure 1.2. Changes in Subnational Shares of Revenues and Expenditures, 2000–06**

Source: GFS data.
A necessary, albeit not sufficient, condition for fiscal discipline is a broad plan to match spending responsibilities with overall resources at each level of government. Therefore, appropriate sequencing of the decentralization process requires that the devolution of spending responsibilities to subnational governments be closely coordinated with the corresponding assignment of own-revenue sources and transfers from the center. Several reasons support this condition. First, the required level of subnational resources has to be defined in relation to the aggregate estimate of subnational expenditure needs. Second, an appropriate mix of taxes and transfers can best be determined once expenditure responsibilities are defined. Finally, unless revenue assignments and transfers are adequately clarified, effectively imposing a hard budget constraint on subnational governments is difficult.

However, political, and sometimes economic, pressures frequently prevent such an orderly process. Devolution of resources has often proceeded unmatched by a corresponding reassignment of spending responsibilities, as was the experience of Colombia in the 1990s, Indonesia in 2000, and Nigeria in the recent oil-boom years. The same situation may have been happening in the Democratic Republic of the Congo and Kosovo in 2009, as these countries moved toward decentralization. During the initial phase in such cases, administrative weaknesses may limit subnational governments’ capacity to spend the devolved resources (as happened initially in Indonesia); over time, the increased revenue availability tends to promote additional (and frequently inefficient) spending. As a result, emerging deficits at the central government level may not be offset by surpluses at the subnational level, leading to deteriorating budget and debt positions of the general government as a whole (or requiring additional increases in the overall tax burden). In other cases (for example, the transition economies of the former Soviet Union in the early 1990s), fiscal stress at the central government level led the government to push spending responsibilities down to the subnational level, without passing on the corresponding resources. In these circumstances, subnationals had to resort to unsustainable borrowing (or accumulation of arrears), and the quality of devolved services (e.g., health and education) deteriorated sharply.

Designing, implementing, and enforcing policies that ensure a hard budget constraint are, however, challenging tasks. Unless a hard budget constraint can be effectively enforced at the subnational level, no plan to match spending responsibilities with resources can ensure adequate maintenance of fiscal discipline. In the absence of such a constraint, subnational governments may overspend, or slacken their revenue efforts, or both, eventually resulting in fiscal pressures for the general government.

For these reasons, designing fiscal decentralization reforms requires a consistent and well-coordinated package of measures. Countries have typically displayed a tendency to change some specific aspects of their systems of intergovernmental fiscal relations in isolation (e.g., modifying expenditure mandates, introducing new revenue-sharing schemes, or changing the transfer system). If not assessed and designed as part of a comprehensive framework, these isolated changes may eventually create inconsistencies and imbalances across government levels, undermining the effectiveness of fiscal policy.

Institutional and political arrangements at the subnational level—although not immediately related to the IMF mandate—have also been taken into account in IMF advice on fiscal decentralization. In countries where there are too many subnational entities (or they are too small to be viable), issues of spending and tax assignments cannot be properly addressed in the absence of some form of territorial reorganization, whereby subnational governments are streamlined and their roles refocused. This situation has been noted in Liberia and the former Yugoslav Republic of Macedonia (FYR Macedonia), for example. Similarly, merit may be found in increasing local participation in economic decision
making outside of formal channels, for example, by seeking increased consultation with local communities. Although not a substitute for devolution of actual fiscal powers, these and similar steps might mitigate the political imperative driving fiscal decentralization, allowing more time to prepare properly for its design and implementation. Finally, sound and viable political mechanisms must be in place to identify and express local preferences—this is the channel through which fiscal decentralization can deliver its promise of better services. In this respect, political mechanisms such as local elections should be in place to help local preferences to be revealed and accountability to subnational constituents to be established. As the background information in Chapter 6 notes, introducing the local election of mayors contributed to the success of fiscal decentralization in Colombia.

Defining Spending Responsibilities

Earlier normative theories of fiscal decentralization provide guidance on the assignment of expenditure responsibilities across government levels. As indicated in Chapter 1, efficiency considerations should drive the assignment of spending responsibilities to subnational governments; according to the so-called decentralization theorem, “each public service should be provided by the jurisdiction having control over the minimum geographic area that would internalize the benefits and costs of such provision” (Oates, 1972, p. 55). At the same time, national public goods (benefiting all citizens and involving externalities, such as defense, foreign affairs, and macroeconomic stabilization) should be centrally provided.

In practice, however, most public outputs do not lend themselves neatly to a categorization into national (centralized) versus local (decentralized) assignments; and concurrent and joint assignments are common. Beyond a few functions that can be predominantly and exclusively assigned either to the center (as in the examples above) or to lower tiers of governments (such as local garbage collection and street cleaning) on the basis of considerations of “internalized benefits,” most spending assignments are jointly undertaken by different government levels. More generally, spending assignments reflect “political jurisdictions,” not “economic clubs” based on normative benefit considerations (Dafflon, 2006); in practice, identifying “minimum geographic areas” within which the costs and benefits of public service provision can be internalized is generally not feasible.

Most spending assignments and functions tend to overlap. The assignment of spending responsibilities covers three main decisions: which level of government should formulate a spending program; which level should finance it; and, finally, which level should implement the related spending.1 Accordingly, it is not uncommon to find that different levels of government are responsible for different aspects of a given spending function, thus creating concurrent assignments. For example, a given service may be considered a national priority, so the center retains some legislative and regulatory control in the definition of related policies and standards, and provides some or all financing, while lower levels of government are directly involved in the provision of such service. Typical examples of concurrent assignment are health care, education, social welfare, environment, infrastructure, and water and sanitation. The case studies in Part II of this occasional paper confirm this pattern, regardless of the degree of spending decentralization (as measured by subnational spending shares, Figure 2.1). Therefore, there are reasons for functions to overlap, and fiscal decentralization reforms should aim to clarify responsibilities and identify appropriate resources for their financing, rather than seek a complete remapping of spending assignments based on optimal allocation of functions—this would be neither a feasible nor a useful task.2

Concurrent responsibilities may nonetheless present fulfillment problems, when clarity in their

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1See Ahmad, Hewitt, and Ruggiero (1997). Implementation of public spending, in turn, covers two dimensions: (1) providing or administering a service; and (2) actually producing a good or delivering a service. For example, municipalities may provide garbage collection services, but the actual service may be delivered by a private operator contracted by the local government (Feruglio, Martinez-Vasquez, and Timofeev, 2008).

2In practice decentralization often does not involve a clean transfer of new responsibilities, but an adding of new layers of responsibility for local governments.
Lack of clarity in spending assignments is, therefore, a root cause of soft budget constraint problems. One immediate implication of unclear spending assignments is that accountability is weakened: if voters do not know which level of government is responsible for possible shortcomings in service provision, politicians can play a blame game and avoid taking responsibility and corrective action. The difficult situation of health care in Italy is a case in point: while the center sets standards and largely provides financing, the regions are mainly responsible for administering service provision. Repeated episodes of “ex post” bailouts have occurred, as regional financing needs for health care have exceeded the center’s allocations (Bordignon, 2006).3

Difficulties with overlapping expenditure assignments are apparent in many countries. In Colombia, the 1991 constitution envisaged that education and health care would be provided at the local or municipal level, and provided for earmarked transfers for this purpose. However, the responsibility for hiring and firing teachers and health care workers remained with the center—attempts to move this function to municipalities were thwarted by powerful unions. In Bolivia, municipalities are responsible for building infrastructure for education and health care, and for the operation and maintenance of that infrastructure; departments hire the teachers, and the central government pays the salaries of the teachers. In addition, municipalities certify hours worked. In these circumstances, information on total spending on education or the actual number of teachers or health care personnel is not available. At the same time, different government levels may operate in their areas of competency without proper consideration for, and coordination with, other levels’ operations (for example, school facilities may be built without taking into account staffing availability; or teachers may be hired without considering the availability of school facilities). Similar cases of divided responsibilities arise in Africa (see Gershberg and Winkler, 2004). In Nigeria, under the new constitution adopted in 1999, primary education was assigned to the lowest tier—districts. However, most districts lacked the capacity to manage this function, and the financing from transfers was not effectively used for this purpose, with resulting shortfalls in the payment of teachers’ wages. An effective “recentralization” of this function then took place, with the states hiring and managing teachers, and financing occurring through a special-purpose or earmarked grant from the center.

The need to clarify roles and responsibilities of government levels has been emphasized in IMF staff advice. Without proper definition of which government level is responsible for what, the appropriate balance between spending mandates and resources to fund them cannot be addressed. Thus, staff have

3 These issues were also covered in IMF (2000).
often called for rationalizing the legal framework and, where possible, eliminating overlaps that could lead to waste and duplication (Table 2.1 summarizes the main policy recommendations on spending assignments in the case-study countries). At the same time, assignments should reflect the subnational governments’ implementation capacity. When capacity is limited or varying, asymmetric options might allow a more-rapid take-up of responsibilities, for example, in advanced regions and the main urban centers, while capacity continues to be built elsewhere. This approach was recommended in FYR Macedonia, a very centralized country where significant devolution of spending was planned. Specific phasing was devised to help safeguard fiscal sustainability, ensure continued service quality, and avoid straining limited capacity at the municipal level.4

Finally, in China (one of the most decentralized countries, Figure 2.1), decentralization of pension provision to, in some cases, the lowest government tiers has put an excessive burden on jurisdictions and undermined risk sharing. Therefore, staff have recommended pooling of pension provisions, if not at the central level, at least at the provincial level.

Decentralization of spending responsibilities could start in areas where success is more likely to be rapid, and where accountability can be easily established. This would give rise to asymmetric sectoral decentralization. In FYR Macedonia, for example, it was recommended that specific strategies and the time frame needed for decentralization vary by sector. It was noted that fiscal decentralization in the education sector might be easier to achieve than in the health sector, and should therefore proceed at a sector-specific pace. General guidance was provided on specific stages, starting with the transfer of physical assets (e.g., buildings) to the municipalities along with the responsibility for maintaining them, moving on to responsibilities for personnel decisions (e.g., recruiting teachers), and in the final stage, for paying a significant share of current expenditures (e.g., at least part of the wage bill). Decisions on which sectors could be the best candidates for decentralization should be informed by the advice of specialists, for example, from the World Bank (as recommended in FYR Macedonia, as well as in Kosovo).

Another important issue is the impact of spending decentralization on the quality of service delivery. In principle, the assignment of expenditure responsibilities among government levels could be a valuable tool for improving performance of the overall public sector, by generating efficiency gains in the management of existing resources and strengthening accountability—one of the foremost rationales for decentralized provision of some public services. In practice, however, evidence of a positive relationship between decentralized spending and improvements in service delivery is hard to come by, not least because measures of outcomes of subnational spending—needed to gauge performance—are often lacking. Conclusive evidence of the positive impact of decentralization on the quality of public services remains limited.5 Service efficiency hinges on strong accountability links between the players in the delivery chain—service providers, customers and citizens, and policymakers. Decentralization can either strengthen or weaken these links, depending on the way in which it affects the incentives of the various players, thus yielding, on average, mixed results for service outcomes. For example, in cases where “partial decentralization” is implemented—with citizens not able to hold local governments accountable for budgetary allocations and their outcomes—the successful provision of decentralized public services cannot take place and the promised gains of decentralization—better quality services—do not materialize.6

4Even when not explicitly recognized, asymmetric arrangements tend to prevail, for example, in capital cities or major urban centers (such as Bogotá in Colombia, Skopje in FYR Macedonia, and Shanghai in China). The use of contracts among levels of government to address assignments is an interesting area of research (e.g., see Spahn, 2006).

5Ahmad and Brosio (2009) review the literature on these issues, and provide a series of case studies.

6Under partial decentralization, local governments have no discretion to choose among competing uses for resources subject to a budget constraint, and citizens are not aware and cannot evaluate government’s decisions (for example, when the central government provides earmarked grants for capital expenditures). Devarajan, Khemani, and Shah (2009) explore these issues in more detail.
### Table 2.1. Main Recommendations on Spending Assignments in Case-Study Countries

<table>
<thead>
<tr>
<th>Countries</th>
<th>Main issues</th>
<th>IMF advice</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Clarification and definition of expenditure assignments</strong></td>
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<tr>
<td>Bolivia</td>
<td>Spending responsibilities overlap in many sectors, including health and education; are not in line with revenue assignments; and do not reflect differences in subnational capacities.</td>
<td>Clarify and review spending responsibilities.</td>
</tr>
<tr>
<td>Colombia</td>
<td>Unclear legal framework with overlapping jurisdictions.</td>
<td>Clarify legal framework and eliminate overlap.</td>
</tr>
<tr>
<td>Congo, Dem. Rep. of</td>
<td>Constitution does not clearly define “shared expenditure responsibilities.” Institutional capacity on the provincial level is very weak, particularly in the reunited eastern provinces.</td>
<td>Aim for a clear delineation of expenditure responsibilities. Transfer expenditure responsibilities gradually, in line with progress in strengthening provincial capacities, including PFM. Full and immediate transfer to largely unprepared provincial authorities implies high risks for the quality of spending, including large-scale misappropriation of funds.</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Spending responsibilities overlapped in many sectors, including health and education; were not in line with revenue assignments; and did not reflect differences in subnational capacities.</td>
<td>Clarify and review spending responsibilities. Be careful to consider all levels of service delivery and limit cost shifting.</td>
</tr>
<tr>
<td>Kosovo</td>
<td>In 2007, it was noted that status resolution would bring increased spending responsibilities to municipalities and introduce asymmetric arrangements for Serb-majority jurisdictions. In 2010, discussion focused on strengthening incentives for municipalities to spend better.</td>
<td>Clarify spending responsibilities—often defined in legislation but blurred in practice. Assign increased responsibilities in line with proven capacity to execute functions and based on well-defined accountability mechanisms. In 2010, advice is to eventually remove staff ceilings in the context of a well-designed civil service reform. Cost out functions before the grant system is revised, so that funds can be properly allocated in line with spending mandates.</td>
</tr>
<tr>
<td>Liberia</td>
<td>Liberia follows a deconcentrated model, with counties operating as agents of central line ministries. Limited spending autonomy is taking place through the County Development Fund (CDF), with some merits and shortcomings.</td>
<td>Because counties have limited capacity, precede a move to fiscal decentralization with structural reforms and legislative initiatives. Meanwhile, pursue increased deconcentration to promote a stronger role of government in the provision of needed services at the local level. Improve procedures for CDF operations.</td>
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<tr>
<td>Mexico</td>
<td>Expenditure responsibilities were not clearly defined, with health and education being two main areas of overlapping responsibilities. Subnational spending was dominated by personnel expenses, while spending on goods and services (including investment) was limited.</td>
<td>Clarify functional spending responsibilities for lower levels of government, while allowing full control over the choice of economic inputs (wages and salaries, operations and maintenance, and so on).</td>
</tr>
<tr>
<td>Nigeria</td>
<td>Clarity is lacking in certain areas (both through omission and shared responsibility), as is coordination of intergovernmental expenditure policy. There is a proliferation of deductions-at-source practices by higher levels of government to undertake some spending responsibilities assigned to lower government levels.</td>
<td>Pass national legislation to detail the distribution of functions relating to individual public services, such as education and health. Establish streamlined special-purpose transfers to achieve national objectives in fundamental areas. Ensure that the availability of financial resources for a level of government be broadly commensurate with the devolution of expenditure responsibilities.</td>
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<tr>
<td><strong>Asymmetric options for spending devolution</strong></td>
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</tr>
<tr>
<td>Macedonia, FYR</td>
<td>This has been a very centralized country; while fiscal decentralization reforms are driven by political considerations, assigning spending mandates to municipalities will require careful sequencing and avoidance of duplication of spending.</td>
<td>Expenditure assignments should be transferred gradually, starting from some basic administrative tasks at no or small financial cost, and progressively expanding to decision-making powers. The devolution of spending should proceed at different paces in different sectors, and across different municipalities (asymmetric options).</td>
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<tr>
<td><strong>Centralization of devolved spending</strong></td>
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<tr>
<td>China</td>
<td>Local governments have replaced the state-owned enterprise sector as the main provider of social services (health and education) and social security (pensions). These burgeoning spending mandates were not clearly defined or financed.</td>
<td>Clarify and review spending responsibilities. Centralize social security (pensions) to allow better pooling of risks and ensure proper financing.</td>
</tr>
</tbody>
</table>

Source: Case studies in Part II of this occasional paper.
Note: PFM = Public financial management.

By their nature, issues of expenditure assignment are inextricably linked to sectoral policies. This intertwining has been the experience in a number of countries where staff have provided advice on fiscal decentralization, and where specific recommendations required dedicated expertise of specific sectors. Therefore, in a number of cases, staff’s technical assistance has benefited from World...
Ensuring Sound Public Financial Management

A clear and transparent public financial management (PFM) framework, at the subnational level as well as the central government level, is a crucial ingredient of successful fiscal decentralization (Ahmad, Albino-War, and Singh, 2006). It facilitates consistent decision making to ensure macroeconomic stability and accountability for effective use of public resources. Sound PFM arrangements need to be supplemented by legal provisions and institutional mechanisms governing the responsibilities and financing of different levels of government to generate the incentives to manage resources efficiently. In countries in which subnational PFM systems do not meet minimum adequacy standards—for example, where budget formulation is incomplete, and information and reporting of government operations is limited, inaccurate, and not timely—staff have emphasized that strengthening PFM arrangements should be a prerequisite for increasing decentralization (this was the position taken in Bolivia, the Democratic Republic of the Congo, Indonesia, Kenya, Kosovo, Liberia, and Nigeria).

Several elements of good PFM and governance are critical at the subnational level. Among these elements are a realistic budget envelope prepared in a timely manner; an adequate budget classification system, preferably compatible with international standards (e.g., the Government Finance Statistics 2001—especially for economic and functional classifications), and an accounting framework consistent with such classification; effective audit and control mechanisms, with a high probability of detection of, and penalties for, misuse of public funds; and firmly enforced requirements for timely and accurate reporting.

The budget framework should encompass all government levels. To facilitate consistent decision making across the whole general government, the budgets of all jurisdictions must be based on common macroeconomic assumptions, use a harmonized budget classification, and be formulated and executed according to well-coordinated schedules. Problems arise when operations at all government levels, and their financial interactions, are not fully captured in the budget. For example, in Nigeria, a portion of the transfers to state and local governments is netted out against subnational mandatory spending (including for teachers’ salaries), a practice that significantly reduces the coverage of the budget and weakens transparency and accountability. In Liberia, where the budget document does not include information on operations at the county level, staff advised to start including in the budget an annex showing consolidated projected spending by county, because transparency and more-informed decisions would also lead to a rationalization of such spending, thus paving the way for effective further devolution of functions to counties in the future. In some cases, the budget calendar does not allow coordination among government levels—a problem exacerbated in countries where the fiscal years differ across government levels,9 or where the central budget is adopted late and subnationals do not receive information on their allocations until late in the fiscal year, a problem experienced in China.

In cases where the center cannot impose or enforce a common framework, consensus can be forged to introduce it. This strategy is being used in Nigeria, where the government is seeking to institutionalize a framework for the sharing and spending of oil revenue, as well as mechanisms to coordinate policy priorities and spending levels between the federal government and the states. Similarly, the states have been encouraged to approve fiscal responsibility legislation that parallels that of the federal government, which enshrines a fiscal framework based on an oil price–based rule. The 2007 Nigerian Fiscal Responsibility Act also sets out

9 This used to be a problem in Tanzania, where the central government followed a July–June fiscal year, and the subnational governments adhered to the calendar year. As of 2008, the subnational fiscal year is aligned to that of the central government.
transparency requirements, sanctions, compliance provisions, and guidelines for budgetary practices. In Brazil, the passage of a national Fiscal Responsibility Law, binding for all levels of government, was facilitated by a comprehensive and effective consensus-building effort by the federal government with subnational governments, as well as the federal congress and public opinion at large.

Timely monitoring and transparent reporting of fiscal operations at all government levels, to include guidance for subnationals on the content and format of reporting, are important for effective macroeconomic management. A common framework for accounting and reporting—consistent with the budget classification—is critical to establishing transparency and accountability. Among various issues in this area, the importance of an adequate information management system cannot be overemphasized. Although systems can differ across government tiers, especially in larger, federal countries, the systems need to interface to allow comprehensive reporting. Effective auditing and control systems, together with firmly enforced sanctions for non-compliance, constitute additional conditions for good governance.

Staff advice on strengthening subnational PFM systems has focused on different issues in different countries, depending on the specific needs and circumstances of the requesting country (Table 2.2). It has focused especially on those elements of PFM systems that are most critical from a macroeconomic standpoint. In a number of countries, staff advice has emphasized strengthening the framework legislation for PFM, which provides the basis for sound budget formulation, execution, accounting, and reporting. For example, staff provided input for the Financial Management Legislation in Iraq (2004) and, more recently, for planned reforms to framework legislation for financial management for all government levels in Bolivia and Peru.

Staff advice has also emphasized the importance of treasury single accounts (TSAs). TSAs are used in modern administrations to consolidate the government’s cash, minimize borrowing requirements, facilitate asset and debt management, and also establish a better record of who spends what and when. TSAs also make it less likely that government funds, which might otherwise be held in thousands of bank accounts with little oversight, are misused. The establishment of a TSA, even if shared with the central government on an agency basis—one of the options recommended in Mexico—need not impair the autonomy of subnational governments. On the contrary, it could serve as a vehicle for increased transparency and, hence, better decision making.

In Kosovo, municipal operations are covered by the central TSA, which provides the main source for reporting on municipal finances and cash flows. Whether subnationals should have their own TSAs or use a centralized TSA depends on institutional arrangements and political preferences, as long as ledger accounts (used in a TSA in lieu of bank accounts) are used to track spending by enabling the identification of the resource use.

In cases where the “above-the-line” information is either inaccurate or not available, staff have advised to monitor “below-the-line” subnational operations. In Mexico, staff recommended tracking subnational fiscal operations from bank transactions, with assistance from the Bank of Mexico. Because this would not identify the possible buildup of arrears or contingent liabilities, establishing and maintaining subnational debt and risk registries was also recommended in some countries (Bolivia, China, and Mexico).

On occasion, staff have also provided advice on organizational issues. Decentralization typically places responsibilities on the Ministry of Finance (MoF) to guide and monitor fiscal relations with subnational governments. Although the degree of MoF oversight over intergovernmental relations varies across countries, the basic set of MoF responsibilities includes preparing and disseminating financial management instructions for subnationals; providing guidance to subnationals for budget preparation; collecting, consolidating, and publishing subnational budgets and budget execution data; and monitoring adherence to financial rules and the PFM legal framework. Given that these tasks...
### Table 2.2. Main Recommendations on Public Financial Management in Case-Study Countries

<table>
<thead>
<tr>
<th>Countries</th>
<th>Main issues</th>
<th>IMF advice</th>
</tr>
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<tbody>
<tr>
<td>Bolivia</td>
<td>Weak budget process does not impose hard budget constraint. Economic classification, link with chart of accounts remain inadequate. The poor budgetary procedures and the related information system (SIGMA) preclude up-to-date reporting of subnational finances.</td>
<td>Adopt a new organic budget framework law. Assess options for the information system (the existing system is inadequate, and it may prove more costly to fix than to design a new one or get one off the shelf).</td>
</tr>
<tr>
<td>China</td>
<td>Budget formulation, execution, and reporting showed weaknesses at the subnational level, making it difficult to monitor subnational operations.</td>
<td>Adopt a modern budget classification (and revise the chart of accounts consistent with it) across levels of governments, to improve the transparency of government operations. Design and implement nested subnational information systems and treasury single accounts.</td>
</tr>
<tr>
<td>Colombia</td>
<td>Lack of effective macroeconomic coordination across levels of government hindered policy formulation and implementation, along with lack of consolidated fiscal accounts.</td>
<td>Consolidate the data coming from various sources that collect local fiscal data. Introduce a fiscal coordination council.</td>
</tr>
<tr>
<td>Congo, Dem. Rep. of</td>
<td>Institutional capacity of subnational governments in budget preparation and execution, as well as treasury management, is weak. Harmonized accounting and computer systems are nonexistent.</td>
<td>Strengthen local governments' PFM capacity and harmonize accounting standards.</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Budget classification structure used by regions was not aligned with the central government; there was no regional government reporting mechanism; data on subnational governments were provided with a two-year delay, with no information available on local spending during the year.</td>
<td>MoF to provide guidance to the regions on classification. Develop budget planning allowing for smoothing large variances in regional transfers. Establish regional reporting framework, with monthly reports on expenditures provided to the MoF. Introduce penalties for subnational governments failing to report budget documents to the MoF, via reducing central government transfers.</td>
</tr>
<tr>
<td>Kosovo</td>
<td>Despite significant improvements in budget preparation, execution, and reporting at the municipal level, there was still a need to consolidate progress in PFM, in particular regarding the public investment process.</td>
<td>Continue to pursue PFM reforms and build capacity, and execute municipal budgets through the central treasury system. Introduce a more stringent certification scheme for municipalities. Strengthen the public investment process, including project selection, planning, and execution. Allocate funds for municipal projects directly (albeit gradually) to municipalities, rather than line ministries, within a well-specified medium-term framework.</td>
</tr>
<tr>
<td>Liberia</td>
<td>The centralized system has hampered the development of PFM capacity at the county level. All financial transactions take place in the capital. Weak or nonexistent capacity poses a risk to the successful devolution of funds and functions.</td>
<td>Adopt a sequenced approach, starting with increased transparency and coverage of county-level operations in the budget. Establish county treasures to provide treasury services and ensure better use of cash resources and provide regular reporting of county financial transactions. Prepare the legal framework and the institutional framework for decentralization, including through the establishment of a small unit at the MoF.</td>
</tr>
<tr>
<td>Macedonia, FYR</td>
<td>All stages of the municipal budget process (including budget preparation, execution, reporting, and audit) were in need of improvement. Absent a significant PFM reform at the municipal level, fiscal decentralization would be bound to fail.</td>
<td>Strengthen PFM system by establishing comprehensive and timely reporting mechanisms on budget execution, as well as by strengthening human capacity in these areas (including via training of municipal financial officers). Introduce penalties for noncompliance.</td>
</tr>
<tr>
<td>Mexico</td>
<td>Standardized and timely information on fiscal performance of states and municipalities was lacking. Only a few states have modern information systems (GFMIS) that integrate budget and accounting. This prevented federal government from producing information on general government fiscal operations, and did not allow states and municipalities to compare with others.</td>
<td>Establish a common budget classification and accounting framework consistent with international standards, at all levels of government. Determine reporting standards and introduce sanctions for noncompliance. Ensure GFMIS fully integrates budget modules and accounting, and interfaces are designed for the effective flows of information. Federal government, with assistance of Bank of Mexico, should also begin below-the-line tracking of subnational operations.</td>
</tr>
<tr>
<td>Nigeria</td>
<td>There was no common macroeconomic framework for all levels of government; no reporting of information on subnational fiscal developments; no harmonized system of budget classification and accounting for all levels of government; and there was no well-defined treasury system at the subnational level.</td>
<td>Ensure that the budgets of all three levels of government are consistent with the same basic underlying macroeconomic assumptions. Make public the transfers from the Federation Account, as well as subnational budgets and their outturn. Establish comprehensive coverage of fiscal accounts. Prepare a uniform set of guidelines for budget preparation and accounting to be followed by all tiers of government. Establish a consolidated single account for the states at the central bank.</td>
</tr>
</tbody>
</table>

Source: Case studies in Part II of this occasional paper.
Note: GFMIS = Government Financial Management Information System; MoF = Ministry of Finance.
require full-time, dedicated staff with computerized support, ideally, a special unit should be established within the MoF, with clear reporting responsibilities both within the MoF and with other government ministries. The size of this unit would depend on the complexity of the devolved government system and the role assigned to the MoF.10

Preparations for the creation of a dedicated unit—or the assignment of dedicated staff—should begin early in the fiscal decentralization process. Planning should begin at an early stage, particularly for identification of job descriptions, skills, and training. In Liberia, staff advised authorities to start planning a dedicated unit once the main law establishing local governments had been adopted. In Nigeria, staff recommended the creation of a Fiscal Analysis Unit to be in charge of providing a common macroeconomic framework for fiscal policy formulation and of monitoring fiscal developments at all government levels.

**Designing Intergovernmental Revenue Arrangements**

One of the basic tenets of fiscal decentralization is that funds should follow functions; thus, resources assigned to different levels of government should be linked to the scope of the functions devolved to those levels. This matching principle has two main implications: (1) subnational governments’ spending responsibilities should be adequately financed through a combination of own-source revenue, shared taxes, transfers, and to the extent allowed, borrowing; and (2) revenue assignments should be contingent on a transparent and clear definition and delegation of the functions the revenues are intended to fund. These prerequisites are often neglected in practice, because sometimes political pressures emerge to devolve taxes to (or share them with) subnational governments, without due consideration for the use of such funds. For example, this is a risk arising in the Democratic Republic of the Congo, where the planned decentralization strategy would assign some 40 percent of overall revenue to provinces although the provinces would only be responsible for about 20 percent of overall spending (see Chapter 7); it could also be a risk in Liberia if pressures to share large resource revenue flows are acceded to before counties are ready to take up new spending responsibilities. As explained above, in these cases the central government’s fiscal space is significantly eroded, and the ability of the center to undertake stabilization and redistributive policies is hampered.

Defining the right financing mix requires a delicate balancing act. Allowing access to own-revenue (for which subnational governments have discretion over tax rates and bases) at the margin through local taxation is essential to promoting fiscal discipline and accountability, because access to own taxes can help curb perceptions of soft budget constraints. If considerable expenditure responsibilities are devolved, access to significant tax handles at the margin may be needed at the subnational level to ensure that local spending decisions are linked to financing by those who benefit from these expenditures. However, excessive tax autonomy may create inefficiencies and widen disparities across jurisdictions, thereby undermining the stabilization role of the central government. Thus, the right degree of taxing autonomy is a matter of judgment, and reflects historical, political, and other country-specific factors.

Normative theories of fiscal federalism emphasize a number of principles for optimal tax assignments. In this literature, the assignment of taxes derives directly from the optimal assignment of government functions (as described in Table 1.1). Taxes with large and elastic bases, such as income taxes, should be assigned to the central government as the best instruments for both macroeconomic stabilization and income redistribution. For allocation functions, benefit taxation should be used by various government tiers. Accordingly, the provision of local services (such as public utilities and local transporta- tion) should be subject to user charges and fees; services with local benefit zones (parks, roads)

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10For example, South Africa has more than 80 staff members in the Intergovernmental Fiscal Relations (IGFR) Directorate of the National Treasury, whereas Tanzania and Rwanda have only a few staff located within their respective budget departments. In South Africa, the IGFR Directorate is responsible for planning at the local government level, as well as budgeting and financial reporting.
should be financed with local taxes; while goods and services with significant externalities should be financed with regionwide taxes or transfers. To prevent revenue losses or tax erosion resulting from tax competition, local tax bases should be relatively immobile; bases should also be evenly distributed across jurisdictions, to avoid horizontal fiscal imbalances; and their yield should be relatively stable, to allow subnational governments to rely on steady and predictable revenue streams. These principles rest on the assumption that governments behave as benevolent welfare maximizers. When this tenet is challenged—as in the public choice approach (Brennan and Buchanan, 1980)—the opposite conclusion derives, that is, that subnational taxes should be imposed on mobile factors to promote competition among “rapacious” governments; less availability of taxes would help limit the size of governments (the “starve the beast” argument). As explained earlier, however, the main limitation of these normative theories is that they do not explain tax assignments in the real world.

More-recent positive theories underline the political interactions among government levels—and the incentives faced by politicians—as key factors in the distribution of taxing powers. However, while these theories help explain some of the observed intergovernmental tax systems, “no clear indication concerning the optimal tax assignment to different levels of government emerges from them” (Ambrosanio and Bordignon, 2006, p. 314).

In practice, revenue assignments are guided by a number of considerations. In addition to ensuring funding adequacy and promoting accountability, administrative feasibility is an important factor in defining revenue assignments. As discussed below, some tax handles that are appropriate for countries with sophisticated administrations at the subnational level may not be advisable for ones with weaker administrations at the same level. This issue is recognized by both normative and positive theories of revenue assignments. On this basis, most major tax handles—such as the value-added tax (VAT) and income taxes—tend to be assigned to the central government, given that the administration of these taxes within a multilayered government presents particular challenges. Import duties also are typically assigned to the center. These assignments tend to create vertical imbalances in favor of the center because the center collects more revenue than needed to carry out its spending responsibilities. This opens up the possibility to redistribute resources according to various equalization criteria (see “Other Intergovernmental Transfers” later in this chapter).

In addition, revenue assignments rarely take the form of full and exclusive assignments of taxes to one government level. Rather, various options are possible (and countries have indeed adopted different models). Just as establishing a one-function—one-government-level link is not possible, and an overlapping “continuum” of functions is assigned to various government levels instead (see the “Defining Spending Responsibilities” section of this chapter), so the sources of government funding also form a continuum of different yet overlapping alternatives.

Options for intergovernmental revenue arrangements vary according to the degree of subnational revenue autonomy these options allow. Three main types of arrangement exist. First, own-revenue assignments allow some degree of discretion to subnational governments, with a distinction between own-source revenue (under which subnational governments enjoy full legal control over both the definition of taxable bases and the rate structure of the revenue source) and surcharges or piggybacking on central taxes (under which subnational governments have limited or no control over the specification of the tax base, but a typically bounded degree of control over tax rates). Second, revenue-sharing arrangements allocate to subnational governments shares of taxes whose bases and rates are defined (and typically administered) by the central government; in this case, subnational governments have no control over these revenue sources. (In some cases, though, the subnational may collect and administer these taxes, as in Germany.) Finally, intergov-

11The absence of border controls makes it difficult to administer a subnational VAT that is destination-based.

12Subnational governments may still see their effective room for maneuver constrained by economic factors, such as a high degree of mobility of the relevant tax base (e.g., income from capital).
Environmental grants transfer budgetary resources to subnational governments. Although the distinction between revenue-sharing and grants is a fine one, grants are typically characterized by a higher level of central discretion than is revenue-sharing, to the point that subnational governments may not even be able to predict their grant amounts with any degree of confidence. Table 2.3 presents a taxonomy of subnational revenue assignments, further discussed in the remainder of this section.

### Subnational Own-Revenue Assignments

Assigning own-revenue to subnationals is believed to provide incentives to promote improved economic performance. Subnational governments that can keep a share of the revenue raised in their jurisdictions have an interest in promoting business- and market-friendly policies for their positive impacts on local tax bases and revenues. In contrast, when a large portion of locally raised revenue is siphoned off to the center or other jurisdictions, local politicians have little incentive to increase revenue intakes, thus placing lower priority on stimulating economic activity through good policies.13

Property and land taxes are typical subnational own-source taxes, for a number of reasons. The bases of these taxes are immobile, so taxpayers cannot easily shift location to avoid taxation; the taxes reflect the benefit principle because local services (e.g., roads, transportation, parks) confer benefits on properties and increase property values; the taxes allow subnational governments to determine the desired level of services and raise revenues to pay for that level (because the property tax base is relatively inelastic, maintenance of the tax yield may require discretionary policy changes of tax rates or valuations), which makes the tax highly visible and establishes a clear accountability link by enhancing the responsiveness of local politicians to local demands. However, determining the value of property tax bases is often difficult, thus complicating their administration, especially in countries where market valuation is hindered by limited real estate market activity or by limited information on market transactions. Hence, determining the tax base is often a matter of judgment. International experience suggests that the yield from property taxes is usually limited.14 Still, there is a general perception that property taxes remain largely underexploited (OECD, 2004).

Benefit taxes, including user charges, are another important revenue-raising tool for subnational operations at the margin.15 Yet in most cases, the revenue potential remains limited relative to financing needs of subnational governments, mainly because of distributional or political considerations; and these taxes can become nuisance taxes if allowed to proliferate excessively. Similarly, excises of various kinds are sometimes used at the subnational level, and may be relevant at either the intermediate (regional) or local tiers of government. From an efficiency standpoint, excises should be

### Table 2.3. A Taxonomy of Subnational Revenue Arrangements

<table>
<thead>
<tr>
<th>Revenue source</th>
<th>Elements controlled by subnationals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Own-revenue assignments</td>
<td>Tax base  Tax rate  Administration</td>
</tr>
<tr>
<td>Own-source revenue</td>
<td>Yes        Yes        Yes/Possibly</td>
</tr>
<tr>
<td>Surcharges on national taxes</td>
<td>No         Yes        Possibly</td>
</tr>
<tr>
<td>Revenue-sharing</td>
<td>No         Yes        Possibly</td>
</tr>
<tr>
<td>Other intergovernmental transfers</td>
<td>No         No         No</td>
</tr>
</tbody>
</table>

Source: Authors.

13This argument has been used to explain China’s remarkable growth performance compared with that of the Russian Federation in the 1990s: in China, subnational governments had a secure share of local revenue, whereas in the Russian Federation the revenue share was low (Roland, 2000; and Jin, Qian, and Weingast, 2005). However, Treisman (2006b) notes that the changes in the decentralization system in China in 1994, which led to a recentralization of revenue (see also Chapter 5 in this occasional paper), do not seem to have affected market-friendly policies at the provincial level; and the growth surge in the Russian Federation since 1999 happened despite continued tax sharing and weak local incentives. These contrasting results underline that the design of tax assignments is only one aspect of fiscal decentralization, which should be looked at in its entirety, as repeatedly stressed in this paper.

14The share of property taxes in subnational revenue varies considerably, from as low as 5 percent in Turkey and 7 percent in Norway, to 90 percent in New Zealand and 100 percent in Australia, Ireland, and the United Kingdom. As a share of GDP, property taxes account on average for about 1 percent in unitary countries and 2 percent in federal countries.

15These taxes have long been supported in the literature (Musgrave, 1959).
levied on a destination basis (where the taxed good is consumed), but this may give rise to smuggling and cross-border shopping if subnational jurisdictions apply significantly different rates.

More-mobile tax bases are increasingly being recommended in the literature for assignment to subnational governments. Additional competition—within and across regions—may help promote spending discipline. However, these options remain subject to administrative feasibility and constraints. Given its strong long-term revenue potential, interest continues in the possibility of implementing the VAT as a subnational tax, which requires addressing the inherent difficulties noted above. Experiences with subnational VATs in practice, however, have been mixed (Perry, 2009). For example, VAT could become a central-local tax, administered by either level of government on a jointly determined base, but with each government level choosing its own rate (the so-called dual VAT). More-sophisticated options exist, although they have not yet passed the empirical test and remain theoretical. Experiences with subnational VATs have been mixed. While these taxes represent important revenue handles, the lack of harmonization has increased compliance costs to taxpayers operating in different jurisdictions, and has also resulted in tax wars across states (as has happened with the state-level VAT in Brazil). The Canadian dual VAT appears more successful. Experience to date with the state VATs in India is too short to make definitive judgments.

In a few countries, local business taxes have been replaced by a subtraction-type origin-based VAT. This tax is levied on a measure of value added, calculated for each taxable entity as the difference (hence the name “subtraction-type”) between revenue and purchases. This has proved to be a powerful and easy-to-administer revenue tool for subnational governments (the Italian regional business tax, IRAP, and the German local trade tax, Gewerbesteuer, provide good examples). This tax has a number of theoretical advantages, including the avoidance of cascading that might be present with traditional business taxes, and the fact that the tax base is essentially a measure of an entity’s value added. To be effective, this tax should be levied at a single rate. However, although relatively simple to administer, it is not suitable where lower tax-administration levels have limited capacity; in these cases, an alternative may be to have it administered by the central tax administration.

The assignment of specific taxes reflects historical, political, and institutional factors, as well as countries’ levels of capacity and development. Table 2.4 highlights the main advantages and disadvantages of various tax assignments.

Surcharges, or piggybacking, on central taxes may provide additional subnational revenue, building on the central tax administration—indeed, a key source of subnational revenue in many countries. These arrangements confer a more limited degree of autonomy to subnational jurisdictions because the subnationals simply impose a surcharge on tax bases defined by the central government. Still, there may be incentives on both sides—local authorities may have an advantage in identifying potential taxpayers, to the mutual benefit of both the center and the subnational governments. Surcharges are most typically levied on personal income taxes, but piggybacking on sales taxes and excises also occurs. Surcharge tax rates are frequently subject to both upper and lower limits set by the central government. Although surcharges are easy to administer, a possible drawback is that they may create (or deepen) horizontal disparities, because revenue tends to be geographically concentrated in richer and more-developed jurisdictions. This situation would require an appropriate equalization transfer

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17These include the CVAT (compensating VAT) and VIVAT (vertically integrated VAT). The VIVAT makes a distinction between sales to registered traders and sales to households and unregistered traders; the former are subject to a uniform (national) rate, while different (local) rates apply to the latter. In the CVAT, sales to local purchasers (registered and unregistered traders, and households) are subject to a local VAT, but sales to purchasers in other jurisdictions are zero rated for central VAT and subject instead to a compensating VAT. For more detail, see Bird and Gendron (1998), and Keen (2000).

18Capital inputs can be either fully subtracted or, as in Italy, a course can be followed where only depreciation is taken out of the taxable base (thus making the tax an income-type, production-based VAT).
In their advice, IMF staff have attempted to balance normative principles with administrative capacity considerations and political economy constraints (Table 2.5). In most countries, the legal framework for local taxation is unclear; policy weaknesses are often compounded by shortcomings in revenue administrations, making yields from local own-source revenue inadequate to ensure spending accountability and proper funding of subnational operations. In these cases, advice has focused on clarifying and simplifying the legal framework, eliminating nuisance taxes, and improving the design and administration of a few good tax handles, most notably property taxes (for example, in the Democratic Republic of the Congo, Indonesia, Kosovo, Liberia, FYR Macedonia, and Nigeria). In countries with relatively advanced tax administration, new taxes were recommended, along the lines of a local VAT-type tax, either directly assigned to subnational governments (Colombia) or assigned to the national government with piggybacking arrangements for subnational governments (Mexico). In other cases (Bolivia and China, among others), surcharges on national income taxes were suggested to bolster subnational taxation.

Availability of own-source revenue is a necessary, but not sufficient, condition for accountability and fiscal discipline at the subnational level. Even if subnational governments can mobilize own-source revenue, they will not necessarily have an incentive to do so. In fact, although the availability of own-source revenue helps mitigate the common pool problem, it does not automatically eliminate the soft budget constraint problem (as illustrated by the Italian experience with regional health spending mentioned in the “Defining Spending Responsibilities” section earlier in this chapter). Elimination of the soft budget constraint depends critically on the

Table 2.4. Assignment of Taxes to Subnational Governments

<table>
<thead>
<tr>
<th>Tax</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal income tax</td>
<td>• Buoyant revenues</td>
<td>• May create or aggravate horizontal imbalances.</td>
</tr>
<tr>
<td></td>
<td>• Visible (increases accountability)</td>
<td>• In areas where average incomes are below threshold, insufficient yield; also, as most people would not pay, the price-signal effect of the tax is weakened.</td>
</tr>
<tr>
<td></td>
<td>• Cost-effective if piggybacked on national taxation</td>
<td>• If levied at different rates among jurisdictions, it may create distortions if people are mobile.</td>
</tr>
<tr>
<td>Corporate income tax</td>
<td>Sometimes seen as a sort of benefit tax</td>
<td>• Mobile tax bases and complex administration make it suitable for collection by the center (except taxation of small businesses).</td>
</tr>
<tr>
<td>User fees and charges</td>
<td>• Low-mobility tax base</td>
<td>• Generally low yield</td>
</tr>
<tr>
<td></td>
<td>• No obvious horizontal or vertical imbalance problems</td>
<td>• Low cost-efficiency</td>
</tr>
<tr>
<td></td>
<td>• Visible</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Linked to benefits</td>
<td></td>
</tr>
<tr>
<td>Property tax</td>
<td>• Immobile tax base</td>
<td>• Difficult administration (especially in setting up well-functioning cadastres), often resulting in low yield.</td>
</tr>
<tr>
<td></td>
<td>• Visible</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Stable yield</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Indirectly linked to benefits</td>
<td></td>
</tr>
<tr>
<td>Sales and excise tax</td>
<td>• No horizontal or vertical imbalance problems</td>
<td>• May create cross-border shopping if levied at different rates among subnational jurisdictions.</td>
</tr>
<tr>
<td></td>
<td>• Visible</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Easy to administer</td>
<td></td>
</tr>
<tr>
<td>Value-added tax</td>
<td>• If properly designed and administered, it could be a good subnational tax, although experience has been mixed (see text).</td>
<td>• Complex tax administration</td>
</tr>
<tr>
<td></td>
<td>• No obvious horizontal or vertical imbalance problems</td>
<td>• If applied on destination principle, border controls between local jurisdictions required; if applied on origin principle, tax exporting and transfer pricing may arise.</td>
</tr>
<tr>
<td></td>
<td>• Easy to administer</td>
<td></td>
</tr>
<tr>
<td>Resource tax</td>
<td>None apparent</td>
<td>• Significant horizontal imbalances</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Difficult to administer</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Excessively volatile</td>
</tr>
</tbody>
</table>

China Local governments had only limited power to set rates. Introduce a new VAT-like tax in Colombia.

Colombia Although the distribution of revenue bases across levels of government was broadly adequate (departments collected excise taxes and municipalities collected property taxes, a tax on turnover, and a surcharge on gasoline), the structure was complex. Increase local own-source revenue via tax and tax administration measures. Convert the local turnover tax into a simplified (subtraction-based) local VAT. ¹ Simplify departmental excises' procedures and administration; collect them as production (and not consumption) taxes and redistribute part of the proceeds among departments.

Mexico States had limited own-source revenues, and relied primarily on transfers. Piggyback the IDTU (a new federal tax to be levied on business, akin to an income-type, origin-based VAT administered with the subtraction method). ¹ Alternatives would be to piggyback on the income tax and to revamp the property tax. These measures would create greater accountability through a major tax handle for states. Piggybacking could be introduced quickly and be administered by the federal government tax collection agency.

Table 2.5. Main Recommendations on Own-Revenue Assignments in Case-Study Countries

<table>
<thead>
<tr>
<th>Countries</th>
<th>Main issues</th>
<th>IMF advice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Congo, Dem. Rep. of</td>
<td>Tax assignments are not clearly defined, and yields (especially for the property taxes) are insufficient to cover provinces' spending needs.</td>
<td>Establish well-defined tax assignments for subnational governments. Strengthen the design and collection of property taxes; review all subnational taxes with a view to streamlining and eliminating nuisance fees and taxes.</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Limited own-source revenues. The taxes that could be levied by regions had low yields.</td>
<td>Include the land and building tax in the list of local taxes, with local governments allowed to set the assessment rate.</td>
</tr>
<tr>
<td>Kosovo</td>
<td>Municipal own-source revenues are limited. Property tax collections are low because of weaknesses in administration.</td>
<td>Strengthen property taxes through establishing a national fiscal cadastre and applying common and harmonized valuation procedures. Exploit fee-for-service instruments (such as municipal parking lots), which could support municipal own-source revenue. These recommendations were reiterated in 2010, along with a gradual increase in the property tax rates, a review of municipal fees and charges, and a regularization of construction procedures. It was also noted that allowing more spending autonomy at the margin would provide the strongest incentive to boost own-source revenue collections.</td>
</tr>
<tr>
<td>Liberia</td>
<td>The legal framework for taxation at county and city levels is unclear; some local taxes exist, but these are unlikely to fund increasing spending mandates.</td>
<td>Clarify the legal framework for local taxation. Strengthen the design and administration of property taxes, potentially a good revenue handle for subnational governments.</td>
</tr>
<tr>
<td>Macedonia, FYR</td>
<td>Municipal revenues were capped (those in excess of the cap were reallocated using not fully transparent criteria); volatile; and municipal revenue bases were insufficient to provide for increasing spending responsibilities.</td>
<td>Increase municipal tax collections by giving municipalities bounded control over rates; remove caps on their revenue; and allow them to keep all property taxes. As expenditure mandates are broadened, monitor that revenue bases of municipalities are adequate, not only in the aggregate but also across municipalities.</td>
</tr>
<tr>
<td>Nigeria</td>
<td>Non-oil taxes of state and local governments (SLGs) have very low yield and productivity. SLGs do not control the rates of most of the taxes they levy, thus having very limited own-source revenue.</td>
<td>Provide subnational governments with additional sources of revenue, with some control over rates, including excises and business taxes, surcharges on utility bills, and improved property taxes. Repeal nuisance taxes at the local level. Transform oil revenue derivation rule into a royalty share and an explicit environmental excise.</td>
</tr>
</tbody>
</table>

Strengthen own-source revenue through piggybacking on national taxes

Bolivia Both municipalities and regions have limited autonomy regarding the tax base and the tax rates, which are mostly set by the central government, thus encouraging dependence on transfers and central government decisions. This undermines subnational incentives to raise revenue through better tax administration and through increasing revenue. Assign subnational government significant own-sources of revenues (i.e., enabling them to set rates for local taxes and impose, on the margin, surcharges on national taxes) in line with redefined spending responsibilities. Appropriate sequencing is needed in giving subnational governments access to new own-revenue sources and the transfer of additional responsibilities. Only subnational governments that accept new responsibilities and perform them adequately should be given continued access to new tax resources.

China Local governments had only limited power to set rates for a few local taxes. Revenue-generating capacity varied widely across provinces, contributing to the creation of significant disparities in service provision. Give more control over tax rates to local governments. This would also help compensate the richer provinces losing from a more equalization-based system of transfers. To this end, for instance, allow provinces to levy surcharges on personal income tax; grant the power to levy domestic excises; and increase freedom in setting property tax rates.

Introduce a new VAT-like tax

Colombia Although the distribution of revenue bases across levels of government was broadly adequate (departments collected excise taxes and municipalities collected property taxes, a tax on turnover, and a surcharge on gasoline), the structure was complex. Increase local own-source revenue via tax and tax administration measures. Convert the local turnover tax into a simplified (subtraction-based) local VAT. ¹ Simplify departmental excises’ procedures and administration; collect them as production (and not consumption) taxes and redistribute part of the proceeds among departments.

Mexico States had limited own-source revenues, and relied primarily on transfers. Piggyback the IDTU (a new federal tax to be levied on business, akin to an income-type, origin-based VAT administered with the subtraction method). ¹ Alternatives would be to piggyback on the income tax and to revamp the property tax. These measures would create greater accountability through a major tax handle for states. Piggybacking could be introduced quickly and be administered by the federal government tax collection agency.

Source: Case studies in Part II of this occasional paper.

¹See the main text for a description of this tax.
interactions of other elements of intergovernmental fiscal relations, specifically, the clarity of expenditure responsibilities and the scope and design of the transfer system and borrowing options.

### Revenue-Sharing

Revenue-sharing, often used to close vertical fiscal imbalances, can be based on either individual taxes or total tax collection. Although revenue-sharing offers some of the advantages of surcharges, such as administrative simplicity, it does not constitute own-source revenue, in the sense that the subnational jurisdiction does not have control at the margin over the rate structure; and revenue-sharing generally does not provide equalization, as discussed further in this section. In aggregate terms, revenue-sharing may provide greater resources than own-source revenues, but, as indicated above, must be accompanied by own-source revenues to promote accountability at the subnational level. Given that revenue-sharing makes the revenue of one government tier dependent on the choices of another (on tax bases and rates), it is often considered akin to transfers rather than a method of revenue assignment.\(^{19}\)

Similar to transfers, revenue-sharing involves two main policy choices: how to define the revenue pool to share, and how to allocate that share among subnational governments. If some taxes are shared and others are not, a built-in bias occurs for central governments to maximize collections of those taxes that are not (or are less) shared. Taxes should also be shared at the same rates (a certain percentage of all taxes) to avoid distortions; extraordinary revenue, for example, from the sales of assets, should not be shared. In addition, to reduce procyclicality of shared revenues, a moving average of revenue collected over the cycle could be used (or a fraction of a moving average of nominal GDP over the cycle, as recommended by staff in Argentina). As for the distribution of shared revenue, revenues are often shared on an origin basis (where revenues are collected; also called the “derivation principle”). Other criteria are also applied, for example, equal per capita allocations.

Natural resource revenues are not suitable for sharing arrangements because they are very volatile and tend to be geographically concentrated. Two main problems arise: revenue-sharing on an origin basis would create significant horizontal disparities, and subnational governments are typically not well equipped to deal with the inherent volatility of these revenues (Box 2.1). For these reasons, the IMF has recommended against sharing of resource revenues (for example, in the Democratic Republic of the Congo, Liberia, and Nigeria). Rather, advice has focused on introducing production-related excises (together with equalization transfers) in lieu of natural resource revenue-sharing, as in Bolivia, Indonesia, and Nigeria. Excises might be fully or partly assigned to lower levels of government as part of compensation for damage to the environment and other costs, together with a transfer system that ensures that basic subnational spending can be adequately funded.

Despite its administrative simplicity, revenue-sharing presents a number of drawbacks. The first major difficulty with sharing of revenues is the rigidity that it imposes on macroeconomic management. For example, if 50 percent of revenues are shared with subnational administrations, any required revenue adjustment would need to be substantially larger for the central government, because subnational governments may spend part or all of their shares.\(^{20}\) Second, revenue-sharing distorts incentives: if additional taxes have to be shared, governments do not gain much by raising additional revenue (this is believed to be the case in Germany, where the marginal transfer rate—the proportion of revenue at the margin to be transferred away—is significant, thus weaken-
CHAPTER 2  THE IMF’S ADVICE ON DESIGNING AND MANAGING FISCAL DECENTRALIZATION

Table 2.6. Main Recommendations on Revenue-Sharing in Case-Study Countries

<table>
<thead>
<tr>
<th>Countries</th>
<th>Main issues</th>
<th>IMF advice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bolivia</td>
<td>Distribution of hydrocarbon revenues generates vertical and horizontal imbalances and transfer volatility, and has resulted in low incentives to exploit tax bases at the subnational level.</td>
<td>Hydrocarbon taxation should accrue to the central government level only.</td>
</tr>
<tr>
<td>China</td>
<td>Revenue-sharing (based on taxes whose bases were stronger in richer provinces) had elements of regressivity because it favored richer provinces.</td>
<td>Reform transfer system to make it consistent with delivering a minimum standard of public services and based on a rules-based equalization system.</td>
</tr>
<tr>
<td>Congo, Dem. Rep. of</td>
<td>Constitution grants provinces 40 percent of government revenue collected in their territory, but does not define the tax bases.</td>
<td>Full and immediate implementation of the 40 percent rule would create a major vertical imbalance (health and primary education, assigned to local governments, account for less than 20 percent of total expenditures). Revenue-sharing mechanisms should be gradual and in line with the devolution of expenditure responsibilities.</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Oil and gas revenues are included as part of revenue-sharing, thus creating imbalances and increased volatility of transfers. In addition, a floor was imposed on transfers.</td>
<td>Avoid sharing oil and gas revenues on an origin basis.</td>
</tr>
<tr>
<td>Liberia</td>
<td>In 2009, there was no revenue-sharing mechanism in place, but pressures are likely to arise to assign and share natural resource revenue on an origin basis.</td>
<td>Refrain from sharing natural resource revenues because this would complicate financial management at the county level and would open horizontal gaps. In the initial stages of decentralization, limited spending assignments will likely not require funding through revenue-sharing.</td>
</tr>
<tr>
<td>Macedonia, FYR</td>
<td>No revenue-sharing in place at the time the IMF provided technical assistance.</td>
<td>As larger spending assignments are transferred to municipalities, revenue-sharing could be used to close vertical imbalances. Sharing VAT should be preferred to sharing PIT: (1) VAT-sharing is administratively simpler; (2) VAT revenues are more stable; and (3) redistribution may be easier because local incidence matters less.</td>
</tr>
<tr>
<td>Mexico</td>
<td>Complex and nonredistributive system based on revenue-sharing and earmarked transfers.</td>
<td>Reform revenue-sharing and fold it into a new transfer system designed to reflect spending needs and revenue capacity.</td>
</tr>
<tr>
<td>Nigeria</td>
<td>All federally collected receipts are pooled and shared based on two formulas: one for the VAT and one for all other revenues, including oil revenue. Sharing of oil revenue is highly procyclical; increases the sensitivity of subnational finances to volatile oil revenue; and creates marked horizontal imbalances at the state level. States are mandated to share 10 percent of all their receipts with local governments.</td>
<td>Repeal oil revenue-sharing and convert into a royalty share and an explicit environmental excise. Repeal the 10 percent sharing of internally generated revenue of states with their local governments, which has been erratically applied, and fold into properly designed revenue assignments (including piggybacking on PIT).</td>
</tr>
</tbody>
</table>

Source: Case studies in Part II of this occasional paper.
Note: PIT = Personal income tax. Colombia and Kosovo are not included (advice was provided more specifically on transfer design).

improving incentives to raise revenue). Finally, because revenue-sharing on an origin basis exacerbates horizontal inequalities, it needs to be accompanied by compensatory redistributive transfers.

IMF staff advice on this issue has focused on three main elements: First, revenue-sharing should be considered as part of the overall financing framework for subnational governments; because revenue-sharing is conceptually akin to transfers, in some cases advice has focused on the design of transfer arrangements (for example, in Colombia and Kosovo). Second, sharing of revenues that tend to be geographically concentrated (such as natural resource revenue) should be avoided; for example, in FYR Macedonia, staff advised sharing VAT rather than income taxes, given that VAT were more evenly distributed across municipalities. Finally, revenue-sharing should be accompanied by a proper equalization transfer system. Table 2.6 includes more detail on staff policy recommendations on revenue-sharing.

Other Intergovernmental Transfers

A transfer system’s design has a significant impact on incentives to manage subnational operations efficiently. As highlighted in Chapter 1, sole reliance
MAKING FISCAL DECENTRALIZATION WORK

Box 2.1. Sharing of Natural Resource Revenue

Even though the availability of large natural resource revenues typically exacerbates demands for decentralization (with producing jurisdictions claiming control of such revenue), sharing of such revenue should be avoided. Assignment of natural resource revenues to subnational entities has many disadvantages, especially in small countries.

- Attribution of volatile resource revenues to local governments can complicate fiscal management and macroeconomic policy at the central level: during price booms, large resource revenues tend to induce unsustainable expenditure levels, while during price downturns, basic expenditures assigned to subnational governments might come under pressure. This was acutely felt in Nigeria, where the states (which receive a fixed share of the oil revenue) built in unsustainable levels of spending during the oil boom in the late 1990s.
- Geology or geography differences should not determine the distribution of revenues from national resources; when shared on the basis of origin, significant horizontal imbalances arise.
- Resource revenues bring with them little local accountability; this problem exists at the national level, but is probably exacerbated in local government.
- The size of resource revenues, relative to the size of the jurisdiction, may bring risks not only of absorptive capacity, but also of corruption. The central government is often in a better position to smooth fluctuations in natural resource revenues, provided that these resources are transparently managed. Although political economy considerations often suggest some sharing of natural resource revenues, in practice, agreeing on a percentage is hard (resource-rich subnationals would always be better off by keeping 100 percent of all resource revenue)—a problem that is often exacerbated if there are ethnic or religious differences involved, as in Nigeria and Aceh in Indonesia.

on grants, or transfers designed to automatically meet subnational deficits (gap-filling transfers), is likely to sap efficiency and reduce accountability, and should be avoided. The design of transfers has been a major focus in overall assessments of intergovernmental fiscal relations, as well as a subject for which IMF advice has been sought by member countries.

Transfers typically satisfy a number of purposes. They correct vertical imbalances between the spending responsibilities and tax revenues devolved to the local level. Because most taxes tend to be assigned to the national level, but expenditure responsibilities are more easily decentralized, the difference needs to be covered. In this case, general-purpose (or unconditional) transfers are provided by the center to subnational governments for general funding purposes. Equalization transfers are also used to correct horizontal imbalances among subnational governments created by differences in local tax bases. In other cases, transfers may be used to correct exter-
matching requirement, however, may only divert resources from other important or basic spending, particularly in the presence of weak own-source revenue. Moreover, matching requirements may prevent poorer regions from accessing the transfers, and could exacerbate horizontal inequalities. Staff have often recommended that special-purpose grants be provided on the basis of costed programs, where possible, and that these be implemented in countries where the central government can monitor that the grants have been used for the specified purposes, a criterion that is difficult to satisfy in the context of weak PFM systems at the subnational level, given that transferred funds are fungible.

Another key issue is whether these grants should be taken into consideration in setting equalization grants, along with other unconditional grants. Transfers also differ in the degree of central government discretion. Mandatory transfers (entitlements) are rules-based obligations for the government providing the transfer. The transfer amounts and conditions are legally defined. Alternatively, transfers can be discretionary, so that their amounts and the conditions for their disbursement are decided on a one-time basis. Discretionary transfers are usually temporary, for example, for specific infrastructure projects or emergency assistance.

Simple mechanisms to allocate transfers across jurisdictions tend to be based on spending needs, revenue capacities, or both. Providing transfers on an equal per capita basis is the simplest way to achieve some degree of equalization. This formulation, however, does not take into account the differential needs of different groups of the population or of different regions, and more complex formulations use various poverty indices and geographic criteria to reflect cost differentials in service provision. At the same time, sole reliance on needs-based criteria does not account for differences in revenue capacities; conversely, exclusive equalization of revenue capacities implicitly assumes that cost differentials are not significant. Thus, countries use a combination of expenditure needs and revenue capacities to design equalization transfers. Australia and Denmark have advanced transfer systems, and recent reforms in Sweden and Switzerland take these two countries in the same direction. The trade-off occurs with the availability of data and the difficulty of administering such transfers.

Staff advice on transfers has focused on design issues. In many countries, recommendations focused on simplifying transfer design and improving transfer formulas by transparently including both spending needs and revenue-capacity criteria (Bolivia, Indonesia, Kosovo, Mexico, and Nigeria). To make transfers incentive-compatible, staff have discouraged the use of equalizing criteria relative to historical or actual spending and revenue (such criteria could discourage revenue collection, or promote excessive spending, as in Kosovo). Staff have also often advised that special-purpose transfers be simplified, given their administrative costs (China, Colombia, Indonesia, and Nigeria). Finally, because winners and losers are likely to emerge when transfers are redesigned—and losers will create political resistance—staff have sometimes advised in favor of hold-harmless provisions, under which the subnationals standing to lose out from the reform are guaranteed, in the first year of implementation, the same transfer amounts (usually in nominal terms) as in the year preceding the reform, with the full impact generally phased in over a period of time. Hold-harmless provisions were recommended by staff in a few cases, including in Mexico and Kosovo. Table 2.7 summarizes staff advice on transfer design in the case-study countries.

Managing Revenue

The choice between central and subnational tax administration is not easy, and tends to vary depending on country circumstances. Although IMF technical assistance on this issue has been limited, advice was provided when changes in the financing mechanisms of subnationals required a rethinking of existing tax administration arrangements. For example, in Colombia, advice focused on centralizing tax administration while necessary capacity at the

21For example, the IMF has recommended in China that financing to minimize the effects of natural disasters should be a central government responsibility, and that the grants should be treated as special-purpose transfers and not included in the equalization framework.
Table 2.7. Main Recommendations on Transfer Design in Case-Study Countries

<table>
<thead>
<tr>
<th>Countries</th>
<th>Main issues</th>
<th>IMF advice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bolivia</td>
<td>Transfers suffer from excessive earmarking, without due consideration for equity.</td>
<td>Reduce earmarking and reform transfer system to make it more equitable by taking into account spending needs and fiscal capacity.</td>
</tr>
<tr>
<td>China</td>
<td>The transfer system was complex and not fully transparent.</td>
<td>Reform transfer system to make it consistent with delivering a minimum standard of public services. Expand the use of well-designed, rules-based equalization system. Clarify and simplify special-purpose transfers.</td>
</tr>
<tr>
<td>Colombia</td>
<td>Transfers were excessively earmarked at the time the IMF provided technical assistance. Transfer amounts were decided as a fixed amount, not linked to revenue (but this was expected to change in 2008).</td>
<td>Maintain current framework of defined transfer growth because transfers as a share of revenue would (1) create rigidity for the central government; (2) induce procyclicality in fiscal policy (as excess shared-revenues are spent by subnationals); and (3) create volatility at the subnational level. Reduce gradually earmarking of transfers.</td>
</tr>
<tr>
<td>Congo, Dem. Rep. of</td>
<td>A planned equalization fund is unable to mitigate horizontal imbalances generated by revenue-sharing because it is limited to investment financing.</td>
<td>Establish a transfer system based on an equalization formula with transparent and objective criteria (e.g., number of inhabitants and surface).</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Oil and gas revenues were included as part of revenue-sharing, thus creating imbalances and increased volatility of transfers. In addition, a floor was imposed on transfers.</td>
<td>Remove floor on transfers (which can create rigidities and complicate macroeconomic management) while keeping the hold-harmless rule for the general purpose fund.</td>
</tr>
<tr>
<td>Kosovo</td>
<td>In 2007, formulas for earmarked transfers in health and education were not adequate to cover municipalities’ spending mandates in these areas, while unconditional transfers were not providing any spending autonomy to municipalities, given their limited size. In 2010, a new transfer system was in place according to 2008 legislation, and was due for review.</td>
<td>Maintain close-ended transfer amounts, but increase size of unconditional transfers, based on equalization criteria, and link block grants for health and education more closely to spending needs. Over time, move gradually to general transfers, based on revenue capacity and spending needs. Include a hold-harmless provision to ensure that each municipality is at least provided with the same nominal level of transfer as in the year preceding the reform. In 2010, hold changes of the transfers until new census data are available and municipal functions have been better costed. Refrain from adding ad hoc grants at the margin. Strengthen the role of the Grants Commission and make its operations more transparent.</td>
</tr>
<tr>
<td>Liberia</td>
<td>Transfers are virtually nonexistent, with the exception of the County Development Fund, which assigns a certain nominal amount to counties for capital projects.</td>
<td>With decentralization, a transfer system will need to fund counties’ operations. A simple formula should be adopted, based on transparent criteria.</td>
</tr>
<tr>
<td>Macedonia, FYR</td>
<td>Transfers allocated using a nontransparent system.</td>
<td>Create Municipal Equalization Fund and adopt a formula-driven allocation rule for equalization across municipalities. As expenditure mandates expand, broaden revenue-sharing or transfer system (or both).</td>
</tr>
<tr>
<td>Mexico</td>
<td>Complex and nonredistributive system based on revenue-sharing and earmarked transfers.</td>
<td>Freeze in nominal terms the existing transfers (hold-harmless provision, to make the reform politically viable) and phase in an equalizing system based on spending needs and revenue capacities. Clarify and simplify special-purpose transfers.</td>
</tr>
<tr>
<td>Nigeria</td>
<td>Low correlation between transfers and states’ relative needs. The derivation formula benefits mostly middle- and high-income states. No definition of minimum public services in return to the transfers.</td>
<td>Establish special-purpose transfers in lieu of direct investment by the federal government. Over time, include a new general transfer system based on estimates of spending needs and own-revenue capacities; introduce a floor for transfers to ensure the continued provision of essential services, to be financed by savings from periods of high oil prices. Limit specific-purpose grants to high-priority national objectives.</td>
</tr>
</tbody>
</table>

Source: Case studies in Part II of this occasional paper.
were designed (in line with staff advice) to give the central government additional tax handles, and to establish a state administration of taxation for the center, separate from the local administrations (see Ahmad, Qiang, and Tanzi, 1995; and Ahmad and others, 2002).

Revenue-sharing and surcharging may help circumvent the challenges associated with the administration of major taxes at the subnational level. If certain taxes can be collected with minimal additional effort, such as surcharges on income taxes, and if subnational information may be helpful to the center, resistance is unlikely to arise from the central tax administration to collecting such taxes on behalf of other administrations. The issue of collecting a VAT on behalf of subnational administrations might be more difficult for national administrations. Subnational governments are often concerned that the central tax administration might not have the incentive to devote sufficient resources to collecting subnational taxes, although this might be partially mitigated by well-structured service contracts with the central tax administration.

Subnational tax administrations can be designed and operated on the basic principles of modern tax administration. The large municipalities in Colombia have made considerable improvements in own-revenue collection, and some Brazilian states have shown that it is possible to effectively administer subnational taxes, albeit origin-based ones. However, subnational tax administration is unlikely to be feasible in many developing countries. Setting up information systems and processes to support local tax collection, such as establishing a cadastre as the basis for assessing and collecting property taxes, may be costly. At the same time, complex rules for tax revenue assignment among national and subnational levels of governments may stand in the way of tax modernization efforts. This situation has occurred in Sudan, where a dual network of tax offices (i.e., the national and states offices) collects taxes on businesses, hampering the integration of VAT and income tax operations.

In the Democratic Republic of the Congo, staff recommended that if collection of local taxes were to be assigned to the central tax administration (Direction Générale des Impôts, DGI), the DGI should be granted a larger share of such taxes as compensation for its services; conversely, if administration of local taxes were to be assigned to subnational tax administrations, their responsibilities should be limited to managing only local taxes, within a framework clearly defined by law.

**Identifying Mechanisms to Control Borrowing**

An essential element of fiscal discipline is the avoidance of excessive borrowing by subnational governments. Excessive borrowing results in adverse externalities for other subnational governments, as well as for the central government. These externalities may happen through a number of channels—by preempting a disproportionate share of available financing, and thereby putting upward pressure on interest rates; by pushing up risk premiums on government bonds more generally; or through the cost of bailouts. The likelihood of such externalities constitutes the fundamental rationale for limitations on subnational borrowing.

Borrowing controls can be grouped into four broad, not mutually exclusive, categories: (1) reliance on market discipline, (2) cooperation between central and subnational governments, (3) rules-based controls, and (4) administrative controls. These categories are ranked according to the degree of central control over subnational borrowing, from maximum autonomy (depending on markets) to maximum control (administrative measures, including outright bans on subnational borrowing). Table 2.8 summarizes the main advantages and preconditions for these approaches, and provides examples of their application in different regions and countries.

Sole reliance on market discipline in governing subnational borrowing requires a number of preconditions seldom met in practice, but has worked in countries with high standards of transparency and accounting. Given limited resources, the IMF has not typically provided technical assistance to specific subnational tax administrations, with two exceptions in the 1990s (to the provinces of Cordoba and Buenos Aires in Argentina).

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22The World Bank is actively engaged in providing loans and assistance in this area (e.g., in Bolivia and Peru). Given limited resources, the IMF has not typically provided technical assistance to specific subnational tax administrations, with two exceptions in the 1990s (to the provinces of Cordoba and Buenos Aires in Argentina).

23See Ter-Minassian and Craig (1997) for a detailed discussion of these approaches.
governance at all government tiers (such as Australia, Canada, and Sweden), and with no significant history of bailouts. In most emerging markets and developing economies, as well as in some industrial countries, one or more of the preconditions for effective market discipline to control subnational borrowing are lacking. In particular, information on subnational finances is frequently not accurate and comprehensive or is subject to long delays; subnational governments often have access to privileged channels of financing (including through banks or enterprises they own); and many have significant histories of bailouts (through gap-filling transfers, or debt restructuring). At the same time, when investors perceive an implicit guarantee by the center, market signals do not work effectively; in Germany, states with significant debt levels have nonetheless enjoyed very high credit ratings. Many attribute this to the bailouts of Bremen and Saarland in the 1990s, mandated by the constitutional court (Rodden, 2006; and Stehn and Fedelino, 2009).24

A cooperative approach entails the setting of borrowing limits for individual subnational jurisdictions through negotiations with the center. A variant of this approach involves bilateral negotiations between the central government and individual subnational entities, or groups of them. Examples include Australia’s experience with its Loan Council; European Union countries (including through the so-called Domestic Stability Pacts); Brazil’s debt agreements with states and municipalities; and Argentina’s bilateral pacts between the nation and the provinces. The record of effectiveness of cooperative approaches is mixed. Preconditions for the success of a cooperative approach include the absence of severe fiscal stress; relative economic homogeneity of the subnationals (and, relatedly, absence of strong distributive conflicts); a tradition of cooperation in intergovernmental relations or a relatively strong bargaining position on the part of the central government (as in Brazil’s debt-restructuring agreements); a stable institutional framework for the negotiations; and availability of reliable and timely information to assess compliance with agreed-on borrowing limits.

Fiscal rules provide a third approach to controlling subnational borrowing. These rules may take the form of quantitative ceilings on borrowing, debt, or debt service of subnational governments (often specified in relation to these governments’

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24 The Constitutional Court’s rejection of a bailout request by Berlin in October 2006 may contribute to changing states’ and investors’ perceptions of soft budget constraints and implicit federal guarantees.

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Table 2.8. Approaches to Controlling Subnational Borrowing

<table>
<thead>
<tr>
<th>Market discipline</th>
<th>Cooperative approach</th>
<th>Rules-based controls</th>
<th>Administrative controls</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Advantages</strong></td>
<td>• Emphasis on self-control</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Monitoring by credit rating agencies</td>
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<td></td>
<td>• Promotes dialogue</td>
<td></td>
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<tr>
<td></td>
<td>• Enhances responsibility of subnational policymakers</td>
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<tr>
<td></td>
<td>• Transparent</td>
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<tr>
<td></td>
<td>• Avoids bargaining</td>
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<tr>
<td><strong>Preconditions</strong></td>
<td>• Comprehensive, timely, and reliable information</td>
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<td></td>
<td>• Developed financial markets</td>
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<td></td>
<td>• No access to privileged financing</td>
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<td></td>
<td>• No previous history of bailouts</td>
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<tr>
<td></td>
<td>• Constitutional underpinnings</td>
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<td></td>
<td>• Culture of fiscal discipline</td>
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<tr>
<td></td>
<td>• Existence of institutions for cooperative decision-making or strong bargaining position of central government</td>
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<td></td>
<td>• Sound and credible rules (e.g., well-defined, transparent, and flexible)</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Clear coverage and full information</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Examples</strong></td>
<td>Canada</td>
<td></td>
<td></td>
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<tr>
<td><strong>Australia</strong></td>
<td>Argentina’s bilateral pacts</td>
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<td></td>
<td>Austria</td>
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<tr>
<td></td>
<td>Denmark</td>
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<td></td>
<td>Domestic Stability Pacts in EU countries</td>
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<tr>
<td></td>
<td>Brazil</td>
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<td></td>
<td>Chile</td>
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<td></td>
<td>Spain</td>
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<td></td>
<td>United States</td>
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<tr>
<td></td>
<td>China</td>
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<td>France</td>
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<td>Japan</td>
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<tr>
<td></td>
<td>United Kingdom</td>
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</tbody>
</table>

Source: Based on Ter-Minassian and Craig, 1997.
Note: Because most countries use a combination of approaches, the examples primarily illustrate the relative reliance by the country in question on that approach.
revenues, as in Brazil and Colombia); or of pro-
cedural rules relating to subnationals’ budget
processes. The rules may be embodied in national
legislation (e.g., Brazil and Spain) or in subna-
tional constitutions or laws (e.g., some states of
the United States and some Canadian provinces).
The effectiveness of such rules depends on their
specificity, comprehensiveness of coverage, and
most important, the degree of political commit-
tment to their observance and enforcement. The
design of the rules also matters, particularly clear
specification of appropriate escape clauses (that is,
legal provisions that would waive the application of
the fiscal rule under well-specified circumstances,
such as national disasters or similar) and of credible
sanctions for noncompliance. Reliance on a revenue
base for subnationals that is relatively stable over the
business cycle is also useful for minimizing the risk
of procyclicality of quantitative ceilings on borrow-
ing or debt for subnational governments. The avail-
ability of timely information to assess compliance is
crucial to these rules’ effectiveness.

Finally, a number of countries (both industrial
and developing) continue to rely to some extent
on administrative and direct controls on subna-
tional borrowing. Given the constitutional status
of subnational governments in federations, admin-
istrative controls tend to be used more in unitary
states, especially with regard to local governments.
Controls vary in comprehensiveness and degree of
detail; increasingly, they have tended to focus on
overall levels of borrowing (flow) or debt (stock),
rather than on authorization of individual borrow-
ing operations. In some cases, control is limited to
external borrowing, while in others limits are set
on banks’ exposures to subnational governments.
Administrative controls, especially those involving
central authorization of individual instances of sub-
national borrowing, carry a significant risk of moral
hazard, because the central government may be seen
by lenders as implicitly backing the service of those
loans. The effectiveness of administrative controls as
instruments to promote subnational fiscal discipline
depends crucially on the depoliticization of the cen-
tral government’s decisions, and on the availability
of information needed to shape these decisions and
check their enforcement (including information on
off-budget activities of the subnational government,
and on arrears incurred).

On balance, no single approach to subnational
borrowing frameworks is preferable in all circum-
stances. Rules-based approaches, underpinned
by adequate enforcement mechanisms, may well
have an edge in countries with inadequate bases
for exclusive reliance on market discipline, and
with relatively weak records of the use of discre-
tion by the central government in its interactions
with subnational governments (or in countries
where some of these governments have strong
political influence on the center). Rules may be
usefully complemented by increasing reliance on
market discipline, as the preconditions for effec-
tive working of market discipline are being put in
place through improvements in the transparency of
subnational government operations, elimination of
privileged financing channels for these governments,
and establishment of track records of no bailouts.
Finally, subnational borrowing frameworks should
also include mechanisms for addressing insolvency
to help manage expectations about possible defaults
and allow efficient resolution of distressed debt (Liu
and Waibel, 2008).

IMF staff have taken an eclectic approach in
advising on the control of subnational borrowing.
Advice has been shaped according to the specific
circumstances of the country in question, includ-
ing any legal or constitutional limitations on the
central government’s powers with regard to subna-
tional governments, and the presence or absence of
preconditions for the effective working of market
discipline. In some countries (for example, the
Democratic Republic of the Congo, Kosovo, and
FYR Macedonia), advice has focused on building
effective preconditions for borrowing arrangements
at the subnational levels; allowing subnationals to
borrow prematurely may severely undermine macro-
economic management and eventually lead to debt-
sustainability problems. In other cases, for example,
in China, the possibility of asymmetric arrange-
ments, under which more-advanced provinces could
seek credit ratings and start limited borrowing, was

See, for example, Kopits and Symansky (1998) and Ter-Mi-
nassian (2005). Some of these issues are also covered in Box 1.2.
### Table 2.9. Main Recommendations on Subnational Borrowing Arrangements in Case-Study Countries

<table>
<thead>
<tr>
<th>Countries</th>
<th>Main issues</th>
<th>IMF advice</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Administrative controls on borrowing</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Congo, Dem. Rep. of</td>
<td>Draft decentralization law requires the Ministry of Interior to authorize all subnational borrowing operations, but does not specify the criteria to control subnational borrowing.</td>
<td>Control mechanisms for subnational government debt should be defined (e.g., through direct controls or central government authorization of individual borrowing operations). Tight control over borrowing is necessary to avoid the risk of unsustainable spending at the provincial level and prevent conflicts with the fiscal stance determined at the national level.</td>
</tr>
<tr>
<td>Kosovo</td>
<td>In 2007, municipalities were not allowed to borrow, but pressures to release current ban were increasing; given that municipalities’ spending responsibilities were expanding, there would be a need to provide them with adequate financing mechanisms, possibly including borrowing. In 2010, a draft Public Debt Law would allow municipalities to borrow, subject to well-specified preconditions (obtaining two consecutive unqualified opinions from the Auditor General).</td>
<td>Develop municipal debt management capacity, even if the immediate impact of municipal borrowing is likely to be small. Put in place procedures and processes to monitor municipal borrowing. Design a mechanism setting borrowing limits by municipality, to ensure that municipal borrowing does not exceed aggregate limits.</td>
</tr>
<tr>
<td>Macedonia, FYR</td>
<td>Municipalities were not allowed to borrow, but increasing spending mandates would need additional financing.</td>
<td>In the initial stage of decentralization, the ban on municipal borrowing should continue. A Municipal Investment Fund could be created, from which municipalities would borrow to fund investment in a limited way.</td>
</tr>
<tr>
<td><strong>Rules-based controls</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td>Weak subnational borrowing framework prior to decentralization: local governments can borrow directly from banks and there is no reporting framework.</td>
<td>Impose borrowing limits and strengthen borrowing reporting framework.</td>
</tr>
<tr>
<td>Mexico</td>
<td>Absence of standardized debt limits and fragmentation in subnational debt information. Proliferation of new instruments, such as securitization of revenues and PPPs.</td>
<td>Establish prudential limits on borrowing, linked to fiscal rules. Ensure total coverage of the subnational debt registry at the MoF. Develop a sound legal framework for PPPs. Greater oversight on credit rating assessments.</td>
</tr>
<tr>
<td>Nigeria</td>
<td>Lack of clear debt limits and reporting requirements by subnational governments.</td>
<td>Restrict domestic borrowing by local governments only to those with a balanced budget in the current and the previous year, and limit it to a certain percentage of local government’s revenue. Maintain the practice of not allowing external borrowing by the local governments. Create professional capacity for debt management in the states’ MoFs. Establish a system for all levels to provide the Debt Management Office with information on all debt aspects.</td>
</tr>
<tr>
<td><strong>Eclectic approaches</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bolivia</td>
<td>Weak subnational borrowing framework and repeated tendency to bail out subnational governments. Lack of political will to implement sanctions and weaknesses in the framework provided incentives for excessive borrowing and soft budget constraint.</td>
<td>Strengthen subnational borrowing framework and transparency. Create a fiscal risk register to take stock of subnational liabilities and facilitate their management.</td>
</tr>
<tr>
<td>China</td>
<td>Although subnational borrowing was not allowed, there was evidence that local governments were using indirect ways to incur indebtedness, with a possible related buildup of fiscal risks.</td>
<td>Adopt an asymmetric framework whereby certain subnational governments would be allowed to borrow, provided certain preconditions are in place. Create incentives for local governments to strengthen their fiscal policy management, while allowing recourse to additional (and needed) resources to carry out their mandates. Establish a subnational fiscal risk registry, to be kept at the central treasury.</td>
</tr>
</tbody>
</table>

Source: Case studies in Part II.
Note: Colombia and Liberia are excluded, as technical assistance did not cover the issue of borrowing arrangements.
suggested. In countries where subnational borrowing was established (as in Bolivia, Indonesia, Mexico, and Nigeria) staff advice focused on setting up guidelines (in some cases, rules) for subnational borrowing, strengthening borrowing-reporting frameworks, and creating professional capacity for debt management. Table 2.9 summarizes staff advice on this topic.

Finally, staff have also emphasized the possible fiscal risk arising from indirect borrowing mechanisms. In many countries, subnational governments have entered (or have expressed an interest in entering) public-private partnerships (PPPs), generally based on the use of the subnational land or other assets. PPPs typically involve complex financial and legal arrangements, and may pose significant risks, especially for inexperienced governments. Experience from various countries demonstrates that successful development of PPPs requires strong institutional and operational frameworks and a clear and transparent legal framework.

PPPs also have to be subject to stringent investment planning and project evaluation, which must be closely coordinated with other public investment projects. Finally, clear standards are needed for disclosure of PPP arrangements in government budgets and accounts, and for transparent financial reporting about these projects. On this basis, IMF advice has cautioned against possible PPP arrangements (for example, in Kosovo and FYR Macedonia) until an appropriate legal framework is in place and, equally important, an appropriate level of expertise has been developed within the government sector to ensure that all levels of risk are well understood and appraised.

However, controls on subnational borrowing are only one of the elements of a sound system of intergovernmental fiscal relations. Borrowing arrangements cannot be viewed in isolation. Subnationals usually demand more borrowing autonomy because their financing means are not adequate—either their spending responsibilities are not sufficiently funded or they do not face a hard budget constraint, possibly resulting in inefficient spending and a pro-deficit bias. These underlying motivations call for a closer and more comprehensive assessment of other aspects of fiscal decentralization, as repeatedly stressed in this volume.

26For example, a developer may agree to finance a public road in return for a long-term lease on land along the road that can be used for commercial purposes. There may also be additional payments, guarantees, and counter guarantees involved in such transactions.
The design of intergovernmental fiscal arrangements is one of the more complex areas of public finance—it spans a number of policy and institution-building issues requiring careful coordination and sequencing, and is shaped by economic, historical, political, and social factors. IMF advice in this area, while focusing on macrorelevant aspects in line with the institution’s core mandate and expertise, has tried to recognize these complexities and adjust to them, particularly because there is no single “right” model for the design or reform of intergovernmental fiscal relations. IMF advice has sought to take into account (1) macroeconomic constraints; (2) the need to strike a balance between efficiency and distributional considerations; and (3) the need to reflect relevant institutional factors, such as constitutional and other legal constraints, and the capacity of subnational governments to spend well and raise own-revenues. As relevant circumstances have changed over time and across countries, IMF advice on fiscal decentralization has evolved.

Despite differences, general lessons can still be drawn from the range of experiences of countries to which the IMF has provided advice on fiscal decentralization. These lessons can be summarized as follows:

- The sequencing of decentralization matters: resources should be made available to subnational governments simultaneously with the assignment to them of spending responsibilities. The importance of sequencing decentralization appropriately is borne out by the difficulties experienced by countries such as Colombia and Nigeria, where the devolution of resources initially outpaced that of spending responsibilities, and conversely by countries (like some transition economies of the former Soviet Union in the 1990s) where spending mandates were pushed down to the subnational level without adequate provision of resources to the affected governments, leading to accumulation of debt or arrears, or to a significant deterioration of the quality of the decentralized public services.

As part of the sequencing, issues of territorial organization and political arrangements are also relevant, although not central to the IMF mandate (as noted in the case studies of Liberia and FYR Macedonia in Part II).

- At the same time, the pace of decentralization should be linked, to the greatest extent possible, to the capacity of subnational governments to effectively carry out the functions assigned to them. Two corollaries derive: First, increased devolution of expenditure functions should be conditioned on compliance by the subnational governments with a minimum set of public financial management (PFM) requirements, in particular an orderly, transparent, and reasonably participatory budget process. Second, because capacity varies among levels of government, there is scope for asymmetric arrangements (differentiated speed, based on clearly specified criteria) in the decentralization of public functions to individual jurisdictions, or groups thereof. Colombia has successfully shown that asymmetric decentralization is not only feasible, but desirable as a means to motivate subnational politicians to implement “good” policies. Asymmetric arrangements would also suit capital cities (or larger or more-advanced jurisdictions) that are, in many countries, better prepared than other subnationals to take on additional responsibilities, as recommended in Kosovo, Liberia, and FYR Macedonia (and in China, as a way to start relaxing borrowing arrangements for some provinces).

- Although spending responsibilities in some sectors (such as education and health) will inevitably overlap across levels of government, adequate clarity of the role of each level of government in the provision of the services must be ensured to avoid duplication, waste, and loss of accountability. The experiences of countries such as Bolivia, the Democratic Republic of the Congo, Mexico, and Nigeria, as outlined in the case studies in Part II, are illustrative of the costs of such lack of clarity.
• In some cases, complementary policy reforms, such as in the civil service and regulatory frameworks, are needed. For example, unless there is adequate scope for geographic or functional mobility of civil servants (including providers of health and education services), increased devolution of public services may result in a deterioration of the quality of the services in certain jurisdictions (e.g., in rural communities) or in increases in overall public employment, or both. Similarly, devolution of subsidized public services (e.g., utilities) to local governments is unlikely to lead to a reduction of subsidies, or may result in deterioration of the services, unless local authorities are allowed to adjust their prices as needed. In fact, allowing some regulatory autonomy and supporting increased participation by subnational jurisdictions in public policy matters may go a long way toward addressing decentralization pressures while allowing more time to make the institutional and legal changes required to implement fiscal decentralization successfully (see next point).

• Realizing the potential efficiency gains of decentralization in the provision of public goods and services often requires significant investments in capacity building and improvement of PFM systems at the subnational level, specifically aiming at improving transparency of the budget process in all its phases. Although technical assistance by multilateral and bilateral development partners, dissemination of good practices, and peer pressure can play useful (sometimes indispensable) roles in this respect, experience indicates that a strong commitment to such reforms by the central as well as the subnational governments is essential to ensuring their lasting success, as shown by experiences in Colombia and Brazil. Unfortunately, such commitment has not always been present, undermining or reversing progress in this area. There is also a risk of spreading too thinly the limited resources of countries where capacity at the central level is being built or rebuilt and skills are in short supply, as in postconflict countries (Democratic Republic of the Congo and Liberia). In these countries, the aim of decentralization should not distract from the fundamental need to continue on the path of PFM reforms at the central level.

• To facilitate the effective implementation of hard budget constraints on subnational governments, subnationals must be provided beforehand with an overall resource envelope that will allow them to carry out their assigned spending responsibilities at an average level of efficiency. A persistent significant mismatch between spending needs and resources of subnational governments is likely to lead over time to inadequate provision of the devolved public services, or to fiscal indiscipline (typically resulting in resorting inappropriately to borrowing, or accumulation of arrears). However, it is not generally easy to assess the spending needs of subnational governments, given the frequent absence of reliable information on the cost-effectiveness of spending programs at all levels of government. Sample studies comparing the cost-effectiveness of selected key spending programs in similar jurisdictions (for example, recent studies in the United States comparing the performance of hospitals in selected states and cities) can help shed light on this area.

• Control over a portion of subnational resources is key to promoting accountability of subnational governments to their constituents, as well as fiscal responsibility. The assignment of own-revenue sources to subnational governments must take into account economic considerations (such as the degree of mobility of the tax base), as well as institutional ones, particularly the capacity of subnational tax administrations. When tax administrations are relatively weak, subnational taxes might best be administered by the central government on an agency basis. Potential candidates for own-revenue sources at the regional government level are surcharges on central or federal taxes (notably the personal income tax); retail sales taxes; and, in relatively advanced countries, some form of regional value-added tax (such as the Italian regional business tax). However, as demonstrated by the experience with the Brazilian state-level value-added tax, a degree of coordination of subnational taxes, especially the definition of the tax base, is important to avoiding predatory tax competition, and to reducing compliance
costs for taxpayers who transact across regional jurisdictions. For local governments, movable (e.g., motor vehicles) or immovable properties provide appropriate, albeit not always adequately exploited, tax handles. IMF advice has typically, but not exclusively, focused on strengthening the design and administration of property taxes, as shown by the case studies in Part II.

- Subnational own resources typically fall well short of spending responsibilities, leading to the need for intergovernmental transfers to offset the resulting vertical imbalances. Revenue-sharing is generally used to correct such imbalances, but can expose the budgets of subnational governments to significant cyclical fluctuations, which they are generally less well able to shoulder than the central government. To address this problem, the least-cyclically sensitive taxes as own-revenue handles and smoothing mechanisms (such as moving averages of central revenues as the basis for revenue-sharing) have been suggested. Although these mechanisms would attenuate the impact of cyclical fluctuations, they are unlikely to eliminate it. It is therefore desirable for subnational governments to build up cushions (such as the “rainy day funds” used by some U.S. states) during boom periods, to be drawn down during cyclical downturns.

- Intergovernmental transfers are also used to moderate horizontal imbalances within each level of government. Horizontal redistribution is best accomplished through a system of equalization transfers, designed to take into account to the extent possible—given data availability—relative taxing capacities and spending needs of subnational governments. Special-purpose, earmarked transfers should be used sparingly because they impart rigidity to subnational spending (as shown in Bolivia, Colombia, Mexico, Nigeria, and Indonesia at an earlier stage), and whether they are being used for the specified purpose is difficult to monitor effectively.

- Limits to subnational borrowing are needed, in most cases, to ensure adequate fiscal discipline. Effective reliance on market discipline alone requires a number of preconditions (notably, a significant history of no bailouts) that are met in relatively few countries (exceptions being Canada and the United States). At the same time, market discipline can usefully complement other control mechanisms. The choice among alternative control methods (administrative, rules-based, or cooperative) depends on country circumstances, and in some cases, a blend of different methods is most effective. In countries with less-developed credit and bond markets or where availability of reliable information on government operations is not adequate to ensure proper monitoring, borrowing should be made contingent upon well-identified preconditions (possibly including certification that subnationals meet a minimum set of PFM requirements), as recommended in China, Kosovo, and FYR Macedonia.

- To enforce any form of control, availability of relevant information is crucial, including on floating debt and contingent liabilities (especially guarantees and public-private partnerships). Countries should seek to establish subnational debt registries (as recommended in Bolivia and Mexico) or fiscal risk registries (as recommended in China) by consolidating various sources of information, especially on “below-the-line” financing flows to subnationals. Progressively developing the capacity of subnational governments to manage their own debt is also important. Debt limits can be complemented by strengthened prudential regulations on financial intermediaries lending to the subnationals. Sound mechanisms for the resolution of subnational debt crises, when they occur, should also be in place.

As the case studies presented in Part II indicate, the effectiveness of IMF advice in the fiscal decentralization area has varied significantly across countries and over time. A fundamental factor has been the degree of political support for reforms that inevitably entail difficult trade-offs and create winners and losers. The degree of political commitment to such reforms at times has been enhanced by external factors, such as an economic crisis. Even then, however, piecemeal reforms (for example, a tightening of borrowing controls on subnational governments) have proved easier to implement than comprehensive reforms that would have helped achieve more efficient and lasting outcomes.
Looking ahead, as decentralization continues to advance even in countries that are currently relatively centralized, the IMF will need to remain engaged in the provision of advice on the more macroeconomically relevant aspects of the process. The IMF should also further strengthen its cooperation with other institutions (such as the World Bank, other multilateral institutions, and some bilateral donors) that are active in this area and that have resources to support capacity-building at the subnational level, given that improvements in capacity are often the linchpin to the success of fiscal decentralization.
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Part II: Background Studies
In Bolivia, the initial drive behind the decentralization process was political. In the late 1980s—after decades of dictatorship and neglect of the poorest regions—a need emerged to strengthen democratic structures, starting at the lower levels of government. Decentralization’s initial stage included the introduction of municipal elections and the development of a legal framework for fiscal decentralization in the mid-1990s. A second stage brought a renewed focus on poverty, linked to the Heavily Indebted Poor Countries (HIPC) Initiative, and an attempt to address growing fiscal imbalances, including the rising subnational debt. Finally, significant changes at the regional level (prefecturas) took place in 2005, when the first popular elections of regional governors were held, and when a new hydrocarbon law changed the revenue-sharing regime by assigning a significant share of natural resource revenue to the regions (discussed later in this chapter). These changes in financing arrangements for subnational governments, however, were not accompanied by a redefinition of spending responsibilities across government levels, severely eroding the central government’s flexibility in budget management. As a result, subnational governments receive about one-third of general government revenue, but are responsible for only about one-fourth of total spending. A very large share of subnational resources is in the form of intergovernmental transfers (Table 4.2).

As of late 2008, in the context of significant regional tensions and constitutional reform, Bolivia is in the midst of a national discussion on a new system of intergovernmental fiscal relations. After a protracted process that began in 2006 and triggered serious confrontations between the government and opposition regions, a new constitution was approved in January 2009. This constitution introduced broad elements of a new system of intergovernmental fiscal relations conducive to more decentralization and included a transitory clause mandating that a provisional regional-autonomy regime be developed until the presidential elections in December 2009. After these elections, a new law on fiscal decentralization was expected to be enacted by the newly elected congress.

### Table 4.1. Bolivia: Indicators of Fiscal Decentralization

<table>
<thead>
<tr>
<th>Type of government</th>
<th>Unitary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population (million, 2007)</td>
<td>9.4</td>
</tr>
<tr>
<td>Area (million km²)</td>
<td>1.1</td>
</tr>
<tr>
<td>Levels of government</td>
<td>3</td>
</tr>
<tr>
<td>Regions (prefecturas)</td>
<td>9</td>
</tr>
<tr>
<td>Municipalities</td>
<td>112</td>
</tr>
<tr>
<td>Average municipality size (population)</td>
<td>84,172</td>
</tr>
<tr>
<td>Minimum municipality size (population)</td>
<td>1,287</td>
</tr>
</tbody>
</table>

Source: Authors.

### Table 4.2. Bolivia: Summary of Subnational Governments’ Finances, 2005

<table>
<thead>
<tr>
<th>Percentage of general government</th>
<th>Percentage of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total subnational revenue</td>
<td>33.8</td>
</tr>
<tr>
<td>Own-source revenue</td>
<td>3.2</td>
</tr>
<tr>
<td>Transfers from the central government</td>
<td>28.6</td>
</tr>
<tr>
<td>Total subnational expenditure</td>
<td>25.1</td>
</tr>
<tr>
<td>Overall balance (before transfers)</td>
<td>n.a.</td>
</tr>
<tr>
<td>Overall balance</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

Sources: Data provided by the authorities; and authors’ calculations.

Note: n.a. = Not applicable.

Transfers include shared revenue.

### The 1990s: Increasing Municipal Autonomy Leads to Fiscal Imbalances

The decentralization process in Bolivia started with municipalities, the lowest tier of government. The first popular elections for mayors were held in 1987; however, fiscal decentralization only truly started in the mid-1990s. The laws of Popular Participation (1994) and Decentralization (1995) set the legal framework for new intergovernmental relations. Municipalities were given new spending and revenue responsibilities, including local taxes, and revenue-sharing agreements were established (municipalities were assigned 20 percent of most national taxes). The status of regions (prefecturas), however, was not as well defined. While they also received new spending and revenue responsibilities (a share of revenues from natural resources and
excises), they remained largely under central control, with regional governors appointed by the president.

The decentralization system, although providing poorer local governments with greater resources, suffered from significant vertical imbalances, and only partially addressed horizontal inequalities. Before the reform began in 1994–95, a few cities (regional capitals) received almost all devolved revenues; after 1995, smaller municipalities saw their resources increase substantially, as much as 300 percent in some cases. Nevertheless, local governments remained highly dependent on transfers from the center (including revenue-sharing agreements and earmarked transfers), with own-revenues representing less than one-third of local expenditures during the 1990s. Transfers were mostly based on municipalities’ population size, with no effective mechanism to address inequalities in income and revenue capacity.

Although the weaknesses in the system contributed to increasing deficits at the subnational level during the 1990s, the costs of the decentralization were not initially perceived as a threat to macrofiscal stability. The heavy reliance on central transfers and weak controls on subnational borrowing led to soft budget constraints at the subnational level and a gradual deterioration of the municipalities’ accounts. Because Bolivia was undergoing significant reforms in the 1990s and economic growth was accelerating, the cost of the decentralization was viewed as relatively limited, and easily compensated for by surpluses at the central level. However, subnational debt, particularly short-term debt, started to rise rapidly, especially in the largest municipalities.

As a result of growing concerns with the rising levels of subnational debt, IMF staff were called to provide technical assistance on subnational public finances in the late 1990s. A first technical assistance mission in 1997 focused mainly on the need to develop effective administrative controls on local debt, though it noted that the incentives for overborrowing were due to the lack of clear spending responsibilities (leading to overspending) and the dependence on the central government (and potential bailouts). A follow-up mission in 1998 provided a broader analysis of intergovernmental relations and recommended a series of actions to reduce the underlying weaknesses and improve overall fiscal management. The recommended actions included reducing reliance on transfers by increasing local revenues; better defining spending responsibilities, taking into account institutional capacities of smaller municipalities; and improving the transfer system to reduce vertical and horizontal inequalities.

The legal framework was improved, partly reflecting IMF advice and attempts to control subnational debt, but the main weaknesses of the system were not tackled. In 1999, a new law for budget administration reinforced the powers of the Ministry of Finance to control subnational debt and reduced the debt limits. In addition, the authorities made changes in the transfer system to address some of the imbalances. In particular, poverty indicators were to be included when distributing cofinancing resources and HIPC-related revenues (see below); however, the main transfers (revenue-sharing agreements) remained unchanged.

The efforts to coordinate overall fiscal policy and to control debt levels continued to be undermined by the absence of comprehensive, reliable, and timely information, and by the lack of political will at the center to enforce restrictions on subnational borrowing.

As the largest municipalities’ financial positions deteriorated, the central government started a debt-restructuring program for subnational governments in 1998. Given the lack of effective budget constraints and the difficulty of monitoring subnational debt, several of the largest municipalities (representing more than three-quarters of local spending) continued to accumulate deficits, with some breaching the debt limits by the late 1990s. Debt-restructuring programs were agreed to between the central and local governments (and one prefectura). In exchange for central government financial support, the municipalities committed to take measures to increase local revenues and control spending. The debt-restructuring program also focused on changing the debt composition, from mostly short-term debt (with private contractors and public agencies) to longer-maturity debt (from the Corporación Andina de Fomento and the World Bank).

1According to the 1997 budget law, debt service was not to exceed 25 percent of revenues and debt stock was to be lower than 250 percent of revenues.
Although the debt-restructuring program helped improve municipalities’ financial positions, a 2001 IMF technical assistance mission stressed the need to strengthen mechanisms to prevent future problems. The mission also emphasized that the inclusion of a central bailout component could lead to moral hazard issues. The mission advised establishment of credible sanctions against local governments breaching the rules and significant improvement of the reporting of fiscal and financial data to the Ministry of Finance (including acceleration of the implementation of the new information system, SIGMA, which was being supported by the World Bank and the Inter-American Development Bank).

The Early 2000s: Fiscal Unraveling

Bolivia’s fiscal position deteriorated in the early 2000s as a result of its economic and political crisis, and the ensuing need for a large fiscal adjustment highlighted further tensions in the decentralization system. At the end of the 1990s, Bolivia entered a period of economic and political crisis—with negative per capita growth in 1999–2002—and the fiscal deficit ballooned, reaching 8–9 percent of GDP in 2002–03.

When fiscal adjustment finally began in 2004, it fell disproportionately on the central government, mainly reflecting difficulties in coordinating fiscal policy across government levels. Almost any revenue measure was partially offset by higher subnational spending (because revenue-sharing agreements mandated transferring part of increased collections to subnational governments). In addition, the central government’s ability to reduce spending was limited by the lack of clarity in spending responsibilities and of coordination with subnational governments. For example, subnational governments, which controlled teachers’ hiring and working hours, had no incentives to find savings (e.g., by reducing fraud and waste) because the central government had to pay the large wage bill.

Meanwhile, the Enhanced HIPC Initiative led to a new push in the decentralization process, further compounding challenges for fiscal management. Under the 2000 National Dialogue law, savings from the Enhanced HIPC Initiative were to be redirected to municipalities based on poverty indicators. While these resources represented a welcome windfall for the poorer municipalities, the associated earmarking rules introduced rigidity in their use. Furthermore, the HIPC initiative also created unintended fiscal pressures at the central level because the increase in debt (resulting from the fiscal crisis of 2000–02) effectively eliminated any savings from the HIPC debt relief—but not the obligation to transfer funds to municipalities.

The Late 2000s: Stronger Prefecturas Demand Control of Hydrocarbon Resources

Although fiscal decentralization initially focused on municipalities, over time regions have demanded greater autonomy and revenue devolution, especially in the context of booming hydrocarbon prices during 2004–08.

Starting in 2005, two significant changes took place: First, regional governors (previously appointed by the president) were popularly elected, marking greater political autonomy for regions. Second, a new Hydrocarbon Law assigned more resources to regions, but without a corresponding transfer of expenditure responsibilities. The hydrocarbon-producing regions have been the main beneficiaries of this new system because a large share of the royalties accrues to them.

Regions rely primarily on the sharing of hydrocarbon revenues with the center. Royalties on oil and natural gas represent almost two-thirds of total revenue, creating significant horizontal imbalances; for example, Tarija, with 4 percent of the country’s population, receives almost 50 percent of total royalties distributed.

A new Direct Tax on Hydrocarbons (IDH) was introduced in 2005; although it has resulted in an increase in the overall government take from the hydrocarbon sector, close to 60 percent of IDH collections is transferred to subnational governments. In addition, the share of royalties going to subnational governments was increased from 45 percent to 55 percent. Regional governments have been the largest beneficiaries of these increases (universities have also benefited from additional earmarked revenues from the IDH).

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2 For example, focusing spending cuts at the central agencies level undermined the functioning of critical agencies and public services. In addition, the authorities adopted a financial transactions tax (excluded from revenue-sharing) after attempts to pass other measures met stiff resistance, also by regions and municipalities.

3A new Direct Tax on Hydrocarbons (IDH) was introduced in 2005; although it has resulted in an increase in the overall government take from the hydrocarbon sector, close to 60 percent of IDH collections is transferred to subnational governments. In addition, the share of royalties going to subnational governments was increased from 45 percent to 55 percent. Regional governments have been the largest beneficiaries of these increases (universities have also benefited from additional earmarked revenues from the IDH).
to regional governments. The heavy dependence on energy-based transfers poses important challenges to regions, which may be ill-equipped to manage their volatility; in addition, regions have little control over the hydrocarbon revenue take, which depends on decisions made by the central government (e.g., on the fiscal regime and contract specifications).

The existing revenue-sharing structure has resulted in low incentives to exploit tax bases at the subnational level. Both municipalities and regions have limited autonomy regarding the tax base and the tax rates, which are mostly set by the central government, thus encouraging dependence on transfers and central government decisions. In addition, heavy reliance on central transfers undermines subnational incentives to raise revenue through better tax administration and through increasing revenue. The changes in revenue-sharing introduced by the 2005 Hydrocarbon Law have only exacerbated these problems.

Excessive earmarking of transfers provides incentives for nontransparent accounting and inefficient spending. Most programs earmark transfers in fixed proportions to capital and current expenditures or to a specific sector. This creates incentives to distort the definition of current and capital expenditures to meet defined percentages. The absence of a functional classification of expenditures and weaknesses in the subnational public expenditure management systems also constrain transparency in the fiscal accounts.

Significant overlaps in spending responsibilities create inefficiencies and reduce accountability. Health and education are characterized by extensive concurrency among the central government, regions, and municipalities. The central government sets the norms and the curricula, and pays for salaries of teachers and medical personnel. Municipalities are responsible for construction and maintenance of schools and health premises and for educational and medical equipment and supplies. Regional governments are responsible for the implementation of norms and standards set by the center. Selection and hiring of teachers and medical personnel are performed at the regional level, but the certification of hours worked occurs at the municipal level. Lack of coordination has led to spending inefficiencies; one of the consequences of this setup is that, while new construction generates new requests for personnel to run the premises and to provide the services, separation of responsibilities results in frequent discrepancies between the building of new premises and their staffing. More generally, investment spending decisions are not coordinated across levels of government.

In late 2007, the subnational revenue-sharing system was modified again to change the distribution of the hydrocarbon tax (IDH). IDH transfers to regional governments were cut by about 60 percent, based on the argument that the center needed funds to finance a new transfer program; this was also an opportunity for the central government to reassert some authority over the regional governments, especially those with autonomy aspirations. Half the amount clawed back was reallocated to the municipalities as increased transfers.

**Conclusions**

The recommendations from the most recent technical assistance mission in 2004 remain largely valid. They include the following:

- **Clearly define spending responsibilities** (avoiding duplication) and improving accountability. In general, one level of government should control both the size and quality of a spending item and its financing. For example, the dispersion of responsibilities for public education and health contributes to the relatively high education wage bill and the lack of quality control in these sectors.

- **Simplify the transfer system** (reduce overlapping programs) with well-defined policy objectives. The transfer system could be further improved by introducing a new equalization system that would take into account the revenue capacity and expenditure needs of subnational governments. Hydrocarbon taxation should accrue to the cen-
Making Fiscal Decentralization Work

...central government level—a goal toward which the constitutional assembly has not succeeded to date in making progress (regions that are resource-rich and dynamic would like to retain a large share of the natural resource revenues, while the central government would like to claw back the revenues to strengthen the finances of the treasury and for redistribution).

- Assign subnational governments significant own-sources of revenues (i.e., enabling them to set rates for local taxes and impose, at the margin, surcharges on national taxes) in line with redefined spending responsibilities. Appropriate sequencing is needed in giving subnational governments access to new own-revenue sources and transferring additional responsibilities. Only subnational governments that accept new responsibilities and perform them adequately should be given continued access to new tax resources.

- Strengthen the rules limiting subnational borrowing and muster a political commitment to a no-bailout policy. Steps that can be taken to improve fiscal rules to limit borrowing include (1) setting the debt stock limit as measured by present value, given the concessional nature of most of the debt, and including in it any guarantees given by subnational governments or related public enterprises; (2) making debt limits comprehensive by referring to all entities belonging to a department or municipality; and (3) calculating the debt-service-to-revenue ratio for the entire term of a new operation or the next 10 years (whichever is shorter). However, the political commitment to a no-bailout policy is the key element. The no-bailout commitment should include strict implementation of the legal framework for subnational debt control and the application of sanctions to violators. In particular, municipalities that are unable to generate timely and comprehensive reports on their debt and finances should be barred from borrowing.
Fiscal decentralization since the early 1980s has supported economic growth and the process of transition to a market economy in China. However, China’s impressive performance has not benefited all subnational governments equally— income disparities across provinces have widened. Furthermore, the provision of public services is skewed in favor of richer provinces. The role of intergovernmental relations in perpetuating these disparities has come under increasing scrutiny.

Given China’s size, it is not surprising that the levels of subnational governments (four) and the number of jurisdictions (more than 40,000) are larger than in other countries. The first subnational tier consists of provincial-level authorities (22 provinces, five autonomous regions, and four municipalities— Beijing, Shanghai, Tianjin, and Chongqing). The second tier comprises prefecture-level authorities (333 prefectures and cities at the prefecture level). The third tier encompasses 2,859 counties and cities at the county level, while the last tier includes 40,813 villages and townships.

Fiscal relations between the central and local governments in China since 1990 have evolved in two broad phases— decentralization in the early years, and recentralization since the mid-1990s. Fiscal reforms in the 1980s decentralized the revenue-sharing system, contributing to a sharp decline in the central government’s share of total revenue, from about 40 percent in 1985 to 28.3 percent in 1993; this drop in the center’s share was even more dramatic considering that national government revenue had declined over the period, from more than 22 percent to about 12 percent of GDP. By the early 1990s, the authorities considered central revenue to be seriously inadequate, especially for redistributive purposes. This prompted a new round of reforms in 1994, which included changing the revenue-sharing rules, introducing a central tax administration, and increasing the role of transfers.

Based on subnational expenditure shares, China is at the high end of the decentralization spectrum. Local governments are largely responsible for public service delivery and implementation of social policies, and account for nearly 80 percent of total spending (Table 5.2). However, a widening gap is emerging between the local governments’ expenditure mandates and the resources available to them. Local governments, particularly in poorer provinces, experience difficulties in financing basic services (Ahmad, Albino-War, and others, 2004).

The IMF has provided significant technical assistance to China on intergovernmental fiscal relations, initially on the new revenue-sharing, tax assignments, and transfer systems in 1994, and in 2003 through a diagnostic mission on the overall design of intergovernmental fiscal relations, followed by an assessment of fiscal risks associated with decentralization. Almost 15 years into the fiscal federalism reform, some aspects of intergovernmental fiscal relations need to be modified. In particular, the design and clarity of expenditure mandates (which were not addressed in the first round of assistance in the mid-1990s), and the tax assignments and

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1 This case study is based on Ahmad, Lee, and Kennedy (1993); Ahmad, Craig, and Mihaljek (1994); Ahmad, Craig, and Searle (1994); Ahmad, Qiang, and Tanzi (1995); Ahmad, Keping, and others (2002); Ahmad, Brixi, and others (2003); Ahmad, Albino-War, and others (2004); Fedelino and Singh (2004); and Fedelino and Ter-Minassian (2006).

2 As of the end of 2007, according to the National Bureau of Statistics of China.
transparency and efficiency of the transfer system, need to be revisited. Despite growing recognition that the current system of intergovernmental fiscal relations needs reform, the authorities have not yet signaled a clear intention to adopt a comprehensive strategy to address these issues.

The 1994 Fiscal Reform

Recentralization of Revenue

The core objective of the 1994 reform was to ensure a higher revenue-to-GDP ratio, while also boosting the share of the central government in total revenue. A new tax sharing system was introduced, which shifted revenue collection and distribution away from a negotiated basis to a mix of tax assignments and tax sharing. A new value-added tax was adopted, to be shared between the center and the local governments. The State (central) Tax Administration was made responsible for the collection of central and shared taxes, while local government agencies remained in charge of collecting local taxes. However, tax rate-setting authority remained largely with the central government; local governments had only limited powers to set rates for a few local taxes. These arrangements still broadly apply to date.

The 1994 reform was largely successful in achieving its objectives. Revenues recovered quickly from the trough of the mid-1990s, and the central government’s share surged to above 55 percent—more than twice the level registered just before the reform. The reform also streamlined the tax system and enhanced tax administration, providing the center with institutional tools it previously lacked. However, important differences in revenue-generating capacity across provinces not only remained, but increased over time.

Broadened Expenditure Mandates

The “recentralization” of revenue was not accompanied by a corresponding shift in expenditure assignments. While local governments’ share of total expenditure have remained stable at about 70 percent since the late 1990s, their expenditure nonetheless became increasingly disproportionate to their own-resources, and considerable further spending pressures lie ahead on account of pensions, local investment needs, and industrial restructuring.

Various factors explain the proliferation of local governments’ expenditure responsibilities. The industrial restructuring process has transferred spending responsibilities of state-owned enterprises—especially in social areas, such as education and health—to subnational governments as such enterprises are reformed; rapid urbanization has created a need for subnational governments to provide basic infrastructure (such as electricity and transport); and the administration of pensions remains largely decentralized, in most cases all the way down to the county level (where there are signs of difficulties in paying pensions). In addition, minimum service standards set by the center create challenges, particularly for poorer counties. For example, the provision of health care services in rural areas—to be partly covered by specially designed central subsidies—requires matching funds from recipient counties, further stretching their service provision capacity.

Inadequate Transfers

In addition to a clear redefinition of the tax assignments, the 1994 reform also redesigned the transfer system, moving away from one-time, negotiated transfers toward a more rules-based and transparent mechanism. The transfer system is currently based on two main pillars:

- **Specific-purpose grants** (special transfer payments, Table 5.3). These grants are earmarked transfers

<table>
<thead>
<tr>
<th>Table 5.2. China: Summary of Subnational Governments’ Finances, 2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage</td>
</tr>
<tr>
<td>of general</td>
</tr>
<tr>
<td>government</td>
</tr>
<tr>
<td>-------------</td>
</tr>
<tr>
<td>Total subnational revenue</td>
</tr>
<tr>
<td>Own-source revenue</td>
</tr>
<tr>
<td>Transfers from the center</td>
</tr>
<tr>
<td>Total subnational expenditure</td>
</tr>
<tr>
<td>Overall balance (before transfers)</td>
</tr>
<tr>
<td>Overall balance</td>
</tr>
</tbody>
</table>

Sources: Data from www.mof.gov.cn/yusuansi and authors’ calculations.
Note: n.a. = not applicable.
allocated to special programs and uses, including transfers for capital construction, innovation funds, science and technology promotion funds, and agricultural support.

- General-purpose grants aimed at providing each province with adequate resources. These grants are rules-based and depend on variables such as provincial GDP, student-teacher ratios, number of civil servants, and population density. They increased from 10 billion yuan in 1994 to 250 billion in 2007, and their share in total transfers reached 35 percent in 2007.

In addition, other single-purpose transfers cater to specific needs and purposes. Among these, “tax-for-fee reform transfer payments” were introduced to compensate local governments when they lost important revenue handles as a result of the tax-for-fee reform; “adjusting-wage transfer payments” were introduced in 1998, targeting provincial governments that could not cover the increase in civil servants’ wages; and “minority ethnic areas transfer payments” are paid to a few entities, including the five autonomous regions.

Despite their large size, transfers have proved inadequate to provide sufficient financial support for the provision of essential services such as rural education and rural public health. General-purpose transfers, although growing, represent only one-third of the total. The system’s ability to redistribute fiscal revenues across provinces, therefore, remains limited. Specific-purpose grants comprise hundreds of different earmarked grants, allocated on a one-time negotiated basis. Their large share reflects the proactive regional policy that the center is carrying out. However, by their nature these grants make the transfer system less transparent and more difficult to monitor because the center lacks the ability to track the actual spending from earmarked transfers. These grants also undermine the rules-based character of the transfer system that the 1994 reform aimed to introduce.

Uncertainty about the size and timing of central transfers further complicates budgetary formula-

3 A provincial pilot project, launched in 2001, replaced numerous fees with a surcharge on the local agricultural tax. This “tax-for-fee” reform was gradually extended to all the provinces.

**Table 5.3. China’s Transfers, 2007**

<table>
<thead>
<tr>
<th></th>
<th>Billions of yuan</th>
<th>Share (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal-power transfer payments</td>
<td>708.9</td>
<td>50.7</td>
</tr>
<tr>
<td>General transfer payments</td>
<td>250.1</td>
<td>17.9</td>
</tr>
<tr>
<td>Ethnic minority area transfer payments</td>
<td>17.3</td>
<td>1.2</td>
</tr>
<tr>
<td>Tax-for-fee reform transfer payments</td>
<td>75.9</td>
<td>5.4</td>
</tr>
<tr>
<td>Adjusting-wage transfer payments</td>
<td>223.4</td>
<td>16.0</td>
</tr>
<tr>
<td>Rewards or subsidies transfer payments</td>
<td>33.9</td>
<td>2.4</td>
</tr>
<tr>
<td>Other</td>
<td>108.3</td>
<td>7.7</td>
</tr>
<tr>
<td>Special transfer payments</td>
<td>689.9</td>
<td>49.3</td>
</tr>
<tr>
<td>Education</td>
<td>39.1</td>
<td>2.8</td>
</tr>
<tr>
<td>Technology</td>
<td>7.5</td>
<td>0.5</td>
</tr>
<tr>
<td>Social security and employment</td>
<td>196.1</td>
<td>14.0</td>
</tr>
<tr>
<td>Health</td>
<td>63.0</td>
<td>4.5</td>
</tr>
<tr>
<td>Environment protection</td>
<td>74.8</td>
<td>5.3</td>
</tr>
<tr>
<td>Agriculture, Forestry and Water Affairs</td>
<td>96.1</td>
<td>6.9</td>
</tr>
<tr>
<td>Other</td>
<td>213.3</td>
<td>15.2</td>
</tr>
<tr>
<td>Total transfer payments</td>
<td>1,398.8</td>
<td>100.0</td>
</tr>
<tr>
<td>Percentage of GDP</td>
<td>5.4</td>
<td></td>
</tr>
</tbody>
</table>

Source: Data provided by the authorities.

Implications of the Current System

The current intergovernmental fiscal system poses a number of fiscal risks. Faced with widening financial pressures—in the presence of limited tax-setting powers, an inadequate transfer system, and a legal prohibition against borrowing—local governments have continued to raise revenue outside the budget system, mainly in the form of fees and charges that accrue to locally managed extra-budgetary funds. Extra-budgetary revenues also circumvent the borrowing prohibition. Although reported extra-budgetary funds managed by the central government declined significantly after the 1994 reform, those controlled by subnational governments continued to increase.

Financing constraints have also induced subnational governments to seek ways to circumvent their legal funding limits. This situation has led to the creation of channels for raising indirect financing and the shifting of some public functions to seemingly nongovernment entities. Large-scale infra-
structure projects offer an example: most provinces have experienced intense activity in building highways, airports, and urban ring roads. Most of these projects have been financed by bank loans, with the expectation that the sale of appreciated land leases in the areas in which these projects are implemented will make the projects financially viable. However, these projects may also present significant fiscal risks if local governments, and ultimately the central government, are called upon to shoulder the associated fiscal costs. The shift of public functions to nongovernment entities to overcome legal borrowing constraints might also generate opportunities for waste and corruption without necessarily improving service delivery. The authorities are aware of these problems, as candidly described in a number of audit reports from the National Audit Office.

**IMF Advice and Possible Reforms**

The transfer system, designed to compensate local governments for revenue lost to the center and to promote equalization across regions, is in need of reform. First, it has proved to be inadequate to tackle the large regional disparities. Second, local governments’ expenditure mandates remain unclear and, in some cases, largely unfunded. A case in point is pension costs, for which local governments are ill-equipped to shoulder the related costs, and higher-level pooling is called for. Finally, indirect means of local government financing and creation of implicit liabilities at the local level may present significant fiscal risks, underscoring the need for comprehensive, centralized monitoring of subnational operations.

Staff technical assistance advice since 2002 has addressed these issues. Key considerations include the following:

- The impact of increased control of local governments over tax rates, and changes in revenue assignments (including with reforms of the value-added tax and income tax), should lead to a reconsideration of local spending responsibilities and financing arrangements.
- Transfers should be tailored to facilitate the delivery of minimum standards of public services, and should reflect a rules-based equalization system.
- The buildup of fiscal risks at the local government level should first be addressed by taking stock of these liabilities, for which estimates are not now available. A fiscal risk register could be built by consolidating information from several sources, including from the banking and securities sectors, and through the management of state assets. These “below-the-line” sets of information could be consolidated and maintained at the central treasury.

Staff also recommended that legal constraints on local government borrowing should replace the current informal arrangements, but cautioned that a number of structural reforms would have to occur first. These reforms include strengthening the recording and reporting of local government operations and enhancing the accountability and transparency of local government financial management. Reforms being implemented at the central government level in the public financial management area (which include the broadening of the treasury single account and the implementation of a new budget classification—also issues for which the IMF has provided extensive technical assistance) could help in such efforts, by setting a model for similar reforms at the subnational level.

These reforms are part of an extensive and interlocking package of measures that will take several years to implement fully. The pace of reform will depend on the speed at which the expenditure and revenue assignments can be adjusted. Chinese authorities have generally favored a pilot approach to implementing structural fiscal reforms. Thus, any important policy change is first tried out in a handful of carefully selected cities or provinces before nationwide implementation. This approach has helped garner support and allay concerns related to the possible risks of implementing full-scale reforms in a country as widely diverse as China.

Still, a comprehensive and systematic strategy for intergovernmental fiscal relations is needed. Although no major reforms toward fiscal decentralization have been implemented recently in China, the system of local-central fiscal relations has been affected by a number of fiscal policy changes. For example, taxation of agriculture (the main revenue handle in
poorer provinces) has been eliminated to favor low-income farmers; and in rural areas, free education through ninth grade is guaranteed and health care coverage has been broadened. So far, most of these policy changes have resulted in increased expenditure mandates for local governments and, at least in the already less-favored rural areas, lower own-revenue; however, significant changes in the design of central transfers have not taken place, which leaves open the question of the sustainability of these policy changes for poorer local governments. Overall, tinkering at the margin with piecemeal measures—absent an overall and consistent fiscal decentralization framework—poses the risk of actually deepening tensions and inequalities that the current system has contributed to generating.
Colombia is a unitary country at a relatively advanced stage of decentralization. Colombia’s decentralization process began in the early 1980s and was reinforced by the 1991 constitution. In 2010, the country is a decentralized republic consisting of a central administration, 32 departments, 1,120 municipalities, and four special districts and indigenous territories that are politically independent. Subnational political and administrative institutions replicate the structure of the central administration, and governors, members of departmental assemblies, mayors, and members of municipal councils are elected directly.

Fiscal decentralization in Colombia has been driven by a belief that subnational governments are better positioned to deliver effective services, and therefore should receive commensurate resources. The constitution promulgated in 1991 stipulated large-scale revenue transfers from the center to subnational governments to finance their expenditures in social sectors. Transfers were intended to correct vertical imbalances and provide a stable income flow to subnational governments, as well as to address horizontal differences across subnationals.

However, increased revenue devolution was not matched by broader spending mandates, resulting in weakened fiscal discipline at the subnational level. The 1991 constitution established a revenue-sharing system, earmarked by sector; the base for calculating the transfers was extended to all current revenues (previously, only a share of selected tax revenues was transferred), and a gradual increase in the transferred percentages over time was targeted. Transfers increased dramatically, from 2.4 percent of GDP in 1990 to 6.2 percent of GDP in 2006 (Table 6.2). However, despite devolving more resources to subnational governments, the central government continued to carry out many of its original spending responsibilities, leading to over-spending and inefficient service outcomes, including in the social sectors.

Increased reliance on automatic transfers muted incentives for revenue collection and, ultimately, fiscal discipline. The rigid formula linking transfers to local governments to current revenue diminished the central government’s incentive to collect more revenue. Subnational governments came to rely on central transfers, rather than having to activate own-source revenue for additional spending, thus weakening accountability and fiscal discipline. Coupled with limited expenditure control, these circumstances led to a substantial increase in subnational debt levels (an increase of 40 percent in 1993, and

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Table 6.1. Colombia: Indicators of Fiscal Decentralization

<table>
<thead>
<tr>
<th>Type of government</th>
<th>Unitary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population (million, 2007)</td>
<td>46.0</td>
</tr>
<tr>
<td>Area (million km²)</td>
<td>1.1</td>
</tr>
<tr>
<td>Levels of government</td>
<td></td>
</tr>
<tr>
<td>States and provinces</td>
<td>33</td>
</tr>
<tr>
<td>Municipalities</td>
<td>1,120</td>
</tr>
<tr>
<td>Average municipality size (population)</td>
<td>41,106</td>
</tr>
<tr>
<td>Minimum municipality size (population)</td>
<td>242</td>
</tr>
<tr>
<td>IMF technical assistance missions on fiscal decentralization</td>
<td>1995, 2005</td>
</tr>
</tbody>
</table>

Source: Authors.

Table 6.2. Colombia: Summary of Subnational Governments’ Finances, 2006

<table>
<thead>
<tr>
<th></th>
<th>Percentage of general government</th>
<th>Percentage of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total subnational revenue</td>
<td>31.3</td>
<td>10.2</td>
</tr>
<tr>
<td>Own-source revenue</td>
<td>12.4</td>
<td>4.1</td>
</tr>
<tr>
<td>Transfers from the center</td>
<td>18.5</td>
<td>6.2</td>
</tr>
<tr>
<td>Total subnational expenditure</td>
<td>32.7</td>
<td>10.7</td>
</tr>
<tr>
<td>Overall balance (before transfers)</td>
<td>n.a.</td>
<td>–6.6</td>
</tr>
<tr>
<td>Overall balance</td>
<td>n.a.</td>
<td>–0.5</td>
</tr>
</tbody>
</table>

Sources: Data provided by the authorities; and authors’ calculations.

Note: n.a. = Not applicable.

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1This case study is based on Ahmad, Ruiz, and Garrido (1995); Ahmad, Velorn, and others (1995); Adenanuer (2005); Seade, Adenanuer, and others (2005); and Lozano, Ramos, and Rincón (2007).

2Between 1996 and 2006, transfers to subnational governments increased by more than 460 percent.
an average of 23 percent each year between 1994 and 1999). In addition, bank lending to local governments rose substantially through the mid-1990s, with banks using the transfers from the central administration as collateral for their loans. Eventually, several departments collapsed financially, and had to be bailed out by the central administration.

Most of the subnational financial problems were tackled by a series of reforms in the second half of the 2000s. Fiscal rules were established that brought down local debt and put local public finances on a sustainable footing. A reform of the transfer system moderated the growth in intergovernmental transfers, and mechanisms were set up to improve macroeconomic coordination among layers of government. At the same time, political decentralization—which, among other things, allowed for local election of mayors—contributed to the success of fiscal decentralization, especially in those local governments where reformist politicians skillfully took advantage of various reforms to improve fiscal outcomes. Bogotá’s remarkable performance (discussed in more detail later in this chapter) provides an example of this de facto asymmetric decentralization.3

The 1990s: First Round of Decentralization Reforms and IMF Advice

By the mid-1990s, a number of shortcomings in the decentralization framework were evident. The decentralization process was hampered by the lack of adequate own-resource instruments at the subnational level, particularly in the smaller municipalities and departments; expenditure responsibilities were ill-defined across layers of government; and taxes and transfers were not linked to expenditure needs and were excessively earmarked, based on purely sectoral considerations. Therefore, subnational governments were struggling to cover the portion of their operating expenses not funded by transfers, while having little incentive to manage other expenditures effectively. IMF technical assistance was requested by the authorities in mid-1995 to address some of these issues.4

A rebalancing of intergovernmental fiscal relations was necessary. Staff advice focused on establishing a nondistorting transfer system that would take into account both own-revenue capacities of subnational governments and their expenditure needs. Spending responsibilities were to be clarified, while more operational flexibility was to be provided through general-purpose transfers. Several tax measures were also proposed to increase the revenue-raising capacity of subnational governments, along with some options for improving local tax administration.

The macroeconomic risks posed by high subnational indebtedness also needed attention. Debt levels had rapidly increased in the early 1990s, and could come to jeopardize the country’s macroeconomic stability. Moreover, limited and incomplete information on subnational debt levels hampered the monitoring and accountability of local fiscal operations. Accordingly, the second technical assistance mission recommended a number of measures to address the growing indebtedness of the subnational governments: reducing the maximum amount of revenue that territorial governments could use as collateral for contracting commercial debt, including transfers from the central government; limiting borrowing to finance investment projects (this is the so-called golden rule, mandating that current spending be covered by revenue); and close monitoring by the central Ministry of Finance of territorial debt levels, including through collaboration with local public accounting offices.

Partly building on these recommendations, Colombia implemented several crucial reforms that improved the overall fiscal decentralization framework on a sustained basis. A number of important

3 De jure asymmetric arrangements are based on legal provisions that allow for a more rapid take-up of responsibilities, typically in the main urban centers and advanced regions, relative to other subnational governments. In Bogotá, the city government managed to take advantage of the opportunities afforded by the legislation to all subnational governments, effectively resulting in asymmetric decentralization.

4 A first mission in early 1995 focused on reforming subnational taxation and transfers, shortly followed by a second mission in late 1995 to examine subnational debt and macroeconomic management.
legislative initiatives helped rein in debt levels and establish fiscal discipline:

- Starting in 1997, Colombia enacted a series of laws that critically contributed to sound fiscal and macroeconomic management at all levels of government. Law 358 was designed to curb excessive debt levels of subnational governments by linking their ability to contract debt to liquidity and solvency indicators. A local entity not adhering to these indicators would have to establish a fiscal adjustment plan, to be monitored by the central Ministry of Finance. However, subnational debt still grew by 15 percent a year on average during 1998–2000, and the performance plans did not always bring about stronger fiscal discipline at the local level because transfers continued to grow and there was no enforced ceiling on expenditure.

- In 2000, in response to the above-described developments another law was passed, which established a set of fiscal rules for subnational governments. It classified departments into five categories, and municipalities into six, based on several indicators related to population and fiscal performance. The law limited the operating expenses of subnational entities to a certain percentage of their freely disposable revenue, that is, revenue excluding earmarked transfers. Subnational governments that did not comply with these ceilings had to establish corrective adjustment programs, to be monitored by the Ministry of Finance.

- In 2003, Law 819 improved fiscal coordination among different levels of government, requiring both the central administration and local governments to present each year a consistent 10-year macroeconomic framework. Although the liquidity and solvency indicators of Law 358 remained binding, Law 819 established an additional rule, that budgets would need to be balanced over a 10-year period. It further stipulated that fiscal policy design and management had to be consistent across government levels: both the central and decentralized budgets had to fully comply with the medium-term frameworks, as well as expenditure authorizations and revenue collection at all levels of government. Law 819 also introduced a market-based mechanism for controlling subnational debt—the obligation for each department and municipality with a population greater than 100,000 inhabitants to obtain a credit risk rating from a rating agency.

As a consequence of these initiatives, the fiscal discipline of subnational entities improved between 2000 and 2006. Spending grew less rapidly than during 1997–99, subnational deficits decreased, and the stock of territorial debt grew by only 5 percent on average over the period. Many fiscally distressed subnational governments benefited from undertaking macroeconomic adjustment programs in collaboration with the Ministry of Finance. As a result, subnational debt declined from 9.6 percent of GDP in 1999 to 5.3 percent in June 2006; and the subnational fiscal balance changed from a deficit position during 1997–2001 to a surplus between 2002 and 2005 (0.3 percent of GDP per year, on average).

Transfer arrangements were also modified in 2001. A constitutional reform was passed, changing the automatic tax-sharing system for a transition period (2002–08). Transfers were to grow in real terms by 2 percentage points over 2002–05 and by 2.5 percentage points over 2006–08.5

This reform, coupled with the fiscal responsibility legislation described above, was instrumental in promoting greater fiscal discipline across the different levels of government. Moving from an automatic revenue-sharing system to one in which real transfers grew at a defined rate helped to address some of the incentive problems at the local level. Moreover, the system ensured a more stable and predictable flow of resources for local administrations. This relatively steady growth in the level of transfers led to lower spending at the local level because windfall gains were less likely. For the central administration, the reform helped to control the growth in mandated transfers.

5Beyond 2008, the rate of transfer growth was to be linked again to the central government’s revenue. This clause was not implemented because of a constitutional amendment in late 2007 that permanently changed the transfer system.
The Successful Transformation of Bogotá

Through an improved decentralization framework, the capital city Bogotá was able to tackle its severe public finance problems and position itself as one of the best-performing subnational entities in Colombia. In the late 1980s, Bogotá was plagued by low tax revenues, limited investment spending, and a high debt burden, which translated into financial strain and low coverage and poor quality of basic services. The city was, however, able to use asymmetric decentralization options to its advantage. In particular, Bogotá received special status as Capital District in the 1991 constitution, and was granted an organic statute through a law in 1993; these measures allowed the city more political, fiscal, and administrative autonomy than other municipalities enjoyed. Moreover, the constitutional reform of the intergovernmental transfer system in 2001 granted Bogotá additional resources for specific social programs while reducing earmarking of the overall transfers from the central government.

Bogotá skillfully used these specific advantages under the decentralization process. Its organic statute and resulting tax autonomy allowed the capital city to increase several tax rates and to expand tax bases (Box 6.1). It also significantly improved its tax administration, including through an anti-evaporation program, and created important institutional structures, such as a fiscal policy council, which were instrumental in upgrading its budgetary management. Moreover, Bogotá introduced performance budgeting, adopted a medium-term fiscal framework, and significantly enhanced fiscal transparency by disseminating its fiscal data regularly and on a timely basis through the Internet. Its bonds were rated by several internationally recognized credit agencies. Revenue collection increased significantly, and through the enhanced control of current outlays, resources could be shifted toward public investment. Debt levels fell, and both the provision and quality of services improved dramatically. Primary education coverage, for example, reached 90 percent in 2003, and drinking water coverage is almost universal today.

IMF Advice in Recent Years and Remaining Challenges

Although the reforms described above led to better management of subnational spending and borrowing, the central administration continued to run a deficit. An IMF technical assistance mission in 2004 helped take stock and identify areas that needed further reform.

Limited progress in the assignment of expenditure responsibilities across the different layers of government was the main reason for the center’s fiscal difficulties. The opposition by strong unions to the decentralization of certain services hindered a clear specification of responsibilities among government levels for certain sectoral expenditures, particularly in education and health. Against this background, the 2004 mission recommended the following approaches to the main pending issues:

- **Institutions and macroeconomic coordination.** Coordination mechanisms between different levels of government needed to be strengthened further. An institution to assume leadership of all aspects of fiscal decentralization was desirable, so that budgets and fiscal targets could be coordinated more systematically, as stipulated by the 2003 responsibility law.

- **Expenditure responsibilities.** After a sound diagnosis of remaining overlaps in expenditure responsibilities, the same institution should clarify the roles and service responsibilities of the different layers of government, especially in the health and education sectors.

- **Transfers.** The transfer system should remain permanently decoupled from the central administration’s revenues, and possibly linked to the rate of inflation, which would curb pressures on the central administration’s deficit. The distribution side of intergovernmental transfers should be simplified, with a view to reducing earmarking to provide more room for local expenditure discretion. Moreover, the distribution should be based on local own-revenue capacity and expenditure needs.

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6Municipalities already had some flexibility to increase rates for most taxes before the organic statute was approved. Bogotá exploited this opportunity.
Box 6.1. Effective Decentralization in Bogotá

The city of Bogotá provides a good example of the way in which a major transformation in fiscal management and service provision at the local level can take place when effective decentralization is implemented. Since the mid-1990s the city managed to increase its resources dramatically and use them to improve its service delivery—not an easy task in a city with a population of more than 7 million. From a city facing a severe financial and urban crisis in the late 1980s, with public utilities, education, health, urban transport, and sanitation services in disrepair, the city turned around to become a beacon of modern management and change, as a result of three main factors:

- The sequencing of the decentralization process in Colombia, starting from the popular election of mayors and ending with the granting of greater administrative autonomy, led to a major shift in the balance of intergovernmental powers in favor of subnational governments. Popular elections opened the door to the selection of mayors with great leadership skills, who are largely credited with the turnaround in the city’s predicaments.
- Asymmetries in the decentralization process (enshrined in a 1993 organic statute, among other provisions, giving the city greater fiscal, political, and administrative autonomy) paved the way for tax and spending reforms. On the revenue side, a new gasoline tax was introduced, rates were increased (mainly for the industry and commerce tax), and tax bases were expanded (for property and vehicle taxes); these actions resulted in a significant increase in the city’s revenue. On the spending side, the city improved the management of public utilities and social services. Entities that were no longer needed or that were extremely inefficient were eliminated, others were merged, excessively large staffs were reduced, and wages were kept under control; for example, hospitals were merged or shut down, hospital staff was reduced, and results-oriented management and competition with private hospitals were introduced. In addition, the city significantly expanded opportunities for private participation in service provision through the adoption of concessions.
- Bogotá has also placed emphasis on the market as a fiscal disciplinary factor, welcoming private participation to improve the management and reduce the cost of services, and implementing fiscal transparency measures to ensure that the market and the political and social control mechanisms function efficiently.

Local revenue. Further tax and tax-administration measures should be identified to increase local own-revenues. Possible measures include streamlining or strengthening the local property tax assessment and a simplification of local tax instruments such as the consumer tax. Differences in revenue bases across Colombian municipalities are significant, and would need to be reflected in an appropriately defined equalization transfer system.

Reporting and monitoring of subnational governments. To promote transparency and accountability of local governments, a comprehensive set of fiscal data should be regularly released at the local level and consolidated into an overall position of the total public sector. Less-demanding reporting requirements, however, should be set for smaller municipalities that lack the capacity to draw up medium-term comprehensive macroeconomic frameworks and provide monthly data. In the interim, the central government should continue to rely on below-the-line data to monitor subnational operations.

An important constitutional amendment in mid-2007 introduced a reform to the intergovernmental transfer system. Transfers to local govern-
ments are mandated to grow in real terms by 4 percent over 2008–09; 3.5 percent in 2010; and 3 percent over the period 2011–16. From 2016 onward, local governments are to receive a fixed share of central government revenues. The reform was originally expected to reduce central government transfers as a share of GDP, although this may be difficult to achieve in the projected lower-growth environment.

Although this is a welcome step, further reforms to the intergovernmental transfer system are needed. IMF staff have encouraged such reforms to ensure that intergovernmental transfers do not undermine the ability of fiscal policy to adjust and sustain the required fiscal surplus over the medium term. Proposals by the Expenditure Commission to broaden the local tax base, remove central government guarantees on local borrowing, and increase local cofunding of transport projects could, over time, alleviate pressure on transfers and increase incentives for fiscal discipline.

Formal mechanisms to improve macroeconomic coordination among different government levels in the definition of fiscal targets are also warranted. Information flows and consultation still need improvement.
Fiscal decentralization in the Democratic Republic of the Congo has been viewed as a way to hold a vast and diverse country together following a long civil war. The country—divided and governed by different factions during the 1998–2003 civil war—was officially reunited with the promulgation of the Transitional Constitution in April 2003. The creation of the Government of National Unity in July 2003 and the inauguration of the National Assembly and the Senate in August 2003 were major accomplishments of the peace process and symbolized the end of the six-year-long war. A new constitution was approved by a national referendum in 2005 and entered into force in February 2006. For the first time in half a century, parliamentary and presidential elections were held in 2006. Despite these positive steps, holding together this vast country—populated by 62 million people and 250 ethnic groups, with four times the area of France and as many as 700 local languages and dialects—has proved to be a major challenge.

The constitutionally mandated provincial institutions were created in early 2007. Direct election of the members of the provincial parliaments (Assemblées Provinciales) took place in late 2006, and the provincial parliaments elected governors and vice-governors in January 2007. The provincial governments, consisting of up to 10 ministers in addition to the governors and vice-governors, began operating in February 2007. However, their functioning has been impaired by the following factors: (1) delays in drafting and approving a legislative framework for the relationship with the central government, including with respect to fiscal decentralization; (2) insufficient resources for the operations of the new institutions; and (3) weak administrative capacity, partially reflecting insufficient staffing and an inappropriate skill mix in the new provincial administrations. Against this background, it remains unclear whether the constitutionally mandated creation by May 2010 of 26 provinces (25 provinces plus Kinshasa), instead of the current 11 provinces (10 provinces plus Kinshasa), will be possible.

IMF staff have provided advice on the decentralization process over the last few years. A staff mission in 2004 found that central and local governments often spent their resources outside their competencies, own-revenue collection was weak, and the draft decentralization law posed large macroeconomic risks. The mission recommended a gradual and carefully sequenced decentralization strategy. Although no dedicated technical assistance on decentralization has been provided since that mission, these issues have remained on the radar screen. The World Bank has been leading the dialogue with the authorities in the area of decentralization, and has closely cooperated with IMF staff, especially regarding macrofiscal aspects of the decentralization process. Since April 2008, the World Bank has been supporting decentralization and capacity building in the provinces through the Enhancing Governance Capacity Project.

Fiscal Arrangements Prior to Enactment of Decentralization Legislation

Until recently, the Democratic Republic of the Congo had a deconcentrated system. According to

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1This case study is based on Seade, Brosio, and others (2005).
2Art. 198 of the constitution stipulates that the elected governors and vice-governors have to be installed by the country’s president.

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### Table 7.1. Democratic Republic of the Congo: Indicators of Fiscal Decentralization

<table>
<thead>
<tr>
<th>Type of government</th>
<th>Unitary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population (million, 2007)</td>
<td>57.5</td>
</tr>
<tr>
<td>Area (million km²)</td>
<td>2.3</td>
</tr>
<tr>
<td>Levels of government</td>
<td>3</td>
</tr>
<tr>
<td>Provinces</td>
<td>11</td>
</tr>
<tr>
<td>Municipalities</td>
<td>1,005</td>
</tr>
<tr>
<td>Average municipality size (population)</td>
<td>57,262</td>
</tr>
<tr>
<td>Minimum municipality size (population)</td>
<td>…</td>
</tr>
</tbody>
</table>

Source: Authors.

Note: … = data not available.
the organic public finance law existing at the time, four categories of local governments, called Entités Administratives Décentralisées (EADs), maintained separate legal personalities, had their own budgets, and had the right to raise local taxes. Heads of EADs were officially nominated by the president. They were representatives both of the state (and as such, responsible for implementing central government policies) and of the local executive branch. Decisions of the local authorities were subject to central control. Their budgets had to be approved by the minister of the interior (for the provinces) or by the governor (for other EADs).

The transfer system was based on largely arbitrary revenue sharing. Revenue transfers from the central government to provinces were supposed to be based on the amount of central government taxes and duties collected in the provinces by the three revenue collection agencies, and to be paid into the provinces’ accounts at the central bank.3 Since 1998, transfers had been officially set at 20 percent of revenues collected in the provinces; three-quarters of that 20 percent was supposed to be transferred automatically by the central bank to the provinces. However, actual revenue transfers were 6.4 percent and 6.5 percent of total domestic revenue in 2006 and 2007, respectively. Moreover, important differences surfaced in the distribution of transfers between provinces. The three richest provinces (Kinshasa, Katanga, and Bas-Congo), which together account for 76 percent of total domestic revenues, benefited from the highest absolute transfers, but were also affected by the largest shortfall with respect to the 15/20 percent rule.4

Deficiencies of the Constitutionally Mandated Fiscal Decentralization

The new constitution leaves fiscal arrangements largely undefined. Although provinces enjoy far-reaching fiscal autonomy, the directly elected provincial governors perform a dual role by simultaneously representing their provinces and exercising central government tasks. The constitution establishes three government levels: central, provincial, and subprovincial (Entités Territoriales Décentralisées, ETDs).5

The constitutionally mandated revenue-sharing arrangements are vaguely defined. The constitution stipulates that 40 percent of “national revenues” collected in each province will be devolved to them (Art. 175), while another 10 percent will be assigned to an investment fund with equalization purposes (Caisse Nationale de Péréquation) in charge of reducing the development differential between provinces (Art. 181). However, the constitution neither assigns responsibilities for revenue collection to the different government levels nor clarifies the methodology, including the definition of the tax base, for calculating the 40 percent of revenues to be transferred to the provinces and the 10 percent for the Caisse Nationale de Péréquation. The constitution also lacks clarity about expenditure assignments across government levels, thereby giving rise to the risk of a duplication of responsibilities and unfunded mandates in sectors with competing legislative competence.

The approach to fiscal decentralization enshrined in the constitution results in a number of significant fiscal risks:

- The new revenue-transfer system would lead to a sizable resource transfer to largely unprepared provincial and local authorities, possibly resulting in poor-quality spending and large-scale misappropriation of funds. It would also create a major vertical imbalance in favor of the provinces because the public services that are supposed to be transferred to the provinces (health, primary and secondary education, and agricultural ser-

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3Revenue collection functions are split between OFIDA (customs revenue and excise taxes), DGI (tax revenue), and DGRAD (nontax revenues).

4The high concentration of large companies in the capital Kinshasa, which also hosts the large-taxpayer unit (the agency responsible for collecting taxes from large taxpayers), results in a high share of total income tax collection. Moreover, Kinshasa and Bas-Congo (with the main port Matadi) are the main entry points of the country. Katanga has the highest concentration of mining companies.

5The ETDs consist of “villes [cities], communes urbaines, communes rurales [rural and urban communities], secteurs, and chefferies [the latter are rural units].”
services) account for less than 20 percent of total expenditures, leaving the central government with sizable unfunded spending responsibilities.

- The new transfer system would also create serious inequity among provinces. Three provinces would get the lion’s share of revenue transfers (about 77 percent to Kinshasa, about 9 percent to Katanga, and about 5 percent to Bas-Congo). The remaining eight provinces together would receive about 10 percent (compared with their share in total population of 70 percent), with four provinces (Bandundu, Equateur, Maniema, and Province Orientale) each receiving less than 1 percent, which would prevent them from providing even the most basic public services. The Caisse Nationale de Péréquation would not help mitigate these horizontal imbalances because it is limited to investment financing in its foreseen format.

- Mechanisms for fiscal policy coordination and control remain undefined, which is a critical concern in a system with a highly fragmented economic policy management framework. Key responsibilities are divided between the Ministries of Finance, Budget, and Planning, with none of them having sufficient oversight over subnational governments. Moreover, the absence of clearly defined taxing powers for subnational governments also weakens an important accountability mechanism in the conduct of fiscal policy at the subnational level.

Against this background, World Bank and IMF staff have emphasized the merits of a gradual approach to fiscal decentralization. Revenue transfers to the provinces should be increased only gradually and in line with the devolution of expenditure responsibilities. Expenditure responsibilities, in turn, should go hand in hand with progress in building provincial capacity.

Most important, the pace of revenue and expenditure devolution should depend on progress in public financial management (PFM) reforms. World Bank and IMF staff called for transitional arrangements that would make the establishment of certain institutions and the transfer of spending responsibilities contingent on administrative capacity. Such arrangements could help avoid a situation in which newly created institutions at the level of provinces and ETDs would be required to fulfill their legally established duties without a clearly defined resource envelope and while lacking the capacity to perform the functions transferred to them. IMF staff suggested that each line ministry develop medium-term sectoral transfer plans, to be accompanied by performance indicators that would trigger moving to the next stage.

The National Forum on Decentralization

Cognizant of the deficiencies of the constitutionally mandated approach to fiscal decentralization, the authorities, with broad donor support, organized in October 2007 a National Forum on Decentralization to develop recommendations with respect to several aspects of the decentralization process, including fiscal and human resources management. The forum concluded that the base for calculating the revenue transfer to provinces should be narrowly defined by excluding oil revenues, which accounted for 20 percent of total revenues (excluding grants) in 2007. This narrow definition would help contain the risk of vertical imbalances by reducing the gap between the supplementary revenue transferred to provinces and expenditure devolution.

The formula would also go a long way toward mitigating horizontal imbalances. The forum advocated dividing domestic non-oil revenues into two categories:

- **Category A revenues**: 40 percent of all nontax revenue and revenue collected by the tax collection agency (DGI) minus revenues collected by the large-taxpayer unit would be automatically transferred to the provinces in which these revenues were collected.

- **Category B revenues**: 40 percent of all customs duties, excise taxes, and revenues collected by the large-taxpayer unit would be distributed to the provinces based on population.

The distribution mechanism for category B revenues denotes a significant horizontal redistribution, with the share of the three richest provinces in total revenue transfers declining to 41 percent from the 92 percent it would have been under the constitutional scenario. Still, this mechanism may
not be capable under all circumstances of providing sufficient resources to the poorest provinces to cover wages and goods and services for the responsibilities transferred to them (primary and secondary education, health, and agricultural services). Simulations prepared by World Bank staff suggest that the coverage of current spending in the poorest provinces crucially hinges on wage policy assumptions and the provinces’ capacity to generate own-revenues.

**The 2008 Decentralization Legislation**

Three laws promulgated in October 2008 contribute little to clarifying the fiscal relationship between the central and the provincial governments. These laws specify the legislative powers and the organization and functioning of public administration at the level of the provinces and the ETDs. However, they leave the methodology for implementing the constitutionally mandated revenue-sharing mechanism undefined; and instead of providing for a more-precise delineation of expenditure assignments in areas with competing competencies, these laws repeat the definitions in the constitution. Fiscal aspects of the decentralization process are now supposed to be regulated in a new organic public finance law (discussed in the last section of this chapter).

The decentralization legislation does, however, deviate from the consensus reached at the National Forum on Decentralization with respect to a key element. Art. 55.3 of the Loi sur la libre administration des provinces stipulates that all revenues, including oil revenues, are part of the base for calculating the revenue transfer to the provinces, thereby compounding vertical fiscal imbalances. It is unclear whether there is scope for the organic public finance law to reverse this stipulation, at least on a transitory basis.\(^7\)

\(^6\)The decentralization legislation consists of the following three laws: (1) Loi sur la libre administration des provinces [Law on the Autonomous Administration of Provinces]; (2) Loi sur les Entités Territoriales Décentralisées [Law on Decentralized Territorial Entities]; and (3) Loi sur la Conférence des Gouverneurs de province [Law on the Conference of Provincial Governors].

\(^7\)A transitory clause on the exclusion of oil revenues could be justified on the basis that it will take a few years to establish the necessary administrative capacity in the provinces to manage the new resources efficiently.

**Current Transitional Arrangements**

In the absence of a new organic public finance law, the 2009 budget reflects an ad hoc approach to fiscal decentralization. In compliance with Art. 55.3 of the Loi sur la libre administration des provinces, the 2009 budget provides for the transfer of 40 percent of all domestic revenue—including oil revenue—to the provinces. The transfers to the provinces (rétrocession) have been divided into three components:

- **Wage bill of public services transferred to the provinces.** Payments for this component (36 percent of the total rétrocession in the 2009 budget) continue to be executed, as under the 2008 budget, by the central government on behalf of the provinces. This reflects a consensus that provincial capacity is still insufficient for carrying out timely wage payments on a large scale.

- **Transfer for provincial spending on goods and services.** These are the only actual non-earmarked transfers to provinces in 2009, amounting to 28 percent of the total rétrocession to provinces.

- **Public investment in the provinces.** Resources corresponding to this component (36 percent of the total rétrocession) are not being transferred to the provinces. The government stated that it envisages managing these resources jointly with the provinces, but discussions on the definition of comanagement are ongoing. Although some share of the contracting and implementation is supposed to be carried out at the provincial level, contracts that would have economies of scale would be handled by the central government. This approach raises a number of issues. Although the continued management of the wage bill of transferred public services reflects a consensus with the provincial governments, the withholding of the investment component constitutes a new earmarked portion of the rétrocession that is not provided for in the legislative framework. In fact, this approach has been criticized for being contradictory to the constitution and the Loi sur la libre administration des provinces, which provide for a clear
separation of the public finances of the provinces from those of the central government. Earmarking 36 percent of the total rétrocession for investment is also problematic because it prevents the provinces from freely choosing the ratio of investment to goods and services that they consider most beneficial. Moreover, this approach raises the question of whether the central government might avail itself of a part of this resource envelope to finance its own expenditures—a risk that may increase with weakening revenue performance in the context of a deteriorating global environment.

Ensuring the timeliness and predictability of transfers will be important. Although an accord had been reached between the provinces and the central government in July 2008 on the modalities for transferring the rétrocession, the center has not adhered to it and actual monthly transfers fell short of the agreed amounts. To instill confidence in the decentralization framework and allow for predictability of the resource envelope available to the provinces, adhering to the rules will be crucial.

Work on necessary interim solutions for provincial public financial management and personnel management is still ongoing. To bridge the gap until the approval of the new organic public finance law and the law on civil service in the provinces, five decrees were drafted in August 2008. These decrees provide for the establishment of minimum requirements with respect to an orderly budget execution, including through the introduction of an expenditure chain in provincial governments. Moreover, they aim at clarifying the reassignment of civil servants working for transferred public services to provincial governments. However, these decrees had not yet been implemented as of mid-2009. The reassignment of civil servants to the provinces is also complicated by the fact that the census of teachers and health sector employees has not been finalized. On the positive side, the responsible line ministries and the Ministries of Budget and Decentralization recently agreed on a road map for decentralization in health, education, and agriculture, which takes into account stages of capacity building.

The Key Role of the New Organic Public Finance Law

The new organic public finance law will be crucial for containing vertical and horizontal fiscal imbalances. Following several months of preparation involving technical assistance from World Bank–financed consultants, the draft organic public finance law was scheduled to be discussed by the government in April 2009, together with the accompanying draft law on the public finances of the provinces and the ETs. It is essential that the organic public finance law establish clear regulations for the revenue-sharing mechanism, preferably excluding oil revenues, and the allocation of expenditure responsibilities.

The new law will need to ensure appropriate budgetary control. The central government must firmly manage provincial spending by enforcing budget monitoring and reporting mechanisms, including expenditure procedures to be used at the subnational levels, particularly with respect to internal and external financial control. Successful execution of this task will require giving the Ministry of Finance an explicit role in regulating, coordinating, and supervising local government finances. Mechanisms for sanctioning provinces that do not comply must be included, preferably in the form of withholding future rétrocession.

The new law should also regulate provincial borrowing. IMF staff have suggested direct controls on borrowing, including annual ceilings on debt flows and the overall debt stock of provinces as well as central government review and authorization of individual borrowing operations. Limiting provincial borrowing to the level of public investment will not be sufficient to prevent a rapid and unsustainable accumulation of debt. The law should also specify that provinces and local authorities are

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8The 2008 budget law reflected the consensus reached during the National Forum on Decentralization with respect to the determination of the revenue base and the revenue distribution formula. However, in the actual budget execution, particularly in the first half of the year, rétrocession payments fell well short of the amounts that would have resulted from a strict application of the distribution formula.

9This covers a portion of employees of other deconcentrated services, in addition to civil servants working for transferred public services (primary and secondary education, health sector, and agricultural services).
not allowed to borrow from the central bank, and
should prohibit the use of shared revenue to col-
lateralize subnational borrowing.

In a similar vein, tax assignments and responsi-
bilities for revenue collection will require further
clarification. The central government should
remain in control of major taxes and customs. At
the same time, the administration of all national
domestic taxes (both direct and indirect taxes), as
well as customs duties, should remain the respon-
sibility of the central tax administration. In the
medium term, building local-government abil-
ity to collect own-taxes and to reinforce budget
preparation and execution will be critical, as will
be strengthening treasury management and the
accounting framework.
Indonesia is often cited as an example of a “big-bang” approach to fiscal decentralization. Until the late 1990s, Indonesia’s decentralization efforts had proved timid, with deconcentration of service delivery to regional governments in the 1980s and 1990s being used to address dissatisfaction with lack of control over the allocation of public expenditures, especially in natural resource-rich regions. With the 1997–98 economic and political crisis, demands for increased regional autonomy and the need to stem deep political turmoil added urgency to the decentralization agenda, leading to more-rapid attempts at decentralization. Separatist movements gained strength again, particularly in resource-rich regions such as Aceh, which had felt deprived of their natural resources by the central government.

Responding to these pressures, the government quickly drafted and enacted the basic legal framework for decentralization during 1999–2001. This was an ambitious plan to hold together a country with more than 200 million people (the fourth most populous in the world), speaking more than 200 languages, and comprising in excess of 17,000 islands. Extensive technical assistance from both the IMF and the World Bank stressed the importance of moving carefully on the proposed decentralization agenda. Several missions were fielded during this period (and advisors were posted at the Ministry of Finance) to provide advice on the key dimensions of the envisioned reforms, including on the specific services to be devolved to local government; design of own-taxes, revenue-sharing, and equalization transfers; and subnational borrowing. Appropriate sequencing of expenditure and revenue assignments, coupled with accountability mechanisms, was seen as crucial to minimizing possible risks from a hastened decentralization process.

Despite the call for cautious implementation, a major decentralization reform began in January 2001. All public services except those explicitly expected to be carried out by the central government were delegated to subnational governments. The framework also led to a sharp increase in transfers to subnational governments, and gave regional governments more scope for own-revenue collection. Since then, subnational governments have enjoyed almost complete authority over the spending of their fiscal resources. Subnationals now manage nearly 33 percent of total public expenditures (Table 8.2) and carry out about 50 percent of development expenditure.

Initial implementation surpassed expectations, and no substantial disruption of public services occurred. By the end of the first year, over 16,000 public service facilities had been transferred to the regions, along with responsibility for about 2 million civil servants. Regional spending doubled from the previous year. The effects of the reforms can be seen in the significantly increased transfers to subnational governments, from 1.5 percent of GDP before the reform (FY1999/2000) to a peak of 6.8 percent of GDP in 2006.

Table 8.1. Indonesia: Indicators of Fiscal Decentralization

<table>
<thead>
<tr>
<th>Type of government</th>
<th>Unitary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population (million, 2007)</td>
<td>231.6</td>
</tr>
<tr>
<td>Area (million km²)</td>
<td>1.9</td>
</tr>
<tr>
<td>Levels of government</td>
<td>3</td>
</tr>
<tr>
<td>Provinces (including special regions)</td>
<td>33</td>
</tr>
<tr>
<td>Districts (regencies and cities)</td>
<td>510</td>
</tr>
<tr>
<td>Average district size (population)</td>
<td>498,153</td>
</tr>
<tr>
<td>Minimum district size (population)</td>
<td>14,065</td>
</tr>
</tbody>
</table>


Source: Authors.

1Following independence in 1945, decentralization attempts dating to the early days of the Republic were offset by the center’s reluctance to grant significant autonomy to the regions. Legislation was first passed in 1957 to revitalize regional autonomy but was stopped after regional unrest in Sumatra and West Java. A new law in 1974 attempting to revamp the process was never implemented because of concerns about the administrative capacity of regional governments.

2This could have also been the result of the “hold-harmless” policy (stipulating that the regions will not receive lower transfers...
Since the 2001 reform, the number of subnational governments has increased. Currently, Indonesia comprises 33 provinces (provinsi), including special status regions (Nanggroe Aceh Darussalam, Papua, and West Papua), Yogyakarta Special Region (DIY Yogyakarta), and Jakarta Special Capital Region (DKI Jakarta); and 510 cities (kotapodya) and regencies (kabupaten), including six within the capital Jakarta. These compare with 27 provinces and fewer than 300 districts before the reform.

**IMF Advice on Fiscal Decentralization**

In the early stages of the government reform, IMF staff advice focused on proper and gradual sequencing of decentralization. A December 1998 staff mission first assessed plans for a law on decentralization, also covering services to be devolved. At that early stage of the debate, the staff team noted its fundamental concern with the revenue-sharing arrangements—at that point there was no agreement on the specific services to be devolved, taxes to be assigned, or borrowing arrangements; analysis of distributional effects across local governments was lacking, as were estimates of the transitional costs; and no detailed plans for the transition had been laid out. Given the political pressures to move forward, the mission recommended that legislation be limited to broad principles, without including a specific blueprint for implementation.

Political realities, however, dictated a fast-tracked decentralization, and two decentralization laws were quickly drafted. The Law on Regional Governance, under the authority of the Ministry of Home Affairs (MoHA), focused on enhanced administrative and political decentralization and included the only references to the devolution of expenditure responsibilities. Meanwhile, the Law on Fiscal Balance, being drafted by the Ministry of Finance (MoF), governed the distribution of resources across regions. Two separate ministries were drafting these laws under a very tight timetable resulting in the emergence of some inconsistencies. A second staff mission in early 1999 provided advice on the legal framework for decentralization, recommending that expenditure assignments should follow local capacity; transfers of resources should follow those of expenditures; and decentralization itself should be fiscally neutral. It also strongly encouraged the authorities to coordinate closely the political and institutional legislation being prepared by the MoHA and the MoF.

In line with the authorities’ plan to move expeditiously, both decentralization laws were approved by Parliament in May 1999. In addition, a new Regional Taxation Law (Law 34) was adopted in 2000, allowing local governments to introduce new taxes.

### Expenditure Assignments

The Law on Regional Governance broadly defines assignments for different levels of government. First, the law drastically rebalanced power in Indonesia by breaking the hierarchical relationship between provincial and local governments; both levels now have the same direct hierarchical relationship with the central government. All public services were delegated to districts, except those expenditures explicitly reserved for the central government, including, among others, international policies, defense and security, judiciary, and monetary and fiscal policy. Districts were given responsibility for key public services such as public works, health, education, agriculture, and local infrastructure; and provinces were made responsible for the provision of services.

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**Table 8.2. Indonesia: Summary of Subnational Governments’ Finances, 2006**

<table>
<thead>
<tr>
<th></th>
<th>Percentage of general government</th>
<th>Percentage of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total subnational revenue</td>
<td>40.3</td>
<td>8.2</td>
</tr>
<tr>
<td>Own-source revenue</td>
<td>3.6</td>
<td>0.7</td>
</tr>
<tr>
<td>Transfers from the central government</td>
<td>33.3</td>
<td>6.8</td>
</tr>
<tr>
<td>Total subnational expenditure</td>
<td>34.5</td>
<td>6.9</td>
</tr>
<tr>
<td>Overall balance (before transfers)</td>
<td>n.a.</td>
<td>–5.5</td>
</tr>
<tr>
<td>Overall balance</td>
<td>n.a.</td>
<td>1.3</td>
</tr>
</tbody>
</table>

**Sources:** Data provided by the authorities; and authors’ calculations.

**Note:** n.a. = Not applicable.

1 Transfers include shared revenue.

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spanning districts, and held as a fallback if a district could not perform an assigned function.

Staff advised that the actual transfer of responsibilities be linked to the institutional capacities of the local governments to take on those new responsibilities. They also recommended that the devolution of expenditure to local governments be underpinned by a strengthening of budgeting, monitoring, and auditing arrangements at the local level to improve transparency and avoid misuse of public funds.

**Revenue Arrangements**

The scope for own-revenue collection expanded greatly with the 2000 Regional Taxation Law. Regional governments can add taxes through regulations approved by regional parliaments, without central government approval, as long as they abide by certain criteria: new regional taxes should not conflict with public interests, and their bases should not be subject to tax by the center. The central government has the authority to annul regional taxes breaching these criteria. However, local tax assignments remain inadequate, without major sources of own-revenues. In 1999, staff had strongly (but unsuccessfully) advised that the land and building tax, collected by the central government and shared with regions, be assigned to the local level, to provide the localities with a degree of own-revenue-raising responsibility.

The importance of revenue-sharing arrangements significantly increased with decentralization. The Shared Revenue Fund (DBH) is split into two parts, the Tax DBH and the Natural Resources DBH. The former includes income tax (20 percent), land and building taxes, and taxes on land and building transfers (80–90 percent). The Natural Resources DBH includes revenues collected by the central government based on natural resources (e.g., oil, gas, forestry, fishery, and mining), and is shared with subnational governments according to specified rates. The sharing formulae include some elements of redistribution, but not enough to affect the overall unequalizing impact of the system.

These arrangements, made after intense negotiations between the center and local governments, led to several weaknesses in the decentralization framework. Staff had advised against sharing oil and gas revenues on an origin basis because it would exacerbate inequalities in regional revenue capacities (three provinces got about 80 percent of the total local share). In addition, highly volatile prices and output would complicate the local governments’ budgeting of shared resources.

**Intergovernmental Grants**

The system of grants was radically reformed with the 2001 decentralization. A General Allocation Fund (Dana Alokasi Umum, or DAU) was created as the cornerstone of the intergovernmental fiscal system. The grant constituted over 60 percent of all central transfers to regions; it replaced the system of transfers to regions composed of the Subsidy for Autonomous Regions and Presidential Instruction Grants for sectoral expenditure that existed before 2001. The law required the central government to transfer to the subnational level a minimum of 25 percent of central government revenues after tax sharing and minus energy subsidies. Regencies and cities received 90 percent of the DAU pool, with the provinces receiving the remaining 10 percent. The DAU allocation to individual provinces and local governments is, in principle, determined by formulae (separate ones for local governments and provinces). Several transitional elements were added to the DAU distribution in addition to the formula, including a base amount, used as a floor, and a contingency allocation to protect regions receiving lower funds than needed.

A special allocation grant (DAK) was established for earmarked transfers. The law states that DAK

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6“Tobacco yield excises” are also shared with tobacco-producing regions (2 percent), but the arrangement is designed as an earmarked grant.

5These rates vary from 15.5 percent of total collection for oil to 30.5 percent for gas revenues and 80 percent for general mining, and forestry and fishing. Special (higher) rates originally applied to resource-rich special autonomy regions; however, the peace deal with Aceh in 2005 gave Aceh virtually total control over all natural resource revenues.
can be used for special needs of the regions, including emergencies, and for financing central priorities at the regional level. It initially covered five types of grants (education, health, rural roads and irrigation, public administration infrastructure, and forestry). Regions are supposed to apply to the central government for the grant, with proposals that meet the allocation criteria. Although DAK-related amounts are nominally small, their share in total grants (excluding revenue-sharing) from the central government increased from about 1.5 percent in 2001 to 10.5 percent in 2009.7

Staff had advised extensively on the grant design. They recommended an equalization grant system based on relative expenditure needs and revenue capacities—as reflected in the Law on Fiscal Balance. Staff had also recommended that specific grants for sectors and projects be focused on areas for which minimum service standards are societally important. Nevertheless, their main advice against the floor on general allocation fund transfers, set at a minimum of 25 percent of net domestic revenues, was not included in the law.8 The staff’s advice reflected a concern that the floor could pose significant macrofiscal risks in the short run (by leading to a higher central government deficit) at a time when districts were not in a position to use transfers adequately. Despite some equalizing features of the intergovernmental fiscal transfers, regional inequalities had initially increased with decentralization. Wealthy regions were able to retain a high share of their natural resource revenue and were in a position to mobilize more own-resources. They also received higher general-purpose (DAU) transfers than implied by a formula based solely on a fiscal gap measure. As a result, inequality after transfers—as measured by the Gini coefficient—increased with decentralization (according to the World Bank Public Expenditure Review, 2007).

Public Financial Management Arrangements

Given Indonesia’s extensive countrywide network of treasury offices, staff advised the central government to offer to provide subnational governments with treasury services rather than leaving each province and district to set up its own arrangements for managing treasury operations. These services would include tax collection, payments, and accounting. In the end, the authorities opted for letting subnationals set up their own arrangements for budget and treasury management, despite staff’s position that strengthening public financial management should be a prerequisite for increasing decentralization. This is also one factor behind the difficulties with subnational reporting.

Some progress was made on subnational accounting. The MoHA drafted its own chart of accounts, which initially was different from the new chart being drafted for the central government. In line with staff advice, one single chart of accounts was eventually adopted (the two separate charts were merged, facilitating fiscal reporting according to a common format). However, it is unclear the extent to which common reporting formats have been adopted at the three levels of government.

Although the legal framework for fiscal decentralization covers local governments, its application remains largely limited to the central government. While the 2003 State Finances Law and the 2004 Treasury Law cover subnational governments, as do the 2007 Cash Management Regulations, in practice, these are observed only by the central government. The same applies to the 2004 Planning Law and the 2007 External Audit Laws. For external audit—important for accountability—only about 60 percent of subnational government accounts are audited regularly (World Bank, 2007).

The fiscal balance and debt rules for general government are not monitored regularly. Two fiscal rules (capping the deficit at 3 percent of GDP; and

6The number of sectors funded has varied over the years, depending on the central government priorities (for example, the 2009 budget includes 13 sectors).

7The central government also allocates deconcentration and coadministration funds to regions, funded from the central budget. Deconcentration funds are handed out to governors as representatives of the central government’s line ministries in the regions; coadministration funds are disbursed to regional governments or village administrations. The combined amount of these funds is far greater than DAK transfers. In principle, Article 108 of Law No. 33/2004 states that deconcentration and coadministration funds (which have objectives similar to those of DAK) are to be transferred in stages to DAK in the future.

8The provision was actually removed by the executive but reintroduced by Parliament.
the gross debt at 60 percent of GDP) were adopted, as per the Fiscal Balance Law 33/2003. However, irregular reporting by subnationals on their fiscal balances and the unavailability of comprehensive data for subnational debt make it impossible for the central government to monitor compliance with the debt rule, and the deficit rule is monitored with an excessively long lag.

Regional Borrowing

Both the Law on Regional Governance and the Law on Fiscal Balance allowed regional governments to borrow. External borrowing is limited to onlending from the central government. Rules-based controls for domestic borrowing mandated that the total stock of debt not exceed 75 percent of a region’s total receipts in the previous year’s state budget. The law also states that long-term loans can only be incurred for income-generating projects. The central government can withhold DAU transfers (and the shared DBH) if a region fails to meet its debt obligations to the central government. These provisions were largely in line with staff advice from the 1999 mission.

An Assessment of Recent Reforms and Remaining Challenges

Local governments have witnessed a surge in revenue transfers from the central government, but have struggled to increase spending rapidly enough to meet large social needs. Because oil and gas revenue are shared with local governments, transfers to the regions grew threefold from 2002 to 2008. These increased transfers, combined with increases in deconcentrated central government spending, a lack of clear delineation of spending authority between the levels of government, weak budgeting capacity of local governments, and a fear of corruption investigations, caused underinvestment and underspending to occur in many local governments. Nonetheless, subnational government spending continues to account for about one-third of public spending.

Subnational governments have been building up large fiscal surpluses. As a result, sizable regional government deposits have accumulated, although this trend slowed somewhat in 2007 and deposit accumulation remained low in 2008 (the stock at end-2008 was estimated to be about 0.2 percent of GDP, possibly suggesting improvements in budget implementation). However, significant differences exist among districts, with a few resource-rich districts accounting for most of the accumulated deposits.

Subnational government debt remains small. However, given the lack of adequate mechanisms for coordinated fiscal and cash management, the large bank account balances of subnational governments have complicated the conduct of monetary policy for the Bank of Indonesia, especially given that regional governments or provincial banks purchase short-term Bank of Indonesia securities.

A number of changes to the system of intergovernmental fiscal relations were introduced in 2008–09.

- The need to increase the taxing power of regions has been recognized, including in ongoing discussions on a draft law on Regional Tax and Retribution. Some new taxes are proposed to be added, encouraging regions to set higher and progressive taxes on motor vehicles and introduce other related charges. Although the land and building taxes (earlier recommended by staff, as explained above) are not mentioned, the 2009 budget still recognizes the decentralization of these taxes as a future priority.
- Starting in 2009 (according to an earlier-envisioned provision), if the Indonesian crude oil price exceeds 130 percent of the price assumed in the budget, the additional revenue from oil and gas

According to the 2009 budget, outstanding loans of regional governments at end-2007 (onlent foreign loans and domestic loans from the central government) amounted to 0.02 percent of GDP.

The decentralization laws were revised in 2004. Major changes included an increase in the share of oil and gas receipts to the regions by 0.5 percentage point by 2008, with the funds earmarked for education spending; “excess revenue” being kept with the center when oil prices rise by more than 30 percent above the budget price; basic grant allocation no longer being a minimum amount, and reduced by the extent to which fiscal revenue-generation capacities exceed fiscal needs (based on formulae); and reporting by regions of their borrowing and debt positions to the center twice a year under the threat of delayed transfer payments.
will be shared with regions as additional DAU on the basis of fiscal gap considerations.

- DAU allocation policies have changed significantly, and are now fully based on (1) a “basic allocation,” computed based on total salary of regional civil servants; and (2) the “fiscal gap,” defined as the difference between fiscal needs and fiscal capacity (both calculated based on specified parameters).

- The definition of net domestic revenue (26 percent of which funds the DAU) was changed; it now excludes subsidies (including for fuel), with the objective of sharing subsidy costs among levels of government. The introduction of this “burden-sharing” policy means that the total DAU pool in 2009 barely increased.

- Finally, the proportion of the basic allocation in the DAU formula is to be reduced every year, so that the fiscal gap will become increasingly relevant; and the DAU is to be based over time on standardized spending needs indicators. The phasing out of the hold-harmless provision should help reduce inequalities and make the transfer system more equalizing.

Despite these improvements, weak fiscal reporting capacity at the subnational level continues to limit fiscal policy management and coordination. Regional governments are required by law to regularly submit their budgets and to report on budget execution to the central government, but long delays occur—sometimes as long as two years on the execution side—and make it difficult to regularly monitor local governments’ financial operations. Therefore, fiscal policy is conducted on the basis of the central government balance. Although regular monitoring of the local governments’ fiscal stance is still feasible through examination of changes in regional government deposits held at commercial banks (the main source of financing for subnational governments), data have proved more difficult to compile than initially expected.

More generally—and as highlighted by a 2007 staff mission—fiscal risks could arise from subnational governments in the future (Davis and others, 2007). Although immediate risks to the central government budget appear limited, they could rise over time as a result of (1) insufficient coverage of the government sector, which can distort the assessment of the fiscal stance; (2) a weak decentralization framework with limited information systems in place; and (3) high dependence of local governments on potentially volatile transfers. This volatility is to be somewhat moderated by the implementation of the new formula for calculating DAU transfers, which excludes fuel subsidies from the calculation base.

On the positive side, legal limits exist on domestic borrowing by the regions, provided the relevant information for their enforcement is readily available. As indicated above, reporting and monitoring are still issues; the 2009 budget mentions steps that the government is taking to strengthen sanctions for violating regional loan provisions, as well as to improve coordination in planning, evaluating, and monitoring regional loans. These are welcome steps, although additional progress is warranted to ensure sound fiscal policy design and implementation at the general government level.

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11Submission of local government budgets to the MoF significantly improved starting with the 2008 budget, particularly as a result of the introduction of sanctions (delaying DAU and DAK transfers); by end-February 2007, 46 percent of local governments had submitted their 2007 budgets to the MoF. For the 2008 budget, that proportion had reached 82 percent by end-February. In 2009, three local governments were penalized, down from five in 2008 (out of 510 districts).

12A mission from the IMF Statistics Department in April 2009 found that work had progressed on the pilot test of the Local Government Finance and Governance Reform project—implementing systems to improve the timeliness and quality of subnational fiscal data—but that there was likely to be a long lag before complete data become available for all local governments. Accordingly, the mission recommended that a simple, but robust, sample expansion approach be adopted to estimate data for the local government subsector.

13The issue of weak and untimely reporting and its possible implications also featured prominently in the 2006 ROSC Report on Fiscal Transparency (IMF, 2006).

14Based on the new transfer formula, the share of transfers to GDP is expected to decline in 2010, and over time, to about 5 percent of GDP.
Fiscal decentralization in Kosovo has been, and remains, a political priority. Inspired by the Comprehensive Settlement Proposal (CSP), a significant body of legislation was enacted in 2008 to grant municipalities wide-ranging autonomy on a number of issues, while allowing Serb-majority municipalities a high degree of control over their own affairs through asymmetric arrangements. In addition to the constitution (which defines municipalities as the basic territorial unit of local self-governance in Kosovo), relevant legislation includes the Law on Local Self-Government, the Law on Local Government Finance (LLGF), amendments to the Law on Public Financial Management and Accountability, the Law on Administrative Municipal Boundaries, and amendments to the Law on Health and the Law on Education (Box 9.1).

Also politically motivated, the territorial reorganization of municipalities has proceeded quickly. As of end-2009, there were 36 municipalities, with two additional possibly coming on stream in the future. Municipal elections for municipal assemblies and mayors were held in the 36 municipalities in November 2009, but were boycotted in three of the existing Kosovo–Serb-majority municipalities in the north of Kosovo.

The move toward greater decentralization has coincided with increasing macrofiscal pressures. Growth stagnated in 2009, and fiscal imbalances grew. After recording a surplus in 2007 amounting to 7 percent of GDP, the general government budget posted a deficit of almost 2 percent of GDP in 2009. The deterioration in the general government balance was mainly caused by rapidly escalating capital expenditures, which increased from 3 percent of GDP in 2007 to 9.2 percent of GDP in 2009, partly financed by a drawdown in the stock of government bank deposits. In this respect, Kosovo appears to be an outlier compared with other countries in the region, where the level of capital spending is on average 5.5 percent of GDP.

Increased financing to municipalities has led to a sharp increase in their spending at a time when serious fiscal pressures have emerged. Because municipalities cannot borrow, they need to balance their budgets. However, during 2007–09 municipal expenditures rose by almost 2 percent of GDP, to above 5 percent of GDP (Table 9.2), reflecting an increase of over 50 percent in central transfers resulting from a change in the grant formula mandated in the 2008 Law on Local Government Finacing. A fiscal rule limits the annual growth of current spending for municipalities and other budget organizations, so additional funding has been channeled toward capital projects; these pres-

Table 9.1. Kosovo: Indicators of Fiscal Decentralization

<table>
<thead>
<tr>
<th>Type of government</th>
<th>Unitary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population (million, 2007)</td>
<td>2.2</td>
</tr>
<tr>
<td>Area (thousand km²)</td>
<td>10.9</td>
</tr>
<tr>
<td>Levels of government</td>
<td>2</td>
</tr>
<tr>
<td>States or provinces</td>
<td>None</td>
</tr>
<tr>
<td>Municipalities</td>
<td>33</td>
</tr>
<tr>
<td>Average municipality size (population)</td>
<td>67,758</td>
</tr>
<tr>
<td>Minimum municipality size (population)</td>
<td>5,000</td>
</tr>
<tr>
<td>IMF technical assistance missions on fiscal decentralization</td>
<td>2007, 2010</td>
</tr>
</tbody>
</table>

Source: Authors.

1 This case study is based on Fedelino and others (2007); and Olden (2009).
2 Since the end of the conflict in 1999, various attempts have been made to secure agreement with Serbia. While the “Comprehensive Proposal for the Kosovo Status Settlement” (presented to the United Nations Security Council by Special Envoy Marti Ahtisaari in March 2007) failed to gain consensus and was subsequently withdrawn as a result of a veto threat by the Russian Federation in the summer of 2007, it has remained the linchpin of Kosovo’s political strategy. The Kosovo government unilaterally declared independence in February 2008.
3 The population density by municipality varies significantly; according to estimates, the largest municipality (the capital Pristina, with an estimated population of at least 400,000) would outnumber the smallest municipality (the Serb-majority Novo Brdo, with a population of 5,000) by a factor of 80.
4 Excluding a sizable one-off dividend payment from the telecommunications company equivalent to 5 percent of GDP, the underlying increase in the deficit was significantly larger.
sure were likely compounded by the political cycle in 2009. Thus, decentralization is creating tension between the need to ensure fiscal discipline and the demands for greater autonomy of subnational governments.

Fiscal decentralization will need to be balanced against the need to restore medium-term fiscal sustainability. Further reforms in the system of intergovernmental fiscal relations can actually provide an opportunity to make all government levels—the center and the municipalities—more fiscally responsible while more-efficiently promoting growth and development. Further reforms can also prevent the burden of needed future adjustments from falling disproportionately on the central government.

Technical assistance on fiscal decentralization was provided by the IMF in the run-up to Kosovo’s unilateral declaration of independence in early 2008, and again in early 2010. An initial staff visit in the summer of 2007 took stock of the current challenges and provided advice on the overall framework for decentralization. This visit was followed by a full-fledged technical assistance mission in the fall of 2007. Partly emanating from the work of that mission and its recommendations, a short-term expert visited Kosovo in early 2008 to help draft the law on municipal finance. A number of actively involved international agencies, most notably the World Bank, the European Union, and U.S. Agency for International Development, have collaborated closely with the IMF on these issues. A second IMF mission in early 2010 took stock of progress on decentralization, and provided advice on future reforms.

**Overall Framework of the IMF’s Advice**

**Addressing Spending Pressures**

The transfer and assignment of new competencies to municipalities, as defined in the Law on Local Self-Government, proceeded rapidly. In early 2010, only a few own-competencies remained to be transferred, although progress remained to be made on “delegated” competencies. The transfer of “enhanced” competencies to the Serbian-majority municipalities—in particular, higher education and secondary health care—will proceed once political impediments are resolved. Although it is too early for a comprehensive assessment of the uptake of responsibilities by municipalities, it would nonetheless seem that in some cases the assignment of new responsibilities has proceeded too fast, without (1) due consideration for the public financial management capacity of municipalities, (2) an assessment of the need for qualified staff (a need that clashes with the existing hiring freeze), and (3) an accurate evaluation of the cost of the new functions.

With the expansion of municipal competencies, a fundamental tension is emerging. On the one hand, municipalities perceive that the central government is interfering excessively in areas where the Law on Local Self-Government assigns them clear and exclusive responsibilities. For example, budget allocations to central ministries for financing or cofinancing of projects in the area of municipal

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**Table 9.2. Kosovo: Summary of Subnational Governments’ Finances, 2008**

<table>
<thead>
<tr>
<th></th>
<th>Percentage of general government</th>
<th>Percentage of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total subnational revenue</td>
<td>22.6</td>
<td>6.7</td>
</tr>
<tr>
<td>Own-source revenue</td>
<td>3.7</td>
<td>1.1</td>
</tr>
<tr>
<td>Transfers from the central government</td>
<td>18.9</td>
<td>5.6</td>
</tr>
<tr>
<td>General grant</td>
<td>7.4</td>
<td>2.2</td>
</tr>
<tr>
<td>Health grant</td>
<td>2.2</td>
<td>0.7</td>
</tr>
<tr>
<td>Education grant</td>
<td>9.3</td>
<td>2.8</td>
</tr>
<tr>
<td>Total subnational expenditure</td>
<td>21.8</td>
<td>6.8</td>
</tr>
<tr>
<td>Wages and salaries</td>
<td>10.8</td>
<td>3.4</td>
</tr>
<tr>
<td>Goods and services</td>
<td>2.1</td>
<td>0.7</td>
</tr>
<tr>
<td>Subsidies and transfers</td>
<td>0.5</td>
<td>0.2</td>
</tr>
<tr>
<td>Capital</td>
<td>7.7</td>
<td>2.4</td>
</tr>
<tr>
<td>Overall balance (before transfers)</td>
<td>n.a.</td>
<td>–5.7</td>
</tr>
<tr>
<td>Overall primary balance</td>
<td>n.a.</td>
<td>–0.2</td>
</tr>
</tbody>
</table>

Sources: Kosovo authorities; and authors’ calculations.

Note: n.a. = Not applicable.

5The Law on Local Self-Government uses the following definitions (Article 3): “own competencies are competencies vested upon the municipalities by the Constitution or laws for which they are fully responsible insofar as they concern the local interest and in accordance with the law; delegated competencies are competencies of the central government and other central institutions, the execution of which is temporarily assigned by law to municipalities; and enhanced competencies are competencies vested upon a municipality or a number of municipalities by law.”
Box 9.1. The Comprehensive Settlement Proposal and Kosovo’s Legislation on Municipalities

The principles set out in the CSP on municipal roles and responsibilities have been mapped in a significant body of legislation enacted during 2008.

**Municipal competencies (Law on Local Self-Government)**

- All municipalities will have responsibility for areas affecting the daily life of Kosovo citizens, including education at the preprimary, primary, and secondary levels; public primary health care; local economic development; urban and rural planning; public housing; naming of roads, streets, and other public places; and the provision of public services and utilities, among others.
- In addition, designated Kosovo Serb municipalities will have the following enhanced responsibilities:
  - The Municipalities of Mitrovicë/Mitrovica—North, Graçanicë/Gracanica, and Shërpcë/Strpce will have authority over hospitals and the provision of secondary health care in their municipalities.
  - The Municipality of Mitrovicë/Mitrovica—North will have certain responsibilities with regard to the Serbian language university of Mitrovicë/Mitrovica.
  - All Kosovo Serb municipalities will be responsible for the protection and promotion of cultural and religious affairs at the local level.
  - AllSerb municipalities will have an enhanced role in appointing local Police Station Commanders.

**Municipal finances (Law on Local Government Finance)**

- All municipalities will be responsible for their own budgets and are entitled to their own financial resources.

- A fair and transparent block grant system will be established, ensuring greater municipal autonomy in the allocation and expenditure of central funds.

**The establishment of new municipalities (Law on Administrative Municipal Boundaries)**

- The CSP establishes six new or enhanced municipalities with Kosovo Serb majorities: Mitrovicë/Mitrovica—North; Graçanicë/Gracanica; Ranilug/Ranilug; Partesh/Parteš; Klokot/Vërbcoc–Klokovë; and Novobërdë/Novo Brdo.
- The current municipality of Mitrovicë/Mitrovica will be split into the two municipalities of Mitrovicë/Mitrovica—North and Mitrovicë/Mitrovica—South, with cooperation and coordination between them facilitated through a newly established Joint Board.
- Additional municipalities for nonmajority communities may be established in consultation with the respective communities.
- The CSP provisions related to the establishment of new municipalities may be reviewed and revised as necessary by the International Civilian Representative after a census is conducted.

**Intermunicipal and cross-border cooperation (Law on Local Self-Government)**

- Municipalities will have the right to form associations and partnerships with other municipalities in Kosovo to carry out functions of mutual interest.
- Municipalities will have the right to cooperate with municipalities and institutions in Serbia, including the right to receive financial and technical assistance, within certain clear parameters set by the CSP.
The tension between central control and fiscal decentralization is most evident in the limit on municipal staff ceilings. A hiring freeze, applied to all government ministries and agencies, has been in place since 2006 to stem the growth in government spending. Municipalities seem to have broadly respected these ceilings, with overall employment levels averaging around 41,000. Although anecdotal evidence suggests that some municipalities have used the goods and services budget to hire extra staff, this does not seem to be a systemic issue. However, staff ceilings have not restrained wage spending—the central government’s decision to increase wages has resulted in increases in municipalities’ wage bills (because municipalities pay for the salaries of teachers and health personnel). In the future, these ceilings could prove to be downwardly rigid. Staff levels are inefficiently locked in by the backward-looking nature of the related ceilings, and municipalities are hampered in their efforts to attract new skills to carry out new competencies.

The new civil service legislation, to be implemented in 2011, will provide the appropriate framework to remove staff ceilings and address wage issues. A new single pay and grading structure for the civil service will allow rationalization of the status of current employees. Cost implications for the municipalities will arise from the elimination of current pay differences between staff employed in equivalent positions, temporary compensation for staff whose base salary would decline as a result of the grading reform, and salary decompression to increase the pay differentials among positions of different grades. Hiring of additional staff and salary increases should await implementation of the new civil service legislation.6

Strengthening Own-Source Revenues and Incentives to Raise Them

There is scope to strengthen municipal own-source revenue, particularly property taxes. Property tax collections are low (equivalent to less than 0.3 percent of GDP in 2009) reflecting both policy and administrative shortcomings. In 2009, the average municipal property tax collection rate was just 75 percent. However, a minority of municipalities achieved a 100 percent collection rate, while others had rates well below 50 percent. Individual municipalities have full discretion in determining the level of the tax, but rates tend to be at the lower end of the permissible range. Market valuations are also difficult to determine because of the limited number of property sales and insufficient zoning methods. IMF advice focused on the need to strengthen cadastral records, progressively increase property tax rates, and strengthen procedures to settle tax arrears.

Other municipal revenue handles could be more fully used. For example, motor vehicle registration charges could be increased and indexed to inflation. The administration of construction permits could be improved, especially given that Kosovo has been enjoying a construction boom. Most important, allowing more flexibility in the use of own-source revenue would provide the strongest incentive to boost collections.

Keeping the Transfer System Simple and Transparent

The current grant system, as defined in the 2008 LLGF, has a number of desirable features. It is simple, being composed of a closed-end general grant (defined as a 10 percent share of revenue) and two open-ended earmarked grants for health and education, allocated according to specific parameters.7 Given that population is the main parameter, grants provide significant equalization. Funding to municipalities through the grant system increased significantly in 2009—the first year of implementation—by 1.4 percent of GDP. The three grants accounted for one-fourth of central government revenue in 2009.8

7Under the previous system, total grants were capped at 22 percent of revenue. This no longer applies for health and education grants; for example, if the number of enrolled students (one of the variables used to compute the education grant) increases, there will be a corresponding increase in the relevant grant.
8The design of the grant system was also influenced by earlier IMF technical assistance.
Increased funding has generally preceded the actual transfer and assignment of municipal competencies established in the law. The spirit of the LLGF is that the general grant should cover municipal own-competencies; however, because the pool for the general grant was defined and assigned before the actual transfer of all municipal competencies, the central government is expected to continue to grant additional funds as the process of transferring competencies is completed. Indeed, the 2010 budget includes some specific grants. Although the amounts are small, this practice is setting a risky precedent:

- **It creates a perception of a soft budget constraint,** suggesting that every additional transfer of competency will be matched by an additional specific grant—thus creating expectations that current grant design is not sufficient to carry out mandates and weakening incentives to prioritize policies within a binding resource envelope.

- **It puts upward pressures on overall spending.** Ideally, for each competency transferred to municipalities, the relevant central ministry should be subject to a commensurate reduction in its budget allocation (not one for one, because some supervisory and administrative functions would need to be retained at the center). The 2010 budget contained no such reductions at the center.

- **It undermines the integrity of the grant system.** Adding specific discretionary grants, varying in nature and size every year, would only erode the simplicity and transparency of Kosovo’s grant system.

- **It weakens incentives to raise own-source revenue.** If specific grants are conceded every time municipalities need to undertake additional spending, own-source revenues will no longer be urgent.

While municipalities demand additional funds for additional functions, the central government appears in some cases to be passing down unfunded mandates. In 2009, after the amounts for the health and education grants had been determined, the central government decided to have municipalities partially absorb the cost of teachers’ salary increases through the general grant. Similarly, municipalities were asked over the course of the year to shoulder the cost of bonuses for health workers—which were genuinely additional costs that were not taken into consideration in the mid-year budget review. These central government decisions effectively reversed the unconditional character of the general grant guaranteed in the LLGF (since municipalities had to fund additional spending requests mandated by the central government).9

The lack of updated population data hampers the application of the grant system. Grants are largely based on per capita allocations, leading municipalities to resent the lack of updated records (the population census is scheduled for 2011).10 When census data become available, significant, abrupt changes in grants entitlements should be avoided. A hold-harmless provision should be included, ensuring that each municipality is provided at least the same nominal level of transfers as in the year preceding the reform.

The Grants Commission should serve as a vehicle to mediate municipal demands, but in its existing format it does not seem to be fulfilling its responsibilities. Its operations are not fully transparent (for example, there are no public records of commission deliberations and discussions; its meetings take place too infrequently to represent the “voice” of municipal representatives). IMF advice focused on strengthening the Grants Commission’s role by defining operational procedures for it to function in line with its mandate and by publishing information on its operations and deliberations on its website.

### Strengthening Public Financial Management Capacity

Municipalities are seeking to adapt their financial management capacities to the additional responsibilities associated with decentralization, requiring them to shift from the past environment, in which municipalities were treated as deconcentrated units of line ministries. While significant

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9These issues are further explored in Tomeynska (2009) and World Bank (forthcoming).

10An annex in the LLGF sets population levels by municipality; these levels are used for the allocation of grants. The levels are based largely on data from the last census, undertaken in 1991.
progress in planning, execution, and control of municipal budgets has been achieved in recent years, further improvements in public financial management are needed.

Budget formulation needs to be strengthened. Municipalities should be allowed greater input in the formulation of the Medium-Term Expenditure Framework. Municipal accounting could also be strengthened by promoting common use of the installed information management system, and by further development of internal control and audit. The recent decentralization of the payment system shows that with continued efforts and training, municipalities have the capacity to absorb new tasks.

Efforts should also focus on enhancing planning, and monitoring and evaluation of municipal capital projects, given the rapid increase of spending in this area and the continued perceived politicization of project selection. There is scope to increase the transparency of project allocations, both at the central and municipal levels. More-systematic and widespread use of the information technology application designed to manage the Public Investment Program would provide a tool to achieve better prioritization based on objective economic criteria, and would promote accountability through increased availability of information on government projects and better monitoring of those projects.

Remaining Challenges

Pending legislation on public debt will allow municipalities to borrow. The new Public Debt Law rightly imposes stringent conditions on the rights of municipalities to borrow and sets a limit on the stock of debt and associated debt service costs. It also requires municipalities to receive an unqualified audit opinion from the auditor general for the previous two years. Given the findings of the 2008 municipal audit reports (Pristina was the only municipality to gain such an opinion), this is likely to prove a considerable hurdle for the majority of municipalities in the short term and would suggest that significant borrowing will not take place in the immediate future. The law also imposes a ceiling on issuance of long- and short-term debt, equivalent to 40 percent of collected own-source revenue and general grants from the previous year. Based on the current size of these revenue streams, the impact of borrowing on the fiscal position is likely to be minor, at least initially.

A mechanism setting borrowing limits by municipality will need to be devised, to ensure that municipal borrowing does not exceed aggregate limits. This mechanism may require the imposition of nominal debt ceilings on individual municipalities, based on some equitable share of the overall limit. The Grants Commission could be the most appropriate vehicle to recommend municipal borrowing ceilings, provided its role is strengthened. The commission could also monitor municipal borrowing during the year and suggest amendments to allocations, if needed, at the mid-year budget review. The central government will also need to develop monitoring capacity to ensure that municipal debt is recorded and reported in a timely fashion. Procedures for reporting on new borrowing by municipalities, as envisaged in the Public Debt Law, will need to be established and enforced to ensure timely receipt of information.

The current fiscal rules for municipalities—limiting the growth of real current spending and imposing staff limits—have not proved to be the right policy instruments as decentralization deepens. Real current spending at the municipal level has, in fact, been growing well above the mandated rate of growth, largely reflecting central government decisions regarding salaries; although staff limits—a blunt instrument to limit municipal spending—have been adhered to, they have also created significant distortions (increasing capital spending at the margin, given the limits on current spending) and prevented efficient allocation of resources in line with municipalities’ requirements for a new skill mix. A contradiction is emerging between the spirit of fiscal decentralization—granting municipalities

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11At the time of writing, the draft Public Debt Law had been approved by the Kosovo Assembly and was awaiting the signature of the president.
12The new Public Debt Law limits municipalities’ total stock of debt to 40 percent of the previous year’s own-revenues and general grants from central government, and short-term debt to 5 percent of total collected revenues.
wide-ranging autonomy in a number of areas—and the central government’s focus on enacting controls on specific spending categories. Looking ahead, Kosovo’s dilemma is how to secure fiscal discipline in an increasingly decentralized framework. The 2010 mission recommended starting a policy discussion on designing an appropriate fiscal anchor that ensures responsible fiscal management for all government levels.

Finally, monitoring of municipal (and central) finances will need to be strengthened. As municipalities become more active fiscally, their impact on general government finances needs to be properly assessed. The basis for strong reporting is already present in Kosovo, but needs to be used to help the decision-making process and its implementation in a decentralized framework and to help build accountability and transparency over time.
Liberia has historically been a very centralized country. Political decision making was primarily concentrated in the capital Monrovia, creating a significantly skewed economic and political system that alienated much of the population in the outlying counties—one of the root causes of Liberia’s civil wars. Increased inclusion and participation by local communities has been viewed as key to sustaining peace and stability since the return to political normalcy in 2005. Accordingly, a move toward decentralized government is perceived as a way to reverse and safeguard against the past imbalances of centralized decision making.

Liberia is a unitary country with a complex structure of subnational administrations. Below the existing 15 counties, a multitude of districts, cities, townships, and towns exist, with no clearly defined responsibilities. The territorial division into counties plays a central role in the structure of the state and the organization of the legislature. The functions and competencies of all the various government entities are not clearly defined—the constitution is silent on their nature and purposes, although it does contain provisions on appointing or electing administrators (counties are the only subnational government entities mentioned in the constitution). Similarly, the relationships between different layers of local government remain unspecified. Traditional structures operate alongside modern administrative entities. Paramount, clan, and town chiefs are explicitly mentioned in the constitution as holding elected positions. The chiefs perform an essentially consultative role to the appointed officials at the county and district levels; they are also responsible for law and order under customary (traditional) law.

Some political players are advocating ambitious plans for fiscal decentralization. The Governance Commission (an independent advisory body appointed by the president) has prepared a draft “National Policy on Decentralization and Local Governance.” This document lays out a strategy for decentralization with far-reaching taxation and spending powers for counties, requiring complex administrative and political arrangements. However, the implementation of fiscal decentralization faces significant challenges. Basic central government functions are being reestablished and strengthened, but institutional capacity remains weak. The legal framework and the supporting systems and procedures would require significant changes to support successful decentralization. In addition, severe infrastructure limitations, including the absence of paved roads, electricity, and telecommunications in vast parts of the country, make provision of public services at the local level (let alone full-fledged fiscal decentralization) particularly challenging.

IMF staff provided technical assistance on fiscal decentralization in early 2009. Although recognizing that fiscal decentralization is primarily a political choice, advice was premised on the consideration that Liberia’s progress toward macroeconomic stabilization should not be jeopardized by ill-designed and hastily implemented decentraliza-

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1 Since independence in 1847, the government has been mainly composed of an elite group of descendants of the original African American settlers. Located in the capital Monrovia, the central government was in charge of all political and economic matters. A number of local agents, distributed across the territory, had the task of interacting and mediating with the local population, in turn largely self-organized according to preexisting communal rules.

2 The Upper House is organized according to county lines, with two senators per county (largely following the model of the United States Senate).

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Table 10.1. Liberia: Indicators of Fiscal Decentralization

<table>
<thead>
<tr>
<th>Type of government</th>
<th>Unitary</th>
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</thead>
<tbody>
<tr>
<td>Population (million, 2007)</td>
<td>3.5</td>
</tr>
<tr>
<td>Area (million km²)</td>
<td>1.0</td>
</tr>
<tr>
<td>Levels of government</td>
<td>3</td>
</tr>
<tr>
<td>Counties</td>
<td>15</td>
</tr>
<tr>
<td>Cities</td>
<td>126</td>
</tr>
<tr>
<td>IMF technical assistance mission on fiscal decentralization</td>
<td>2009</td>
</tr>
</tbody>
</table>

Source: Authors.
tion. On this basis, IMF staff advised a sequenced framework based on three stages:

- In Stage 0, the government should take stock of current administrative arrangements with a view to streamlining them.
- In Stage 1, the current roles and responsibilities of subnational entities would be clarified and strengthened. This process would allow increased deconcentration, whereby a stronger government presence at the county level would yield significant gains; it would allow local administrations to build needed capacity for broader fiscal responsibilities over time; and it would help address perceptions that the government is not sufficiently taking care of local needs.
- In Stage 2, the effective devolution of some spending and taxation powers would take place, and fiscal decentralization would be finally implemented. A move to the second stage would be difficult (if not unwise) without first implementing the steps identified in the first stage.

**Administrative Rationalization**

There are currently 15 counties in Liberia. They differ in population size and density, geography, and ethnic composition. About one-third of the 3.5 million citizens of Liberia are concentrated in Monrovia. All county officials are appointed by (and directly accountable to) the president, with the role of representing the president and coordinating government activities. On this basis, virtually no officials are directly accountable to local citizens.

Relative to its size and population, Liberia’s current administrative structure appears unnecessarily complex. The number of local governments and officials (which increased during the 1990s as a way of extending political patronage) seems disproportionate to the size or population of some counties. As a result, some counties receive more central funding, in proportion to their size, than larger ones, and are endowed with more staff. Certain of these issues are being addressed by a new legislative proposal (Liberia, Ministry of Internal Affairs, 2009), which, if implemented, would significantly streamline current administrative structures. The elimination of redundant government levels would free considerable resources that could then be used to strengthen the functions and responsibilities of those remaining.

The rationalization of county and subcounty administrations should be an integral part of any fiscal decentralization strategy—some current local jurisdictions are too small to be viable, and will be even less so when decentralization strains their capacity to undertake newly devolved functions. The prospect of increased responsibilities for local governments under fiscal decentralization could help counteract possible political resistance to administrative reorganization. Therefore, the planned fiscal decentralization reform provides an opportunity to review current mechanisms of allocating staff and spending to the local level by ministries, and rationalize county-level staffing assignments by ministries.

**Strengthening Subnational Roles before Decentralization**

At present, fiscal operations at the county level follow a limited deconcentrated model. Counties have virtually no taxing powers, and all county-level spending is decided upon and managed by line ministries at the center. Some elements of fiscal decentralization are nonetheless taking place, through the assignment of limited spending autonomy through the County Development Fund (CDF; discussed below). The prospective assignment of social contributions to affected communities under concession agreements in resource sectors (mining, oil exploration, forestry, and agriculture) also implies some degree of spending autonomy outside current fiscal arrangements.

The CDF is a first attempt at allowing counties a limited degree of spending autonomy. It is financed by appropriations from the budget, and will progressively increase to reach US$3 million in the...
2008/09 budget (about 0.3–0.4 percent of GDP). The CDF is intended to finance small investment projects identified at the county level. Allocations to the 15 counties have been made in equal amounts, regardless of their population size or needs. Delays are occurring in spending the allocated CDF allotments, despite the development needs of counties, because of a number of factors: (1) lags in identifying and executing projects; (2) inadequate project selection (in some cases, projects are started and then abandoned because of insufficient planning and prioritization); and (3) problems in procuring construction supplies.5

Subnational entities have virtually no taxing powers; all taxes and duties under the 2000 Liberia Revenue Code are levied and collected by the central government.6 Under the code, local authorities can, however, levy fees and charges in exchange for services provided. The legal basis for cities’ fees and charges needs clarification—uncertainty over municipal taxation is unhelpful, both to business and traders, and to the municipalities themselves.

In contrast to the centralization of taxes and levies, concessions in natural resource sectors allow for some degree of revenue decentralization, but under widely differing arrangements:

- In mining, concession agreements now regularly include an annual “social contribution” (fixed annual payments) for projects in affected communities (which, nonetheless, are not legally defined and do not necessarily match a subnational jurisdiction). A similar payment is contained in new petroleum exploration agreements.
- In agriculture, new concession agreements include provisions on “community development funds”—again, destined for affected communities—although the implementation framework has not yet been worked out.
- Forestry concessions provide the only example of formal tax-sharing arrangements. The law mandates that land rental fees be shared among the national government, all counties, and affected communities in fixed proportions. In addition, provisions exist for payments of social contributions to affected communities.

The public financial management arrangements in counties remain highly centralized and based in Monrovia. Each line ministry’s representation in the counties deals directly with its own headquarters offices. Given that most financial transactions take place in Monrovia, county-based staff have to travel frequently to the capital in pursuit of their transactions (these trips may take up to a few days, if not weeks, with the added disadvantage that staff are away from their jobs for long periods). Apart from the delivery of salaries, now paid in county headquarters, and the revenue collectorates, directly answerable to the Revenue Department in Monrovia, the Ministry of Finance plays no role in county-level financial transactions. Special county-level arrangements, outside the standard budget execution procedures, have been set up for the handling of transactions related to CDF projects. This centralized approach, while essential to reestablishing central government control in the early postconflict years, will be at odds with fiscal decentralization—and with the increased provision of services at the county level.

Against this background, IMF staff advised the following:

- The Ministry of Finance should start collecting and consolidating data on fiscal operations at the county level, to better inform the public debate on decentralization and increase transparency in government processes. To this end, the budget document should include an indicative breakdown of spending by county for all ministries operating at the county level, and county-level spending should be included in the published quarterly fiscal reports.
- Until devolution of spending is defined, there should be no new assignments of revenue, or of revenue instruments, to subnational levels of government. The government’s current program of tax reform contains no elements of, and has

5Aware of these shortcomings, the president alluded to changes in the CDF procedures in her Annual Message in January 2009, although details are not known.
6The Liberia Revenue Code consolidated all Liberian taxes. The government has proposed a comprehensive program of tax reform, and prepared draft legislation expected to go before the legislature in the first half of 2009. For a summary of the main taxes in Liberia, see Appendix I of the code.
no implications for, fiscal decentralization—and this is appropriate in the short term. 7

- Subnational governments should be allowed limited access to fees and duties, as contemplated by the Liberia Revenue Code. A degree of access would help to begin building capacity in the administration of own-revenue sources. Clarifying regulations should also be issued to address uncertainties in the legal framework.

- There is also scope to rationalize the social contribution schemes under concessions, given that these schemes represent de facto revenue assignments for communities and counties. These schemes should approximate the fixed contribution now customary in mining concessions. For example, this could be achieved without disturbing the terms of existing agricultural concessions, by arranging a swap between the central government and the affected communities. 8

- Separate revenue-sharing schemes should be avoided. The scheme for distributing forestry land rentals across counties is, thus far, the only revenue-sharing scheme. There is a risk that other such schemes could be developed for other resource sectors, operating on different criteria for distribution, and with different implementation mechanisms. This forestry scheme could be viewed as the core of a future general equalization scheme to ensure equitable distribution of a portion of public resource revenues across counties.

- The focus on increased transparency of budgetary spending at the county level provides an additional opportunity for the Ministry of Finance to strengthen its presence in the counties. County treasuries could be established, which would provide treasury services to the county operations of line ministries. 9 These treasury offices would help to ensure efficient use of cash resources and provide regular reporting on county financial transactions. The presence of a local treasury would reduce the need for employees of line ministries to make frequent trips to Monrovia in pursuit of transactions. County treasuries should be implemented in a phased manner, starting with the five counties in which the Central Bank of Liberia has branches. Rollout to other counties could be accomplished gradually as accessibility improves and demand increases.

Toward a Framework for Fiscal Decentralization

Fiscal decentralization is a political choice for the Liberian government. In the view of the 2009 IMF mission, creating new political and administrative structures would be costly; hence, the rationalization and streamlining of existing ones would be critical to strengthening their capacity. As county-level capacity increases, the government should experiment with a gradual allocation of expenditure responsibilities. In addition, asymmetric decentralization could be considered, initially giving more competencies to the counties and municipalities that perform better.

Devolution of spending would initially be limited, so there would be no initial need for it to be accompanied by significant devolution of taxes—with the possible exception of the property tax and small-scale fees and levies. Property tax collections in Liberia are currently well below potential; reform of the tax should accompany steps toward its decentralization. Minor fees and levies, including business license and registration fees, are also suitable for decentralization.

Although Liberia holds the promise of significant natural resource revenue over time, these revenues

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7 The government has proposed a comprehensive program of tax reform, and prepared draft legislation that was expected to go before the legislature in the first half of 2009.

8 The notion of local treasuries is not new. They can be found in most countries that have not yet established devolved governments. Until recently, Kenya provided a long-standing example of such treasuries. Regional treasuries are also a common feature of many Francophone countries in West Africa, where they provide common financial services (budgetary control, centralized payment, and accounting) to all regional offices of line ministries, as well as local revenue collection, and report directly to the Ministry of Finance.

9 The percentage of sales contribution to a CDF could be transferred to the central government; in return, communities could receive a fixed payment from the government (as long as production continues) approximating the estimated value of the contribution, minus a discount for the assumption of price and volume risk by the government.
should not be subject to direct sharing arrangements with subnational governments. Resource revenue–sharing is difficult; the administration of royalties, taxes, and other resource revenue instruments is often complex and more efficiently performed at the national level. In addition, resource revenues are unstable: local governments cannot bear the risk of volatility or delay. Finally, the accident of geology or geography should not determine the distribution of revenues from national resources, which would lead to huge horizontal imbalances among areas of the country.

Because decentralization will commence with limited spending assignments to local governments, a transfer system should be the main basis for financing subnational operations. A transfer system should not be designed in isolation but should complement the responsibilities and own-source revenues chosen to be assigned to subnational governments. Simple criteria, such as per capita allocations, could guide the initial formulation of transfers; the current large variance in per capita spending per county would suggest that objective indicators of costs and needs should be used.

Establishing the appropriate legal framework for fiscal decentralization will likely take several years. The legislative timetable will need to be taken into account when preparing the timetable for decentralization in Liberia. Specialized public financial management regulations will also have to be drafted to meet the needs of the new local governments.

Finally, all fiscal aspects of decentralization will need to be managed by the Ministry of Finance, including budget preparation, disbursement of transfers, and collection and consolidation of financial reports, as well as fiscal oversight arrangements, ensuring adherence to public financial management rules and regulations and control of borrowing. These responsibilities will require the establishment of a specialized unit at the Ministry of Finance to handle intergovernmental fiscal relations.
Despite significant political changes in the 1990s, the former Yugoslav Republic of Macedonia (FYR Macedonia) remained a largely centralized country. The 1991 constitution (enacted following independence from the former Socialist Federal Republic of Yugoslavia) defined municipalities as the basic unit of local government (abandoning the old communal system). The constitution also established the general principles of organization, functions, and financing of local governments. The details were subsequently elaborated in the Law of Local Self-Government (LLSG) enacted in 1995. The territorial organization was redefined in 1996, significantly increasing the number of subnational governments (from 34 administrative districts, communes, or counties to 123 municipalities and the city of Skopje). Despite these steps, the degree of decentralization remained lower than under the previous socialist constitution, with a vertically structured public sector highly concentrated at the central government level; accordingly, municipalities accounted for about 5 percent of general government spending during the 1990s.

Pressures for a higher degree of decentralization grew in the late 1990s and precipitated substantial changes. The Ohrid Framework Agreement was signed in August 2001 to provide political and institutional solutions to the ethnic Albanians’ armed rebellion and to address the perceived deprivation of the Albanian minority (about one-fourth of the population of 2 million) since the establishment of sovereign FYR Macedonia a decade earlier. As a result of the Ohrid Framework Agreement, the constitution was amended in November 2001, defining a new democratic order based on the principle of multiethnicity. Although the form of government remained unitary, a higher degree of decentralization was envisaged.

A new LLSG, passed in January 2002, provided a basic framework for fiscal decentralization. This core framework was supported by a new territorial organization approved in August 2004, which reduced the number of subnational governments from 124 to 84 municipalities plus the city of Skopje (partitioned into 10 additional municipalities); and by the Law of Financing of Local Self-Governments (LFLSG) enacted in September 2004, which regulated the sources of financing of municipalities and established the gradual implementation of the decentralization process.

**IMF Advice on Fiscal Decentralization**

IMF staff have provided significant technical assistance on fiscal decentralization and local government finance in Macedonia. Two missions took place in March 2002 and September 2003; some of the recommendations of these missions were echoed in the 2006 Report on the Observance of Standards and Codes on Fiscal Transparency (IMF, 2006), particularly regarding the appropriate sequencing and alignment of expenditure devolution in line with strengthened monitoring of local finances and improved capacity at the local level.
The focus of the 2002 mission was to develop a general strategy to devolve revenue and expenditure functions to local governments. This strategy was to be based on certain premises: First, a new territorial structure with a significant reduction in the number of municipalities was to be in place before decentralization. Second, fiscal decentralization was to be neutral with respect to total general government spending. Finally, the division of responsibilities and revenues between the central and municipal governments was to be made transparent and to be fully costed.

The basic philosophy was to adopt a phased approach to decentralization, with the devolution of powers to be implemented in stages. In each phase, specific expenditure responsibilities in specific sectors were to be devolved to the municipalities along with adequate financial resources.

Four general phases were recommended, covering the reorganization of expenditure responsibilities, financing, and structural reform needs arising in the context of fiscal decentralization. Phase Zero would start immediately, based on some restructuring and aligning of institutional incentives. In Phase I, physical assets (e.g., buildings owned by the central government) would be handed over to the municipalities to manage. In Phase II, municipalities would assume larger responsibilities for personnel and staffing decisions in specific sectors, with the central government retaining control of the overall expenditure envelope (e.g., salary levels, number of positions). In Phase III, certain expenditure functions with major outlays or national policy implications would be devolved, at least partially (e.g., the wage bill). Box 11.1 summarizes the main elements of each recommended phase.

The four phases were to be supported by institutional strengthening at all levels of government, and significant capacity-building initiatives at the municipal level. The mission recommended that a Fiscal Responsibility Law and an Internal Stability Pact (applicable to all levels of government) would provide a comprehensive framework for good fiscal management. In addition, the institutional framework was to be supported by municipal capacity building to improve public expenditure management. Other key elements included strengthening municipal budget procedures, fiscal reporting, and internal and external auditing; and introducing and enforcing legal penalty provisions for noncompliance.

The proposed explicit phasing of decentralization allowed explicit criteria to be established for advancing from one phase to the next. The mission recommended the adoption of performance contracts with conditionality, to be negotiated between the central government and municipalities as a group. The purpose was to provide a carrot-and-stick approach that would safeguard macroeconomic sustainability while setting out concrete steps for advancing with fiscal decentralization.

Based on this framework, the 2003 staff mission focused on the definition of triggers to proceed from one phase to the next. All municipalities were to implement the Phase I simultaneously. Further advances would be made on the basis of performance contracts, allowing asymmetries in the decentralization process. Progressing in this manner would allow controlled advancement of fiscal decentralization, thus ensuring maintenance of macroeconomic sustainability, a precondition for the ultimate success of the process. These contracts would be geared toward implementing the necessary administrative reforms and capacity building at the local level, before proceeding with fiscal decentralization.

Staff advice, although not fully taken, contributed significantly to guiding policy discussions and mapping policy options. The territorial reorganization of the municipal sector was successfully completed, and the LLSGF is firmly based on the concept of the phased approach recommended by staff. More specifically, the LLSGF envisages a gradual devolution of responsibilities and resources, based upon specific triggers related to institutional capacity building and fiscal performance. Finally, while the option of performance contracts was not taken up, the law emphasizes the monitoring of performance, mainly through

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3At the time of the first mission, the 123 municipalities displayed large variability in population size (from 500 to 120,000 inhabitants); 51 of them had fewer than 5,000 inhabitants. It was felt that many were not viable economic entities.
quarterly financial reports that municipalities submit to the Ministry of Finance.

Current Intergovernmental Fiscal Arrangements

The 2004 territorial reorganization significantly increased the average number of residents per municipality. Even more important, it reduced the proportion of municipalities with fewer than 5,000 residents (the minimum efficient scale) to 20 percent from 40 percent. However, population density ranges widely: some municipalities have slightly more than 1,000 residents, while others have more than 100,000. The degree of fiscal decentralization has been increasing since 2005. Since the first phase of the

Box 11.1. Phased Implementation of Fiscal Decentralization in FYR Macedonia

The following are the main elements of the four phases recommended by the IMF technical assistance in 2002.

Phase Zero

During Phase Zero, municipalities would assume some minor additional administrative tasks (issuing building permits, managing zoning regulations) with virtually no financial implications. Still, this phase would address three main problems on the revenue side: (1) municipal revenues were capped and revenues in excess of the cap were subsequently reallocated using not fully transparent redistribution criteria; (2) there was no mechanism for local taxpayers to express their willingness to pay for higher levels of municipal services; and (3) municipal tax bases were volatile (including taxes on property transactions and inheritance). To address these problems, the mission recommended revenue-neutral changes in horizontal tax-sharing arrangements, aimed at strengthening the ability and interest of municipalities to exploit their existing tax bases:

- Increase municipal tax collections by giving municipalities more control over the rates of municipal taxes (within a range); removing the caps on municipal tax revenues; and allowing municipalities to keep all property taxes (and part of the property transactions tax) collected in their territories.
- Introduce a new equalization program based on clearly defined allocation rules to support municipalities with weak tax bases.

Phases I and II

Municipalities would assume additional expenditure responsibilities, initially related to the transfer of central-government assets and related maintenance costs, to be followed by the transfer of decision-making powers (such as hiring and firing of teachers). Control over the financial envelope (teacher salaries, number of positions) would remain at the center. The transfer of functions would require some vertical rebalancing to avoid financing gaps, notwithstanding higher municipal own-revenues secured in Phase Zero. In this respect, the main recommendations included:

- introducing additional horizontal equalization, and
- addressing rebalancing needs by introducing limited central government–municipal revenue-sharing. This should be done using a transparent and formula-based allocation mechanism, possibly based on the value-added tax.

Phase III

The last phase would be based on the decentralization of major expenditure functions. Decentralizing such functions would only be feasible in the longer term because it would require more-elaborate indirect control mechanisms (e.g., control of minimum standards through performance audits). Larger amounts of funds would need to be transferred in line with specific program-funding needs, using a mixture of additional revenue-sharing and specific-purpose grants, whose allocation criteria would be tailored to the program or responsibility being transferred. The specific strategies to be adopted, and their timing, would vary by sector (such as education, health, and social welfare).
decentralization process started in June 2005, the share of municipalities’ spending gradually increased and reached about 13 percent in 2008 (Table 11.2).3

The LLSG enacted in 2002 describes the assignment of competencies to municipal governments. Article 22 of the LLSG allocates shared or concurrent responsibilities for specific services (urban and rural planning, environmental protection, local economic development, communal activities, culture, sports and recreation, education, social welfare, health care, firefighting, and protection and rescuing activities in the event of natural disaster or war). Still, the LLSG leaves it up to subsequent legislation to determine the exact role of municipalities for each service.

According to the LFLSG, municipalities have several own-revenue sources. Article 4 of the LFLSG makes reference to eight different sources: local taxes, local fees, local charges, revenues from ownership, donations, fines, self-contributions, and others. Own-source revenues account for about 4 percent of general government revenues, slightly increasing their share since 2005. The most significant sources are property taxes, communal fees for use of public space, and construction permit fees.

Municipalities’ own-source revenues are complemented with shared taxes, collected by the central government. Municipalities receive 3 percent of the personal income taxes (PIT) on the salaries of natural persons in the municipalities in which they are declared to live (100 percent of the PIT of natural persons performing craft activities registered in the territory of a municipality). They also receive 3 percent of the value-added tax revenues collected in the previous fiscal year according to a distribution formula based on population (60 percent weight), surface area (27 percent), and number of settlements within a municipality (13 percent).

Municipalities also receive earmarked transfers. The amounts of these transfers—for education, culture, and social welfare—are determined in decrees prepared by the line ministries and adopted by the central government, mainly based on historical costs.

Capital grants based on programs defined by the central government are used for financing investment projects. When municipalities graduate to the second phase of the decentralization process, the earmarked transfers are to be converted into block grants, granting municipalities more spending discretion.

The LFLSG allows municipalities to borrow long term for investment and short term for cash-flow management. However, limitations apply to the outstanding debt stock and debt service for long-term borrowing, as well as to the amounts to be borrowed on a short-term basis. Other safeguards require that borrowing be in local currency, from the domestic capital market, and according to a stable or declining annual repayment schedule. Foreign borrowing by municipalities requires not only a decision by the Municipality Council, but also a separate law by parliament, further increasing control and transparency.5

Remaining Challenges
The assignment of expenditure responsibilities at the central and local levels remains unclear, which is a key challenge that must be addressed to ensure political accountability. One main reason for the lack of clarity in expenditure assignments is that the current delineation of competencies was not preceded nor informed by the develop-

3The second phase of the decentralization process started in October 2007; 68 municipalities had qualified for the second phase by December 2008.

4Includes personal income taxes and value-added tax sharing.

| Table 11.2. FYR Macedonia: Summary of Subnational Governments’ Finances, 2008 |
|----------------------------------|----------|
| Total subnational revenue | 2.5      |
| Own-source revenue | 1.5      |
| Transfers from the central government 1 | 1.0      |
| Total subnational expenditure | 2.4      |
| Overall balance (before transfers) | –0.9     |
| Overall balance | 0.1      |

Source: Authors’ calculations based on data in Feruglio, Martinez-Vasquez, and Timofeev (2007).

5Municipal borrowing is allowed only after municipalities report continuously to the Ministry of Finance on their financial position and are free of arrears (both conditions applying for a period of 24 months).
ment of comprehensive policy frameworks in the sectoral areas to be decentralized. For instance, the legislation should clearly specify who is in charge of hiring and firing teachers and administrative staff, determining the pay scale and the equipment needs, and choosing the overall number of positions in each school. Absent such clarity, public services risk being underprovisioned, especially in a tight budgetary environment; or, at the opposite end of the spectrum, overlaps, duplication, and wasteful spending might take place.

The system lacks an objective, transparent method for arriving at the expenditure needs associated with the assigned expenditure responsibilities. This should be the next step after establishing a clear allocation of spending responsibilities. Otherwise, funding may be inadequate relative to the assigned responsibilities; for example, municipalities with the same expenditure responsibilities may have different expenditure needs depending on the size and age profiles of their populations.

Own-sources of revenues of municipalities remain below potential and insufficient to finance municipal spending. Property taxes have a very low yield (around 0.05 percent of GDP, about 10 percent of the average yield obtained in developing and transition economies). In principle, municipalities have been fully in charge of collecting property taxes since 2005; however, transfer of this responsibility from the central government Public Revenue Office has not proceeded as planned as a result of institutional problems.

The system of unconditional transfers does not provide adequate equalization. Revenues from PIT are very low, which, coupled with a 3 percent sharing rate, makes vertical imbalances difficult to correct. The criteria for the allocation of funds from the value-added tax revenue transfer only approximately reflect expenditure needs. Refinements to the formula, especially including criteria that better capture differences in the ability to provide given standards of public services, could be considered, along with possible criteria for assessing revenue-raising capacity.

The system of earmarked transfers is based on inadequate criteria, and distribution remains uneven. In many cases, earmarked transfers are based on historical patterns; in addition, basing these transfers on the existing physical facilities automatically penalizes municipalities (poorer rural municipalities) in which these facilities do not exist.

Overall, although the phased decentralization approach is appropriate, additional steps are crucial for decentralization to fulfill its promise of improved service efficiency. The process will need to continue to be carefully managed. A gradual approach in assigning responsibilities and related financing will enable the new system of financial flows to be tested and adjusted as needed. However, additional transfer of management responsibilities to municipalities or allocation of block grants on a meaningful formula basis will require significant preparatory work by ministries and municipalities.
Mexico’s constitution provides for a federal system characterized by a complex network of intergovernmental fiscal relations. The federation includes the Federal District, 31 states, and 2,392 municipal governments.

During the 1990s, intergovernmental fiscal relations in Mexico were reorganized, with a major shift toward decentralization. This reorganization occurred against the backdrop of multiparty democracy taking root at all levels of government, and recovery from the 1994–95 financial crisis. However, the process is incomplete and has evolved little since then. Key challenges are to improve the efficiency of spending at the local level, notably through greater accountability and a clarification of responsibilities. Thus, while the political power of the state and local governments has increased, so has dissatisfaction with the effectiveness of decentralized public service delivery. At the same time, social programs at the federal level, particularly those targeted to poor and marginalized populations, have been expanded. These programs, such as Progresa-Oportunidades, have been highly effective in their poverty-reduction impact and are seen as examples of international best practice (Coady and Parker, 2002).

In Mexico, as in other Latin American countries, decentralization of key education and health care functions has been only partial. Although substantial spending responsibilities have been transferred, the federal government retains extensive regulatory and financing powers. This reflects, in part, the influence of national unions, plus the federal government’s concern that these critical functions may not be carried out effectively by subnational administrations. The response to partial decentralization has been to provide targeted transfers for education and health care, resulting in little incentive for subnationals to be fully accountable for the provision of these services, given these overlapping responsibilities.

The issues of education and health outcomes in the context of Mexico’s decentralization have been extensively studied. For example, the World Bank (2006) and the Organization for Economic Co-operation and Development (OECD, 2005) found that the decentralization process in Mexico remains incomplete. Despite a major increase in social program coverage, performance indicators in health and education remain well below OECD averages, and even Latin American levels. Furthermore, wide disparities are identified across states. The main challenges are, therefore, to improve the quality of service performance and correct inequalities at the national level.

From a macroeconomic stability standpoint, subnational governments’ operations are not seen as an immediate concern. Following the resolution of the subnational debt crisis of the 1990s, debt contracted by subnational governments in Mexico—states and municipalities, including the decentralized entities, enterprises, and trust funds of these levels of government—has been relatively stable at low levels (1.6 percent of GDP in 2007, as estimated by the government) and accounts for a small fraction of the gross total public sector debt (38.3 percent of GDP in 2007). Strengthened banking regulations and supervision played a significant role in helping the country to emerge

<table>
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<th>Table 12.1. Mexico: Indicators of Fiscal Decentralization</th>
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<tr>
<td>Type of government</td>
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<tr>
<td>Population (million, 2007)</td>
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<td>Area (million km²)</td>
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<tr>
<td>Levels of government</td>
</tr>
<tr>
<td>States</td>
</tr>
<tr>
<td>Municipalities</td>
</tr>
<tr>
<td>Average municipality size (population)</td>
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<tr>
<td>Minimum municipality size (population)</td>
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<tr>
<td>IMF technical assistance mission on fiscal decentralization</td>
</tr>
</tbody>
</table>

Source: Authors.

1Decentralized Service Delivery for the Poor (World Bank, 2006) and “Getting the Most Out of Public Sector Decentralization in Mexico” (OECD, 2005) are two examples of comprehensive studies of subnational spending assignments and decentralization in Mexico.
from the crisis and maintain stability. Furthermore, subnational debt is not subject to currency risk given that, as established in the legislation, it is entirely denominated in Mexican pesos. Still, some areas of concern, and room for further reform and progress, remain.

The Subnational Debt Crises of the Mid-1990s

The risk to federal government finances posed by subnational governments was brought to the fore in the 1994–95 financial crises. As a result of increases in interest rates, subnational government debt expanded significantly, by 50 percent in real terms in 1994 and another 10 percent in 1995, reaching the equivalent of 2.2 percent of GDP. Although still comparing favorably with debt stock as a percentage of GDP in other Latin American countries experiencing debt crises, Mexican states were not able to service their debt. This inability was due to the states’ heavy reliance on federal government transfers (participaciones) and their limited capacity to raise additional revenue more than to the size of the outstanding debt stock or short maturities. In 1995, the ratio of subnational debt to participaciones stood at 80 percent, significantly higher than 44 percent and 64 percent in 1993 and 1994, respectively.

After the 1995 crisis, the federal government took over the debt of the states. The Fund for Strengthening State Finances, developed as a federal government budgetary item, provided for extraordinary cash transfers, with a cost of Mex$7 billion in 1995; it continued at that level in real terms until 1998. States were required to restructure their debt in Udis, a new unit of account indexed to inflation. In return for the debt takeovers, the states were required to agree on a fiscal adjustment program with the Ministry of Finance. States were required to commit themselves to balance their budgets, reduce debt ratios, present their financial accounts in a uniform way, and update and publish state debt laws to regulate and limit debt.

Following the federal bailout, subnational governments’ debt stock across all states declined, with the exception of the State of Mexico and the Federal District. The total stock of subnational debt was reduced to 1.8 percent of GDP in 1997, representing 3.4 percent of total public debt and 62 percent of shared revenues.

Since the 1995 crisis, considerable progress has been made to move toward a market-based system to ensure fiscal discipline. Previously, subnational governments could run deficits or issue debt. A considerable change in the attitude to borrowing followed the subnational debt crisis of the 1990s, and banking regulations and provisioning requirements were strengthened. Additional requirements for credit ratings have also been a positive development.

Current Intergovernmental Fiscal Arrangements

The expenditure responsibilities of each government tier are not clearly defined. As indicated above, health and education are the two main areas of overlapping responsibilities. Subnational spending is dominated by personnel expenses, while spending on goods and services (including investment) is limited. The system of wage negotiations, with feedback effects between federal- and state-level negotiations, contributes to this problem. Overall, because subnational governments account for a high share of public spending, but have insufficient resources (especially own-taxes at the margin), significant vertical fiscal imbalances persist.

Subnational governments have limited own-tax handles. States have been given hard-to-tax bases, including the small taxpayers who yield little revenue while generating considerable political and administrative costs. States also have the option of piggybacking on the income tax, but this measure has only been adopted by three states because of the...
concern that, by doing so, they will lose competitiveness. For municipalities, the critical tax is the property tax. It raises remarkably little revenue (0.3 percent of GDP over the period 2000–04, compared with the OECD average of 1.9 percent of GDP). Low property tax collections are not attributable to low tax rates, but rather to administration (e.g., outdated cadastre and valuations of property, and low collection efforts).5 States keep the cadastre and all cadastral functions but have little incentive to update them because collections accrue to the municipalities. State legislatures also approve changes to the property tax rates.

States and municipalities are heavily dependent on federal transfers. Thus, the burden of raising taxes and revenues falls exclusively on the federal government and reduces accountability and incentives to efficiency for subnational governments. About 85 percent of states’ total revenues comes from federal transfers. The corresponding share for municipalities is 65 percent. Overall, federal transfers represent 8.1 percent of GDP.

The present transfer system is complex and its formulas are obsolete. The system is based on revenue-sharing (participaciones) and a myriad of additional transfers and earmarked grants (aportaciones). The overall distribution of the transfers is not particularly equalizing because it is based on initial conditions that do not reflect recent trends in needs or demand for public services, or fiscal capacities.

• The pool of participaciones is composed of the main federal taxes, such as personal and corporate income taxes, the tax on assets, the value-added tax, and excises. The pool also includes revenue from oil and mines. A share of 21.06 percent of this pool is transferred to the states according to a complex formula.6

• Earmarked funds are transferred under an increasing number of programs, the biggest of which was instituted in 1998 under the name of aportaciones. Federal earmarked funds represent the largest source of subnational revenues (57.7 percent of the total in 2006). The most important transfer (covering more than 60 percent of total aportaciones) is earmarked for education. The health sector also benefits from a basket of earmarked funds. As with education, the amount of transfers for health is determined according to wage and other expenditures in the health sector and is adjusted yearly according to increases in such expenditures.

Lack of information undermines monitoring of subnational government operations. The absence of budget and accounting standards across government levels limits monitoring by the federal government and the elaboration of information on general government finances. States also differ in their government financial management information systems (GFMISs). Seven states have already purchased the most modern GFMISs, which ensure full integration between budget appropriations and accounting, but other states use outdated information systems. Proliferation of bank accounts at the subnational level also hinders effective cash management. Implementation of treasury single accounts (TSAs) at the subnational level, which could address some of these problems, is hampered by federal requirements mandating the maintenance of separate bank accounts for earmarked transfers.

IMF Advice on Fiscal Decentralization

A staff mission in 2007 provided technical assistance regarding intergovernmental fiscal relations.7 The mission stressed that states should be given more-significant tax handles to promote greater accountability at the subnational level and to encourage the states to play a more active role in revenue generation. The mission analyzed different alternatives. One alternative was for the states to piggyback on the single-rate corporate

5On average, property tax rates range around 2 percent of the value of property, close to prevailing property tax rates around the world.

6The formula for participaciones is based on three components: 45.7 percent of the pool is distributed according to population; 45.7 percent is allocated on a historical basis—the previous year’s allocation—corrected by a tax effort indicator; and the remaining 9.6 percent is allocated according to the inverse of the per capita allocations of the previous components.

7The mission included participation by World Bank staff.
tax (called IETU)—a new tax that was approved in September 2007 and implemented in 2008—because of the potential revenue generation, its likely management by the federal tax administration agency, and the fact that it would represent a major tax handle for the states. If allocated on the basis of income taxes (ISR, Impuesto sobre la Renta), it would provide more revenue to the richer states, but if distributed according to simple apportionment procedures (for example, based on production or employment) it could reduce the “disequalization” from the piggyback. Other alternatives would be to put a floor on the income tax piggyback to eliminate concerns over tax competition; to consolidate all taxation of motor vehicles at the state level; and to introduce additional state excises on items permitted under the constitution. In contrast, an additional retail sales tax might not be viable, given the states’ limited administrative capacity. Furthermore, introducing a piggyback on the value-added tax would replicate existing problems with unequal bases.

Recommendations to overhaul the property tax were also discussed. Measures include strengthening the cadastre, improving the valuation procedures with the support of the states (with federal assistance) for the municipalities, and establishing control over rates at the margin for the municipalities (without the need to refer back to state legislatures—which could enact a band within which rates might be set).

The system of transfers should follow more-transparent and equalizing criteria. In particular, the mission advised improving the distribution of the aportaciones for health care and education by adapting the formulas to reflect actual public service needs, and increasing quality incentives. The distribution of participaciones (excluding those going to municipalities) could follow equalization criteria, such as population and inverse of income per capita, or spending needs and fiscal capacities. To achieve a political consensus, the mission proposed the use of a “hold-harmless clause,” which would convert the existing amount of the transfer pool into a lump-sum transfer fixed in nominal terms, based on data from the year preceding the reforms, to ensure that no entity would be made worse off by the reform.

Clarification of the responsibilities and increasing subnational accountability were also recommended. Functional spending responsibilities for lower levels of government should be clarified, while allowing full control over the choice of economic inputs (wages and salaries, operations and maintenance, and so on).

A number of measures were suggested with regard to subnational debt: establishing prudential limits for borrowing, linked to fiscal rules and targets; evaluating the budgetary and debt treatment of new instruments, including securitization; carefully assessing the fiscal risks associated with public-private partnerships and developing a sound legal framework for such operations; and improving the oversight of credit rating assessments.

A package of measures for public financial management would help improve transparency and good governance based on the following:

• Introducing a common budget classification and accounting framework consistent with international standards, at all levels of government. Subnational governments should follow specific reporting standards, and a common database for their fiscal operations should be established. Sanctions for subnational entities not complying with the reporting standards should also be introduced. Standardized information would enable the federal government to monitor and consolidate subnational governments’ operations to produce accounts for the general government.

• Establishing sound GFMISs to manage effectively public finances at all levels of government. While GFMISs may differ across states, there should be an agreement on minimum common standards and the design of interfaces for an effective flow of information.

• Implementing TSAs at all levels of government would allow borrowing requirements to be minimized and cash to be managed effectively. Legal provisions requiring separate accounts for earmarked transfers should be reviewed. The federal government could explore the possibility...
of providing technical services on the implementation of a TSA to subnational levels on an agency basis.

**Recent Progress and Remaining Challenges**

A reform that modified the system of intergovernmental fiscal relations was approved in September 2007, making the allocation of transfers more transparent and redistributive. It also froze, in nominal terms, the existing transfers at prereform levels and applied the new formulas to any increase in federal revenues. Earmarked transfers for education and health were adjusted to reflect demand and state cofinancing to create incentives to strengthen states’ basic systems. The rest of the transfers were modified according to an equalization criterion, economic activity, and tax collection efforts.

However, the reform failed to give any significant tax handle to the states, instead assigning them additional transfers. The reform gave 30 percent of the revenue gains that would result from the two federal taxes (the single-rate corporate tax and a levy on cash deposits) that were created jointly with the intergovernmental reform to subnational governments. In addition, the reform also allocated to these governments all the collections from other newly created federal taxes, in particular, from the surcharge on diesel and gasoline, and from excises on gambling and lotteries.

The September 2007 reform also included measures to address subnational government public financial management weaknesses. The reform called for a constitutional amendment that would empower congress to issue a law establishing a standard accounting framework across all levels of government, and enable the Superior Audit of the Federation to audit the aportaciones. The constitutional amendment was approved in May 2008, and could pave the way for establishing a standard accounting framework across all levels of government, and introducing legal provisions requiring subnational governments to provide the federal government with timely information on their fiscal operations.

Although the 2007 reform marks significant progress in improving the system of intergovernmental fiscal relations, additional measures would be desirable. Increasing the own-taxing powers of subnational governments remains crucial to ensuring accountability and providing incentives for subnational governments to use these powers. Debt management could be improved by ensuring that all debt—as well as commitments associated with public-private partnerships and guarantees—is registered with the federal government, and by limiting the use of federal government transfers as a guarantee for subnational government borrowing.

Finally, adopting a common budget classification and reporting standards, as well as developing modern GFMISs to interface with a new federal system, would allow monitoring of subnational finances and assessing the general government fiscal position.
Nigeria is a federal state in which high reliance on volatile oil revenue has complicated intergovernmental fiscal relations. The conflicting demands for control of the oil revenues generated in specific parts of the country, and for their distribution to all governments, have marked intergovernmental relations in Nigeria for several decades. In an attempt to attenuate regional and ethnic rivalries, the four regions existing at independence have been transformed into the present 36 states.

Control over oil revenue is a contentious issue that has been tackled through substantial revenue-sharing arrangements. The financial relations among the federal, state, and local governments are currently governed by the 1999 constitution, which set broad revenue and expenditure assignments. The sharing of oil revenue is guided by provisions in the constitution. Currently, 13 percent of oil revenue (net of federation charges) is distributed to oil-producing states and—after deducting the initial 13 percent derivation—26.7 percent and 20.6 percent of the remaining oil revenue is distributed to all states and local governments, respectively. Following the large increases in oil revenue in recent years, state and local governments (SLGs) have come to account for about 55 percent of consolidated government non-oil primary spending.

The high share of spending by SLGs presents a challenge for the execution of macroeconomic policy. SLGs account for about half of general government spending (Table 13.2). As a result, coordinating policies across a very large number of SLGs is difficult, especially in the context of large and volatile oil revenue. In addition, establishing a vast network of strong institutions and processes to minimize duplication and ensure effective service delivery is complex in a country with a large population (more than 140 million people) with substantial needs (nearly 55 percent of the population lives in poverty). The key macrofiscal challenges facing the federal government are to maintain macroeconomic stability and foster greater consensus with states on the management of oil revenues.

### IMF Advice on Fiscal Decentralization

A staff mission in early 2001 provided comprehensive technical assistance on decentralization issues. The mission included participation by World Bank staff and was aimed at examining options for improving the intergovernmental fiscal system in Nigeria. The mission reviewed the institutional framework for decentralization, its macroeconomic implications, expenditure and revenue assignments, and administrative arrangements to improve tax collection and management of public funds.

The mission stressed the deficiencies of the transfer system current at the time. This system—based on sharing of oil revenue and including the 13 percent allocation for oil-producing states on a derivation basis—was viewed as not sustainable given increasing tensions between the demand for additional derivation and the claims for redistribution among different states. The mission found significant horizontal imbalances at the state level, a low correlation between transfers and states’ relative needs, a derivation formulation that benefited mostly middle- and high-income states, and no definition of minimum public services to be provided by SLGs in return for the transfers. Further-

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**Table 13.1. Nigeria: Indicators of Fiscal Decentralization**

<table>
<thead>
<tr>
<th>Type of government</th>
<th>Federal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population (million, 2007)</td>
<td>136.3</td>
</tr>
<tr>
<td>Area (million km²)</td>
<td>0.9</td>
</tr>
<tr>
<td>Levels of government</td>
<td>3</td>
</tr>
<tr>
<td>States</td>
<td>36</td>
</tr>
<tr>
<td>Municipalities</td>
<td>774</td>
</tr>
<tr>
<td>Average municipality size (population)</td>
<td>176,037</td>
</tr>
<tr>
<td>Minimum municipality size (population)</td>
<td>19,710</td>
</tr>
<tr>
<td>IMF technical assistance mission on fiscal decentralization</td>
<td>2001</td>
</tr>
</tbody>
</table>

Source: Authors.

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1The Nigerian federation includes 36 state authorities and the Federal Capital Territory of Abuja.
more, the arrangement makes most subnational budgets highly sensitive to volatile oil revenue, and complicates macroeconomic management by fostering increases in spending as oil prices rise, leading to significant deficits or arrears at subnational levels when oil prices decline.

Greater clarification and understanding at all government levels with regard to the execution of their expenditure assignments was recommended. The formal assignment of expenditure responsibilities among the different tiers of government is similar to that found in large federal systems. However, the mission found lack of clarity and duplication of effort in certain areas (responsibilities were either overlapping or not assigned, especially in relation to education and health care). The mission also noted problems in the coordination of intergovernmental expenditure policies, a lack of accountability in service delivery by SLGs, and the potential proliferation of deductions-at-source practices by higher levels of government to undertake some spending responsibilities originally assigned to lower government levels (this was the case for basic education, for example, because the lower levels could not ensure payments to teachers). In this regard, the main recommendations included the following:

- define through national legislation the detailed distribution of functions relating to individual public services, such as education and health; and
- ensure that the availability of financial resources for each level of government is broadly commensurate with that level’s assigned expenditure responsibilities.

The transfer system should be reformed accordingly. At a minimum, special-purpose transfers should replace direct investment by the federal government in areas of subnational jurisdiction. A more radical approach would also include

- a new general transfer system based on the costing of minimum essential functions and on estimates of overall expenditure needs and own-revenue capacities;
- a floor for transfers to ensure the continued provision of essential services, to be financed by savings from periods of high oil prices; and
- capital transfers to promote a more even distribution of infrastructure.

The mission also called for a strengthening of SLGs’ non-oil revenue collection and administration, and a revision of the revenue-sharing arrangements. Tax policy and administration in SLGs were found to be fraught with weaknesses, including limited non-oil revenue collections with largely unexploited tax bases, lack of control by SLGs over the rates of most of the taxes they levy, widespread tax evasion and noncompliance, and pervasive corruption in tax administration. Despite the fact that transfers are likely to remain large in relation to SLGs’ expenditures, the mission believed that it was essential for accountability that SLGs finance their expenditures at the margin from own-revenue sources. In that context, specific recommendations included

- centralizing the collection of personal income tax in the federal revenue agency while allowing subnational governments to set marginal rates;

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Table 13.2. Nigeria: Summary of Subnational Governments’ Finances, 2006

<table>
<thead>
<tr>
<th></th>
<th>Percentage of general government</th>
<th>Percentage of GDP</th>
<th>Percentage of non-oil GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total subnational revenue</td>
<td>37.5</td>
<td>12.7</td>
<td>20.5</td>
</tr>
<tr>
<td>Own-source revenue¹</td>
<td>2.3</td>
<td>0.8</td>
<td>1.3</td>
</tr>
<tr>
<td>Transfers from the federal government¹</td>
<td>35.2</td>
<td>11.9</td>
<td>19.2</td>
</tr>
<tr>
<td>Total subnational expenditure</td>
<td>48.7</td>
<td>13.1</td>
<td>21.2</td>
</tr>
<tr>
<td>Overall balance (before transfers)</td>
<td>n.a.</td>
<td>–12.4</td>
<td>–20.0</td>
</tr>
<tr>
<td>Overall balance</td>
<td>n.a.</td>
<td>–0.4</td>
<td>–0.7</td>
</tr>
</tbody>
</table>

Sources: Data provided by the authorities; and authors’ calculations.
Note: n.a. = Not applicable.
¹State and local governments coparticipate in 54 percent of budgeted oil revenue, 85 percent of value-added taxes, and 47 percent of the corporate income tax and import duties. Personal income taxes are directly assigned as own-source revenue.
• transforming the 13 percent derivation rule into a royalty share and an explicit environmental excise; and
• providing SLGs with additional sources of revenue, with some control over rates, including excises and business taxes, surcharges on utility bills, and improved property taxes.

Public financial management in SLGs should be strengthened. At the time of the mission, there was no common macroeconomic framework for all government levels, and reporting of fiscal operations by SLGs was lacking, partly as a result of the absence of a harmonized system of budget classification and accounting for all levels of government. To tackle these problems, the budgets of all three levels of government should be consistent, having the same basic underlying macroeconomic assumptions; and a uniform set of guidelines should be introduced for budget preparation and accounting to be followed by all tiers of government. A consolidated account for the states at the central bank would help coordinate treasury functions at the state level.

Setting limits on borrowing by different government levels is crucial to maintaining macroeconomic balance. The mission recommended a set of rules, including limiting domestic borrowing to a certain percentage of SLG revenue, maintaining the practice of not allowing external borrowing by SLGs, creating professional capacity for debt management in the states’ ministries of finance, and establishing a system to provide the federal government Debt Management Office with information on all aspects of debt.

**Recent Progress**

Limited progress has been made to date in implementing the recommendations on decentralization issues, and the challenges may have increased since 2005 in the context of unusually volatile oil prices. Following the return to democratic rule after a long period of dictatorship, building trust in the relationships between the different government levels remains a challenging task. At the same time, intergovernmental dialogue has improved, leading to the implementation of several initiatives to strengthen the decentralization framework.

Since 2004, informal agreements have been reached by all government levels to follow an oil-price-based fiscal rule. Windfall oil revenue, determined on the basis of a conservative oil price, has been set aside in a dedicated account (excess crude account) at the central bank. This fund facilitated the conduct of macroeconomic policy during a time of very high oil prices, and should help to smooth spending in the current downturn. In 2008–09, however, some states have challenged the constitutionality of this arrangement.

The Nigerian authorities started working on the implementation of service-delivery benchmarks for poverty-related spending by SLGs. With support from the World Bank and U.K. Department for International Development, the federal government coordinated the design of benchmarks for service delivery to be followed by most state governments in the context of each state’s own reform agenda—State Economic Empowerment and Development Strategy (SEEDS). A first SEEDS benchmarking report was published in 2007; however, the program was suspended in 2008.

Fiscal responsibility legislation is being prepared as a means to improve intergovernmental fiscal relations. In 2007, the Fiscal Responsibility Act was approved by the National Assembly and signed by the president. The act sets out transparency requirements, sanctions for noncompliance, guidelines for budgetary practices, debt limits, and a fiscal framework centered on an oil-price-based rule. However, this act only applies to the federal government, although it encourages states to follow similar practices. Political agreement has been reached for each state to draw up its own fiscal responsibility legislation, which is meant to be supportive of the objectives of the federal law. Drafting of state-level

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2The rule works as follows: Following parliamentary discussion, a budget reference price is set for an assumed production target. Revenues greater than budgeted are saved in an account at the central bank. In the event of revenue shortfalls, disbursements are made from this account. In addition, the excess crude account has been used to repay Paris Club debt, finance large-scale infrastructure projects jointly agreed to by all levels of government, and finance the explicit fuel subsidy.

3About US$12 billion was used in 2005–06 to cancel the debt with the Paris Club. The budget oil price was US$35 per barrel in 2006, compared with an actual price of US$60 per barrel.
laws commenced in 2008; a few have been enacted, and the federal government and donors are providing support. A key measure aimed at enhancing the transparency and accountability already in place is the publication of the transfers from the Federation Account (the account into which all federally collected revenues are paid on a monthly basis) to the federal government and each SLG.

Borrowing by SLGs appears to have been limited, partly explained by the sharp increase in resources available for SLGs during the period of booming oil prices. In addition, however, a high provisioning requirement was introduced to discourage lending by commercial banks to SLGs, and the federal government is making it difficult for SLGs to use monthly oil revenue distributions as collateral for borrowing. The effectiveness of these measures will be tested as SLGs seek to increase borrowing in response to the sharp decline in oil revenue in 2009. A National Debt Management Framework setting the policy guidelines for debt management in Nigeria has been prepared and includes a number of restrictive provisions and guidelines regarding subnational borrowing. It also offers guidelines for sustainable subnational debt management within Medium-Term Public Debt Strategies (2008–12). The Subnational Debt Management Strategy is to facilitate the development of institutional capacity for public debt management at the subnational level through the provision of support for the establishment and operation of Debt Management Departments in state governments.

**Remaining Challenges**

Comprehensive reform of intergovernmental relationships remains critical to ensuring macroeconomic stability and safeguarding Nigeria’s oil wealth. SLGs are reasserting their constitutional right to use accumulated oil savings and current oil revenues. As a consequence, the informal budget price rule is being reconsidered, some tiers of government are assessing whether to establish a sovereign wealth fund, and there is a risk that the rules for accumulation into, and withdrawal from, the excess crude account might be adjusted. Another source of fiscal risk is linked to the new policy to discontinue withholding states’ external debt service obligations from their allocations from the excess crude account. The 2007 Fiscal Responsibility Act enshrines the oil-price-based fiscal rule, but it cannot bind subnational governments.

Expenditure assignments across government levels need to be clarified further. National legislation should specify the detailed distribution of functions relating to individual public services, such as education and health. At the same time, the availability of financial resources for each level of government must be ensured to broadly match that level’s expenditure responsibilities.

An overhaul of the revenue-sharing system would be needed to reduce horizontal imbalances, increase the correlation between revenues and states’ relative needs, and establish explicit links between revenues and service delivery. Although changes along the lines of staff recommendations are politically difficult, some of the recent measures—the current oil-price-based fiscal rule and the medium-term expenditure framework by the federal government—are steps in the direction of setting spending levels irrespective of current oil prices and more closely linking spending units’ objectives with costed projects and programs. A further stimulus to the discussion of revenue allocations could come from proposals in mid-2009 to make the non-oil revenue system more business friendly. SLGs currently receive 85 percent of value-added tax revenue. Proposals for changes to the non-oil tax regime would increase indirect taxes at the expense of direct taxes, and likely also involve a reconsideration of the value-added tax sharing agreement. Hence, grounds on which to discuss proposals to change the current revenue-sharing system already exist. Even though revenue-sharing will continue to be the dominant source of funds, financing SLGs’ expenditures at the margin from own-revenue sources should increase their accountability.

Judicious borrowing constraints on SLGs need to remain in place. Borrowing by SLGs is limited to the domestic market; it is also constrained by high capital-provisioning requirements on banks.

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4 These issues were discussed by an IMF tax policy mission in December 2007.
(50 percent) and the difficulty most states have in accessing domestic capital markets at nonprohibitive rates (only a small number of states have obtained financial ratings). Furthermore, the Fiscal Responsibility Act requires that all tiers of government present cost-benefit analyses of their borrowing. These constraints must be fully enforced, especially at times of lower oil prices when the sharp reduction in monthly oil allocations is likely to prompt states to borrow more to partly offset the required expenditure adjustment. Details on borrowing strategies and existing debt levels are not yet known, further underlining the need for increased transparency of fiscal operations at the subnational level.


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MAKING FISCAL DECENTRALIZATION WORK


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