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Macro Policy Lessons for a Sound Design of Fiscal Decentralization-Background Studies

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Contents Page

Tables

Boxes

Abbreviations

AD	Basic Allocation (Indonesia)
BI	Bank of Indonesia
CAF	Confederacion Andina de Fomento
CDF	County Development Fund
CF	Fiscal Gap (Indonesia)
DAU	General Allocation Fund (Dana Alokasi Umum)
DAK	Special Allocation Grants
DBH	Shared Revenue Fund
DFID	Department for International Development (United Kingdom)
DGI	Directorat Genaral de Impôts (Tax Collection Agency, DRC)
DMO	Debt Management Office
DRC	Democratic Republic of Congo
EAD	*Entités Administratives Décentralisées* (Decentralized Admin. Entities, DRC)
ETD	*Entités Territoriales Décentralisées* (Decentralized Divisional Entities, DRC)
FAD	Fiscal Affairs Department
FCD	Regional Compensation Fund (Bolivia)
FIR	Federal Revenue Agency
FRA	Fiscal Responsibility Act
GDP	Gross Domestic Product
GFMIS	Government Financial Information Management Systems
ICA	Industry and Commerce Tax (Colombia)
IDB	Interamerican Development Bank
IDH	Direct Tax on Hydrocarbons (Bolivia)
IEHD	Hydrocarbons products excise tax (Bolivia)
IETU	Single-Rate Corporate Tax
ISR	Income Taxes
HIPC	Highly-Indebted Poor Countries
LFLSG	Law of Financing of Local Self Governments
LLGF	Law of Local Government Finance
LLSG	Law of Local Self Government
LRC	Liberia Revenue Code
LTU	Large Taxpayer Unit
MOF	Ministry of Finance
MOHA	Ministry of Home Affairs
OECD	Organization of Economic Cooperation and Development
OFA	Ohrid Framework Agreement
PDN	Net Domestic Revenues
PFM	Public Financial Management
PIT	Personal Income Tax

PPP	Public Private Partnerships
SAT	State Tax Administration
SDO	Subsidy for Autonomous Regions
SEEDS	State Economic Empowerment and Development Strategy
SHCP	Fiscal Adjustment Program with the Ministry of Finance
SLGs	State and local governments
SOE	State Owned Enterprises
TA	Technical Assistance
TSA	Treasury Single Accounts
UDI	Unilateral Declaration of Independence
UFR	Use of Fund Resources
USAID	United States Agency for International Development
VAT	Value Added Tax
WB	World Bank

I. Introduction

1. **This paper provides background to the Board paper on Macro Policy Lessons for a Sound Design of Fiscal Decentralization**. It summarizes the findings and recommendations of the Fiscal Affairs Department (FAD) for ten countries to which it provided advice on fiscal decentralization. The selected countries (Bolivia, People's Republic of China, Colombia, Democratic Republic of Congo, Indonesia, Kosovo, Liberia, FYR Macedonia, Mexico, and Nigeria) represent different regions, varying institutional arrangements, and diverse stages of the decentralization process.[1]

2. **Fiscal decentralization issues are relevant to a broad number of Fund members**. Issues relating to fiscal decentralization have arisen in the context of surveillance and Use of Fund Resources (UFR) activities. A broad range of countries have requested Fund advice on fiscal decentralization, either in the form of full-fledged technical assistance (TA), or of specific policy advice (for example, on proposed decentralization laws).

3. **Decentralization issues arise in different economic and institutional contexts**. As Table 1 shows, the case countries vary significantly: two countries have a federal government structure (Nigeria and Mexico) while the others are unitary countries; some have limited area size and population (Liberia, Kosovo, and FYR Macedonia), while others are much bigger and/or more populated (China, DRC and Nigeria). They also differ in the number of levels of government. Typically countries have three levels of government: central/federal; regions/provinces/states (the latter usually in federal countries); and local, composed of municipalities, townships, or similar entities. This is partly related to size; thus, smaller countries, such as Kosovo and Macedonia, have only one level of government below the central one; while China, by far the largest and most populous country, has four levels of subnational government.

[1] This paper has been coordinated by A. Fedelino, under the oversight of T. Ter-Minassian. A number of current and former FAD staff contributed to the case studies: A. Simone and P. Medas (Bolivia), A. Fedelino (People's Republic of China, Kosovo, Liberia, and Macedonia), I. Adenauer (Colombia), A. Westphal (Democratic Republic of Congo), L. Lusinyan, A. Mati, E. Le Borgne, I. Lienert (Indonesia), P. Lopez-Murphy (Macedonia), M. Garcia-Escribano and G. Palomba (Mexico), and B. Goldsworthy, M. Villafuerte and O. Williams (Nigeria).

Table 1. Comparative Summary Indicators for Case Study Countries

	DRC	Liberia	Nigeria	Bolivia	Colombia	Mexico	Macedonia	Kosovo	China	Indonesia
Population (in millions, 2007)	57.5	3.5	136.3	9.4	46.0	103.1	2.0	2.2	1,307.6	231.6
Area size (in KM2 millions)	2.3	1.0	0.9	1.1	1.1	1.9	25.4	10.9	9.3	1.9
Type of government [1]	U	U	F	U	U	F	U	U	U	U
Levels of government	3	3	3	3	3	3	2	2	4	3
States/provinces [2]	11	15	37	9	33	32	-	-	31	33
Municipalities [3]	1,005	126	774	112	1,120	2,454	84	33	44,016	510
Min size of municipality (inhabitants)	…	…	19,710	1,287	242	102	1,331	5,000	…	14,065
Average size of municipality (inhabitants)	57,262	…	176,037	84,172	41,106	42,009	24,245	67,758	29,706	498,153
GDP per capita (in US dollars, 2008) [4]	14	126	474	356	2,303	7,484	2,350	1,276	846	908

Source: WDI, WEO, Administrative Divisions of Countries.

[1] F=federal; U=unitary

[2] DRC: Regions (10 provinces and 1 capital city), to be expanded into 27 new provinces by 2009. Liberia: 15 Counties. Nigeria: 36 States and a Federal Territory.
Bolivia: Departmental prefectures. Colombia: 32 Departments and 1 Capital District. Mexico: 31 States and 1 Federal District.
China: 22 Provinces, 5 autonomous regions and 4 Municipalities. Indonesia: Provinces (30 provinces, the capital and 2 special districts).

[3] DRC: Administrative Zones. Liberia: cities. Nigeria: Local Government Areas. Bolivia: Provinces, divided into 327 municipal sections.
Kosovo: Municipalities (30 municipalities and 3 pilot municipalities, as of 2007) China: includes townships (lowest government level; above are 333 Prefectures and 28,16 counties).

[4] Nominal GDP per capita for Kosovo. Real GDP per capita for all other countries.

4. **The provision of policy advice in the area of fiscal decentralization has taken a number of forms and covered a range of issues**. Most typically, it has involved full-fledged TA missions, but also shorter and more focused expert visits (Kosovo), seminars (China and Indonesia), as well as policy development and research work (on China). Many of the requests for advice in the area of intergovernmental fiscal relations have related to particular aspects of decentralization—such as revenue assignments and administration, or transfer design (China in 1994 and Colombia in 1995), subnational debt management (a second mission to Colombia in 1995; and China in 2004); and reporting and information systems.[2] Regardless of the specific areas/forms of involvement, FAD's advice has typically focused on the macrofiscal aspects of decentralization, with the primary goal of safeguarding macroeconomic stability and fiscal sustainability. This focus reflected the core mandate of the Fund and the comparative expertise of its staff.

5. **Fund members have approached decentralization reforms from different perspectives**. In some countries (e.g., Indonesia and Peru) fiscal decentralization pressures originated mainly as a reaction to extended periods of centralized rule. In others (e.g., Bolivia and Colombia), they reflected the hope that lower levels of government would be better able to both tailor service delivery to local preferences, and tackle poverty. Yet in others, such as Nigeria, rapid decentralization has reflected efforts to stem ethnically motivated pressures for secession, also acutely felt in post-conflict countries such as the Democratic Republic of Congo and Kosovo. At the other end of the spectrum, a major reform of the intergovernmental fiscal relations in China in the mid-1990s was driven by the need to strengthen the central government's share in total revenue. Reflecting these different

[2] For example, in Argentina (in 2002 and 2004). This country is not covered in the case studies in this paper.

perspectives and needs, the Fund has provided policy advice and technical assistance at different stages, and on different aspects of the decentralization process. In a relatively limited number of cases, it has been involved in a comprehensive evaluation of the overall system of intergovernmental fiscal relations, prior to major overhauls of this system or consideration of new legislation (including Constituent Assemblies, or decentralization laws), for example in the cases of Indonesia (in 1999 and 2000), Bolivia (in 1997 and 2004), D.R. Congo (in 2004) and Kosovo (in 2007). A full assessment was also carried out for China (in 2003) and Nigeria (in 2001).

6. **As advice on fiscal decentralization may cover a number of specialized fiscal issues, cooperation with other institution has been key**. In particular, given the expertise of the World Bank in relation to spending responsibilities, many FAD missions on fiscal federalism have included Bank staff to address these issues, including in China, D.R. Congo, Indonesia, and Nigeria. Other cases have relied on extensive consultation with the Bank, or on parallel work by the Bank or the relevant regional development bank (e.g., Bolivia, Colombia, and Kosovo).

7. **The case studies are largely, but not exclusively, based on technical assistance reports**.[3] As countries undertaking a reform of their intergovernmental fiscal arrangements typically confront a trade-off between best-practice "normative" policies and political economy constraints, the case studies seek to provide an overview of the challenges in the design and implementation of fiscal decentralization at the time FAD advice was provided (and TA missions were fielded); and discuss possible reform options for the future based on recent developments and outstanding issues.

[3] See the Reference section for a list of the main supporting documents.

II. BOLIVIA

Bolivia: Indicators of Fiscal Decentralization

Type of government:	Unitary
Population (millions, 2007)	9.4
Area size (million square Km)	1.1
Levels of government	3
Regions (*Prefecturas*)	9
Municipalities	112
Average municipality size (population)	84,172
Minimum municipality size (population)	1,287
FAD TA missions on fiscal decentralization:	1997, 1998, 2001, and 2004

Driven by political pressures, fiscal decentralization in Bolivia has led to devolution of revenue without a corresponding increase of subnational spending responsibilities. Over time, this imbalance has weakened incentives for fiscal discipline. Sharing of natural resource revenue has also exacerbated tensions among and across government levels.

8. **In Bolivia, the initial drive behind the decentralization process was of a political nature**, as 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. An 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 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 (see below). Such changes in financing arrangements for subnational governments, however, were not accompanied by a redefinition of spending responsibilities across government levels, severely eroding the flexibility in budget management of the central government. As a result, subnational governments receive about one third of general government revenue, but are responsible for only about one quarter of total spending. A very large share of subnational resources is in the form of intergovernmental transfers (Table 2).

9. **At present, 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. The latter introduced broad elements of a new system of intergovernmental fiscal relations conducive to more decentralization and included

a transitory clause that mandates that a provisional regional autonomy regime be developed until the presidential elections in December 2009. After these elections, a new law on fiscal decentralization will have to be enacted by the new elected congress.

Table 2. Bolivia: Summary of Subnational Governments' Finances, 2005

	In percent of general government	In percent of GDP
Total subnational revenue	33.8	10.7
Own revenue	3.2	1.0
Transfers from the central government 1/	28.6	9.0
Total subnational expenditure	25.1	8.5
Overall balance (before transfers)		-6.9
Overall balance		2.2

Source: Data provided by the authorities; and staff calculations.
1/ Transfers include shared revenue.

The 1990s: Increasing municipal autonomy leads to fiscal imbalances

10. **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 the 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.

11. **The decentralization system, while 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, while 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 agreement 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.

12. **While 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. As 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 by surpluses at the central level. However, subnational debt, particularly short-term debt, started to rise rapidly, especially in the largest municipalities.

13. **Due to growing concerns with the rising levels of subnational debt, FAD was called to provide technical assistance on subnational public finances in the late-1990s**. A first TA mission in 1997 focused mainly on the need to develop effective administrative controls on local debt, though noting that the incentives for over-borrowing were due to the lack of clear spending responsibilities (leading to overspending) and the dependence on the central government (and potential bailouts).[4] A follow-up mission in 1998 provided a broader analysis of the intergovernmental relations and recommended a series of actions to reduce the underlying weaknesses and improve overall fiscal management, including a reduction of reliance on transfers by increasing local revenues; a better definition of spending responsibilities, taking into account institutional capacities of smaller municipalities; and improvements in the transfer system, to reduce vertical and horizontal inequalities.

14. **Some improvements in the legal framework took place, partly reflecting the Fund 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 some changes in the transfer system to address some of the imbalances. In particular, poverty indicators were 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 control debt levels continued to be undermined by the lack of comprehensive, reliable, and timely information, and by the lack of political will at the center to enforce restrictions on subnational borrowing.

15. **As the largest municipalities' financial position deteriorated, the central government started a debt restructuring program for subnational governments in 1998**. Giving the lack of effective budget constraints and the difficulty of monitoring subnational

[4] According 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.

debt, several of the largest municipalities (representing more than ¾ of local spending) continued to accumulate deficits, with some breaching the debt limits by the late-1990s. Debt restructuring programs were agreed between the central and local governments (and one *prefectura*). In exchange for the 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 (to private contractors and public agencies) to longer-maturity debt (from the *Confederacion Andina de Fomento* (CAF) and the World Bank).

16. **While the debt restructuring program helped improve municipalities' financial position, a 2001 TA 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. In this respect, the mission advised to establish credible sanctions against local governments breaching the rules and to improve significantly 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 IDB).

The early 2000s: Fiscal unraveling

17. **As the fiscal position deteriorated in the early-2000s, due to the economic and political crisis, the 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.

18. **When fiscal adjustment finally started in 2004, it fell disproportionally on the central government, mainly reflecting difficulties in coordinating fiscal policy across government levels**.[5] Almost any revenue measure was partially compensated by higher subnational spending (as 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 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) as the central government had to pay the large wage bill.

[5] 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.

19. **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 some rigidity in their use. Furthermore, the HIPC initiative also created (unintended) fiscal pressures at the central level, as the rise in debt (due to 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

20. **While fiscal decentralization initially focused on municipalities, over time regions have demanded greater autonomy and revenue devolution, especially in the context of booming hydrocarbon prices in recent years**. 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; and 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, as a large share of the royalties accrues to them.[6]

21. **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 population, receives almost 50 percent of total royalties distributed to regional governments.[7] 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 taken by the central government (for example, on the fiscal regime and contracts specification).

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[6] A new Direct Tax on Hydrocarbons (IDH) was introduced in 2005; while this 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).

[7] In 2005, shared revenue represented about 90 percent of total net resources transferred from the central government to subnational governments, while grants represented the remaining 10 percent. The Regional Compensation Fund (FCD) is funded by 10 percent of hydrocarbons products excise tax (IEHD) and its objective is to reduce inequities in revenues across regional governments. However, large disparities remain after the transfer of these resources contributing to disparities in spending and poverty rates across regions.

22. **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/or 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/or through increasing revenue. The changes in revenue-sharing introduced by the 2005 Hydrocarbon Law have only exacerbated these problems.

23. **Excessive earmarking of transfers provides incentives for nontransparent accounting and inefficient spending**. Most programs earmark transfers in fixed proportions to capital and current expenditures and/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.

24. **Significant overlaps in spending responsibilities create inefficiencies and reduce accountability**. Health and education are characterized by extensive concurrency between 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 school 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 is done at the regional level, but the certification of hours worked is done 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 originates frequent discrepancies between building of new premises and their staffing. More generally, investment spending decisions are not coordinated across levels of government.

25. **In late 2007, the subnational revenue-sharing system was modified again to change the distribution of 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 of the amount clawed back was reallocated to the municipalities as increased transfers.

Conclusions

26. **The recommendations from the most recent TA mission in 2004 remain largely valid**. They include:

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

- Simplifying the transfer system (reducing overlapping programs), with well-defined policy objectives. Furthermore, the transfers system could be improved by introducing a new equalization system, that would take into account the revenue capacity and expenditure needs of subnational governments. Hydrocarbons taxation should accrue to the central government level—an area where the constitutional assembly has not succeeded to date in making progress (as 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 them back to strengthen the finances of the treasury and for redistribution).

- Assigning 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.

- Strengthening the rules limiting subnational borrowing and mustering a political commitment to a "no bailouts policy." Steps that can be taken to improve fiscal rules to limit borrowing include: (i) setting the debt stock limit in terms of 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; (ii) making debt limits comprehensive by referring to all entities belonging to a department or municipality; and (iii) calculating the debt service to revenue ratio for the entire term of a new operation or the next ten years (whatever is less). However, the political commitment to a no bailout policy is the key element. The no bailouts 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.

III. PEOPLE'S REPUBLIC OF CHINA

People's Republic of China: Indicators of Fiscal Decentralization

Type of government:	Unitary
Population (millions, 2007)	1307.6
Area size (million square Km)	9.3
Levels of government	5
States/provinces	31
Municipalities	44016
Average municipality size (population)	29,706
Minimum municipality size (population)	…
FAD TA missions on decentralization:	1993, 1994, 2002, and 2004

Rebalancing intergovernmental fiscal relations in China remains a challenge, as income disparities across provinces widen and poorer subnational governments strive to meet social spending mandates. Following a major reform of tax assignments and tax sharing in 1994, the authorities have since introduced only marginal changes; a comprehensive rethinking of fiscal decentralization would seem warranted.

27. **Fiscal decentralization since the early 1980s has supported growth and the process of transition to a market economy in China**. At the same time, however, China's impressive growth performance has not benefited all subnational governments equally, as 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.

28. **Given China's size, it is not surprising that the levels of subnational governments (four) and the number of jurisdictions (some 50,000) 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, Tienjin, and Chongqing). The second tier comprises prefecture level authorities (333 prefectures and cities at prefecture level). The third tier encompasses 2,859 counties/cities at the county level, while the next tier includes 40,813 villages/townships—overall, some 50,000 entities (at the end of 2007, according to the National Bureau of Statistics of China).

29. **Fiscal relations between the central and local governments in China over the past 20 years 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 above 22 percent to around 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, by changing the revenue-sharing rules, introducing a central tax administration, and increasing the role of transfers.

30. **Based on 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 3). 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, and others, 2004).

Table 3. China: Summary of Subnational Governments' Finances, 2007

	In percent of general government	In percent of GDP
Total subnational revenue	82.3	14.5
Own revenue	46.5	8.2
Transfers from the central government	35.8	6.3
Total subnational expenditure	78.0	14.5
Overall balance (before transfers)		-6.3
Overall balance		0.0

Source: Data from http://www.mof.gov.cn/yusuansi/, and staff calculations.

31. **The Fund has provided significant technical assistance to China on intergovernmental fiscal relations**, initially on the new revenue-sharing, and assignments and transfer systems in 1994, and then more recently through a diagnostic mission on the overall design of intergovernmental fiscal relations, followed up by an assessment of fiscal risks associated with decentralization. Almost fifteen years into the fiscal federalism reform, there is a need to modify some of the aspects of the intergovernmental fiscal relations, in particular the design and clarity of expenditure mandates (which were not addressed in the first round of assistance in the mid-1990s), and to revisit the tax assignments and the transparency and efficiency of the transfer system. While there is 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

32. **The core objective of the 1994 reform was to ensure higher revenue as a ratio to GDP, 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 (VAT) was adopted, to be shared between the center and the local governments. The State (central) Tax Administration (SAT) was made responsible for the collection of central and shared taxes; while local government agencies remain in charge of collecting local taxes. However, tax rate setting authority remained largely with the central government, as local governments had only limited powers to set rates for a few local taxes. These arrangements still broadly apply to date.

33. **The 1994 reform has been largely successful in achieving its objectives**. Revenues recovered quickly from the trough in the mid-1990s, and the center's share surged to above 55 percent—more than twice the level registered just before the reform. The reform has 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 remain, but also have increased over time.

Broadened expenditure mandates

34. **The "recentralization" of revenue has not been accompanied by a corresponding shift in expenditure assignments**. While the local governments' share of total expenditure has remained quite stable at around 70 percent during the last decade, local governments' expenditure has nonetheless become increasingly disproportionate to their own resources, and there are considerable further spending pressures ahead on account of pensions, local investment needs, and industrial restructuring.

35. **Various factors explain the proliferation of local governments' expenditure responsibilities**. The industrial restructuring process has transferred spending responsibilities of state-owned enterprises (SOEs)—especially in social areas, such as education and health—to subnational governments as SOEs are reformed; rapid urbanization has created a need for subnational governments to provide basic infrastructure (such as electricity and transportation); 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 healthcare 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

36. **In addition to a clear redefinition of the tax assignments, the 1994 reform also redesigned the transfer system, moving away from ad hoc 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 4). These are earmarked transfers 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. They 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 ad-hoc transfers cater to specific needs and purposes. Among these, "tax-for-fee reform transfer payments" were introduced to compensate local governments when they lost an important revenue handle due to the tax-for-fee reform;[8] "adjusting-wage transfer payments" were introduced in 1998, targeting provincial governments that could not cover the increase in civil servants' wages; "minority ethnic areas transfer payments" are paid to the five autonomous regions, three provinces, and eight autonomous prefectures.

37. **Despite their large size, transfers have nonetheless proved inadequate to provide sufficient financial support to 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 an ad hoc 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, as the center lacks the ability

[8] 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.

to track the actual spending from earmarked transfers; they also undermine the rules-based character of the transfer system that the 1994 reform aimed to introduce.

38. **Uncertainty about the size and timing of central transfers further complicates budgetary formulation and execution at the local government level**. Where local governments do not have sufficient resources of their own to carry out important public functions, either expenditure cuts are effected, or arrears accumulate.

Table 4. China's Transfers, 2007

	In billions of yuan	Share
Fiscal-power transfer payments	709.3	50.7
General transfer payments	250.1	35.3
Ethnic minority area transfer payments	17.3	2.4
Tax-for-fee reform transfer payments	75.9	10.7
Adjusting-wage transfer payments	223.4	31.5
Rewards or subsidies transfer payments	33.9	4.8
Others	108.3	15.3
Special transfer payments	689.8	49.3
Education	39.1	5.7
Technology	7.5	1.1
Social security and employment	196.1	28.4
Health	63	9.1
Environment protection	74.8	10.8
Agriculture, Forestry and Water Affairs	96.1	13.9
Others	213.3	30.9
Total transfer payments	1,399.10	100
In percent of GDP	5.4	

Source: Data provided by the authorities.

Some implications of the current system

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

40. **Financing constraints have also induced subnational governments to seek ways to circumvent their legal funding limits**. This has led to the creation of channels for raising indirect financing and shifting some public functions to seemingly "nongovernment" entities.

Large-scale infrastructure projects offer an example: in most provinces, there has been intense activity to build highways, airports, and urban ring roads. Most of these projects have been financed by bank loans, on the expectation that the sales of appreciated land leases in the areas where these projects are implemented will make the latter financially viable. However, these projects may also present significant fiscal risks, in case 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 effective service delivery. The authorities are aware of these problems, as candidly described in a number of audit reports from the National Audit Office.

Fund advice and possible reforms

41. **The transfer system, designed to compensate local governments for revenue lost to the center and promote equalization across regions, is in need of reform**. In particular, it has proven inadequate in tackling the large regional disparities. Local governments' expenditure mandates remain unclear and, in some cases, largely unfunded; pension costs are a case in point, where 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 a comprehensive centralized monitoring of subnational operations.

42. **FAD technical assistance advice since 2002 has addressed these issues**. Key considerations include:

- the impact of increased control of local governments over tax rates, and changes in revenue assignments (including with reforms of the VAT 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 rule-based equalization system; and

- fiscal risks building up at the local government level should be addressed first of all by taking stock of these liabilities, for which estimates are not 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, essentially "below-the-line" sets of information could be consolidated and maintained at the central treasury.

43. **FAD also recommended that legal constraints on local government borrowing should replace the current informal arrangements, but cautioned that these would need**

to be preceded by a number of structural reforms. These 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 areas where the Fund has provided extensive technical assistance) could help in this direction, by setting a model for similar reforms at the subnational level.

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

45. **Still, there is a need for a comprehensive and systematic strategy for intergovernmental fiscal relations**. While no major reforms on 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 9th grade is guaranteed and health care coverage has been broadened. So far, most of these policy changes have resulted in increased expenditure mandates of 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 how sustainable these policy changes may be for poorer local governments. Overall, there is a risk that "tinkering" at the margin with piece-meal measures—absent an overall and consistent fiscal decentralization framework—may actually deepen tensions and inequalities that the current system has contributed to generate.

IV. Colombia

Colombia: Indicators of Fiscal Decentralization	
Type of government:	Unitary
Population (millions, 2007)	46.0
Area size (million square Km)	1.1
Levels of government	3
States/provinces	33
Municipalities	1,120
Average municipality size (population)	41,106
Minimum municipality size (population)	242
FAD TA missions on fiscal decentralization:	1995 and 2005

Excessive reliance on, and rigidity of, transfers blunted subnational government's incentives for fiscal discipline in the 1990s, leading to debt problems. Subsequent reforms to improve fiscal management and coordination at all government levels—coupled with a redesign of transfers—have started yielding positive results. Still, the reform agenda remains unfinished.

46. **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. Today, the country is a decentralized republic consisting of a central administration, 32 departments, 1,120 municipalities, 4 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.

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

48. **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 sectors; 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. This has been reflected in a dramatic increase in transfers, from 2.4 percent of GDP in 1990 to 6.2 percent of GDP in 2006 (Table 5). However, despite devolving more resources to subnational governments, the central government still continued to carry out many of its original spending responsibilities, leading to overspending and inefficient service outcomes, including in the social sectors.

Table 5. Colombia: Summary of Subnational Governments' Finances, 2006

	In percent of general government	In percent of GDP
Total subnational revenue	31.3	10.2
Own revenue	12.4	4.1
Transfers from the central government	18.5	6.2
Total subnational expenditure	32.7	10.7
Overall balance (before transfers)		-6.5
Overall balance		-0.3

Source: Central Bank of Colombia; and staff calculations.

49. **Increased reliance on "automatic" transfers muted incentives for revenue collection, and, ultimately, fiscal discipline**.[9] For the central government, the rigid formula linking transfers to local governments to its current revenue diminished its incentive to collect more revenue; while subnational governments came to rely on central transfers, rather than having to activate own source revenue for additional spending, weakening accountability and fiscal discipline. This, coupled with limited expenditure control, led to a substantial increase in subnational debt levels (by 40 percent in 1993, and on average by 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 the central administration had to bail them out.

50. **Most of the subnational financial problems were tackled by a series of reforms over the last few years**. Fiscal rules were established which brought down local debt and put local public finances on a sustainable footing. A reform of the transfer system moderated the growth of intergovernmental transfers; and some mechanisms to improve macroeconomic coordination among layers of government were set up. At the same time, political decentralization—which among other things allowed for local elections of mayors—

[9] Between 1996 and 2006, transfers to subnational governments increase by more than 460 percent.

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. The case of Bogotá and its remarkable performance (discussed below in more detail) provides an example of this "de-facto" asymmetric decentralization.[10]

The 1990s: First round of decentralization reforms and Fund advice

51. **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, in particular 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 some of their operating expenses not funded by transfers, while having little incentive to manage other expenditure effectively. FAD's technical assistance was requested by the authorities in mid-1995 to address some of these issues.[11]

52. **A rebalancing of intergovernmental fiscal relations was called for**. FAD's advice focused on establishing a non-distorting 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.

53. **There was also a need to focus on the macroeconomic risks posed by high subnational indebtedness**. 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 TA mission recommended a number of measures to address the growing indebtedness of the subnational governments: reducing the maximum amount of revenues that territorial governments could use as collateral for contracting commercial debt, including transfers from the central government; limiting borrowing to

[10] *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 the rest of the subnational governments. In the case of Bogotá, the city government managed to take advantage of the opportunities afforded by the legislation to *all* subnational governments, resulting effectively in asymmetric decentralization.

[11] 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.

finance investment projects (a golden rule); and close monitoring by the central ministry of finance of territorial debt levels, including through collaboration with local public accounting offices.

54. **Partly building on the TA recommendations, Colombia implemented several crucial reforms that improved the overall fiscal decentralization framework on a sustained basis**. A number of important legislative initiatives helped rein in debt levels and establish fiscal discipline:

- In 1997, Colombia started to enact 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 the years 1998–2000, and the performance plans did not always bring about stronger fiscal discipline at the local level, as transfers continued to grow and there was no enforced ceiling on expenditure.

- In 2000, another law was passed in response to the latter developments, 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, i.e., excluding earmarked transfers. Subnational governments that did not comply with these ceilings had to establish a corrective adjustment program, 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. While the liquidity and solvency indicators of Law 358 remained binding, the law established one additional rule, namely that budgets would need to be balanced over a 10-year period. It further stipulated that fiscal management at all levels of government, including expenditure authorizations and revenue collection, had to be consistent with the medium-term macroeconomic framework. Both the central and decentralized budgets had to fully comply with the medium-term frameworks. Law 819 also introduced a market-based mechanism for controlling subnational debt: the obligation for each department and municipality with population greater than 100 thousand inhabitants to get a credit risk rating by a rating agency.

55. **As a consequence, fiscal discipline of subnational entities improved between 2000 and 2006**. Spending grew less rapidly than during the period 1997–99, subnational deficits decreased, and the stock of territorial debt grew by only 5 percent on average. Many decentralized governments in distress 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 fiscal deficits during 1997–2001 to surpluses between 2002 and 2005 (0.3 percent of GDP on average).

56. **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 would grow in real terms by 2 percentage points over 2002–05 and by 2.5 percentage points over 2006–08.[12]

57. **This reform, coupled with the fiscal responsibility legislation described above, was instrumental in promoting more fiscal discipline across the different levels of government**. Moving from an automatic revenue sharing system to a system in which real transfers grew at the 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, as windfall gains were less likely. For the central administration, the reform helped to control the growth in mandated transfers.

The successful transformation of Bogotá

58. **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 a 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

[12] Beyond 2008, the rate of transfer growth was to be linked again to the central government's revenue. This clause was not implemented due to a constitutional amendment in late 2007 that permanently changed the transfer system (see below).

additional resources for specific social programs, while reducing the earmarking of the overall transfers from the central government.

59. **Bogotá skillfully used these specific advantages under the decentralization process**. Its organic statute and resulting tax autonomy allowed the capital to increase several tax rates, and to expand tax bases (Box 1).[13] It also significantly improved its tax administration, including through an anti-evasion 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 timely 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.

Fund advice in recent years and remaining challenges

60. **While the reforms described above led to better management of subnational spending and borrowing, the central administration had continued to run a deficit**. A TA mission in 2004 helped take stock and identify areas where further reform was needed.

Box 1. Colombia: Effective Decentralization in Bogotá

The city of Bogotá provides a good example of how a major transformation in fiscal management and service provision at the local level can take place when effective decentralization is implemented. Over the last 15 years, the city managed to increase dramatically its resources and use them to improve its service delivery—not an easy task in a city with a population of over 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 has turned around to become a beacon of modern management and change, due to 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 (sometime independent) mayors with great leadership skills, who are largely credited with the turnaround in the city’s predicaments.

[13] Municipalities already had some flexibility to increase rates in most taxes before the organic statute was approved. What Bogota did was to exploit this opportunity.

- Asymmetries in the decentralization process (enshrined, among others, in a 1993 special charter 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 –ICA), and tax bases were expanded (for property and vehicle taxes)—these 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.

61. **Limited progress in the assignment of expenditure responsibilities across the different layers of government was the main reason for the center's fiscal difficulties**. Strong unions' opposition to the decentralization of certain services hindered a clear specification of responsibilities among government levels for certain sectoral expenditure, in particular in the education and health sectors. 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, including at the formal level. An institution to assume leadership in all aspect of fiscal decentralization would be 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, in particular in the health and education sectors.

- **Transfers**. After 2009, 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 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.

- **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.[14] 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**. In order to promote transparency and accountability of local governments, a comprehensive set of fiscal data should be released at the local level regularly, 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.[15]

62. **An important constitutional amendment in mid-2007 introduced a reform of the intergovernmental transfer system**. Transfers to local governments are mandated to grow in real terms by 4.0 percent between 2008 and 2009; 3.5 percent in 2010; and 3.0 percent between 2011 and 2016. 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 a projected lower growth environment.

63. **While this is a welcome step, there continues to be a need for further reforms of the intergovernmental transfer system**. Fund staff has 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 co-funding of transport projects could over time alleviate pressure on transfers and increase incentives for fiscal discipline.

64. **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.

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[14] "Property assessments" are prepared with relatively low frequency by the national cadastre office. A few municipalities (Bogotá, Medellin) have their own cadastre offices; this has allowed Bogotá to increase substantially its property tax base.

[15] This was also recommended by the October 1995 mission.

V. Democratic Republic of Congo (DRC)

Democratic Republic of Congo:
Indicators of Fiscal Decentralization

Type of government:	Unitary
Population (millions, 2007)	57.5
Area size (million square Km)	2.3
Levels of government	3
States/provinces	11
Municipalities	1005
Average municipality size (population)	57,262
Minimum municipality size (population)	…
FAD TA missions on fiscal decentralization:	2005

The transition from a largely deconcentrated structure to a system of decentralization is mandated by the 2006 constitution. If implemented appropriately, it could enhance governance and accountability for service delivery through control exercised by provincial assemblies. However, the constitution's lack of clarity on fiscal decentralization, combined with increasing political pressure from provinces, have hampered a careful and balanced sequencing of reforms, including the needed significant strengthening of supporting institutions. In particular, the sizeable increase in the resource transfer to subnational governments is not being accompanied by proper accountability mechanisms. Accordingly, fiscal decentralization may generate large vertical as well as horizontal imbalances, and entail significant macrofiscal risk.

65. **Fiscal decentralization in the DRC 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, it has proved to be a major challenge to hold together a vast country of 62 million people and 250 ethnic groups, with four times the area of France and as many as 700 local languages and dialects.

66. **The constitutionally-mandated provincial institutions were created in early 2007**. Direct election for 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.[16] The provincial governments, consisting of up to 10 ministers in addition to the governors and vice-governors, have started operating in February 2007. However, their functioning has been impaired by the following factors: (i) delays in drafting and approving a legislative framework for the relations with the central government, including in respect to fiscal decentralization; (ii) insufficient resources for the operations of the new institutions; and (iii) weak administrative capacity, partially reflecting insufficient staffing and, in part, an inappropriate skill mix of 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.

67. **FAD has provided advice on the decentralization process over the last few years**. An FAD 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 TA on decentralization has been provided since, these issues have remained on the radar screen. While the World Bank has been leading the dialogue with the authorities in the area of decentralization, it has closely cooperated with Fund staff, particularly regarding macrofiscal aspects of the decentralization process. Since April 2008, the World Bank is supporting decentralization and capacity building in the provinces through the project *Enhancing Governance Capacity*.

Fiscal arrangements prior to the enactment of the new decentralization legislation

68. **Until recently, the DRC had a deconcentrated system**. According to the existing organic public finance law, four categories of local governments called *Entités Administratives Décentralisées* (EADs) maintain a separate legal personality, have their own budgets, and have 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 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).

69. **The transfer system was de facto based on largely arbitrary revenue sharing**. Revenue transfers from the central government to provinces were supposed to be calculated 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

[16] Art. 198 stipulates that the elected governors and vice-governors have to be installed by the DRC President.

bank.[17] Since 1998, transfers had been officially set at 20 percent of revenues collected in the provinces, out of which 15 percent were 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, there were important differences 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, albeit being affected by the largest shortfall in respect to the 15/20-percent rule.[18]

Deficiencies of the constitutionally-mandated fiscal decentralization

70. **The new constitution leaves fiscal arrangements largely undefined**. While provinces enjoy far-reaching fiscal autonomy, the directly elected provincial governors perform a double-role by simultaneously representing their provinces and exercising central government tasks. The constitution establishes three government levels: central, provincial, and sub-provincial (*Entités Territoriales Décentralisées, ETDs*).[19]

71. **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 does neither assign responsibilities for revenue collection to the different government levels nor clarify 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 on expenditure assignments across government levels, thereby giving rise to the risk of a duplication of responsibilities and unfunded mandates in areas with competing legislative competence.

[17] Tax collection functions are split between OFIDA (customs revenue and excise taxes), DGI (tax revenue), and DGRAD (nontax revenues).

[18] The high concentration of large companies in the capital Kinshasa, which also hosts the large-taxpayer unit, results in a high share in 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.

[19] The ETDs consist of "*villes, communes urbaines, communes rurales, secteurs, and chefferies*."

72. **The approach to fiscal decentralization enshrined in the constitution entails a number of significant fiscal risks**. More specifically:

- The new revenue transfer system would lead to a sizeable 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, as expenditures for the public services supposed to be transferred to the provinces (health, primary and secondary education, and agricultural services) account for less than 20 percent of total expenditures, leaving the central government with sizeable unfunded spending responsibilities.

- It 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 to 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, as it is limited to investment financing in its foreseen format.

- Mechanisms for fiscal policy coordination and control remain undefined. This is a key concern in a system with a highly fragmented economic policy management, where key responsibilities are divided between the ministries of finance, budget, and planning, with none of them having sufficient oversight over subnational governments. Moreover, the lack of clear definition of taxing powers of subnational governments also weakens an important accountability mechanism in the conduct of fiscal policy at the subnational level.

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

74. **Most importantly, the pace of revenue and expenditure devolution should depend on progress in public financial management (PFM) reforms**. Bank and Fund staff called for transitory arrangements that would make the establishment of certain institutions and the transfer of spending responsibilities contingent on administrative capacity. This 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 lacking the capacity to perform the functions transferred to them. Fund staff

suggested that each line ministry elaborate medium-term sectoral transfer plans, to be accompanied by performance indicators that would trigger moving to the next stage.

The National Forum on Decentralization

75. **The revenue distribution formula suggested by the *National Forum* would help contain the vertical imbalances inherent to the "constitutional scenario."** 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 in respect to several aspects of the decentralization process, including fiscal and human resource 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 would help contain the risk of vertical imbalances by reducing the gap between the supplementary revenue transferred to provinces and expenditure devolution.

76. **The formula would also go a long way in 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 (LTU) would be automatically transferred to the provinces, where these revenues were collected.

- *Category B revenues*: 40 percent of all custom duties, excise taxes, and revenues collected by the LTU would be distributed to the provinces based on their population.

The distribution mechanism for category B revenues implies a significant horizontal redistribution, with the share of the three richest provinces in total revenue transfers declining to 41 percent from 92 percent under the "constitutional scenario." Still, this mechanism may not be capable under all circumstances to provide sufficient resources to the poorest provinces to cover wages and goods and services of the transferred public services (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

77. **Three laws promulgated in October 2008 contribute little to clarifying the fiscal relations between the central and the provincial governments**.[20] They 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 (see below).

78. **The decentralization legislation does, however, deviate from the consensus reached at the National Forum in 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.[21]

Current transitional arrangements

79. **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, i.e. 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 already 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.

[20] The decentralization legislation consists of the following three laws: (i) *Loi sur la libre administration des provinces*; (ii) *Loi sur les Entités Territoriales Décentralisées*; and (iii) *Loi sur la Conférence des Gouverneurs de province*.

[21] 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 efficiently manage the new resources.

- *Transfer for provincial spending on goods and services*: These are de facto the only 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 "co-management" are ongoing. While 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.

80. **This approach raises a number of issues**. While the continued management of the wage bill of transferred public services reflects a consensus with the provincial government, the withholding of the investment component constitutes a new earmarked component of the rétrocession that is not provided for in the legislative framework. In fact, it has been criticized for being in contradiction with the constitution and the *Loi sur la libre administration des provinces,* which provides 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, as it prevents the provinces from freely choosing the ratio of investment versus goods and services that they consider as most beneficial. Moreover, this approach raises the question whether the central government could 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 the deteriorating global environment.

81. **It will be important to ensure the timeliness and predictability of transfers**. While an accord had been reached between the provinces and the central government in July 2008 on the modalities for transferring the retrocession, the latter has not adhered to it and actual monthly transfers fell short of the agreed amounts.[22] 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 key.

82. **Work on necessary interim solutions for provincial public financial management and personal management is still ongoing**. To bridge the gap until the approval of the new organic public finance law and the law on the civil service in the provinces, five decrees were

[22] The 2008 budget law reflected the consensus reached during the National Forum on Decentralization in 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, retrocession payments fell well short of the amounts that would have resulted from a strict application of the distribution formula.

drafted in August 2008. In particular, these decrees provide for the establishment of minimum requirements in 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.[23] However, these decrees have not yet been implemented. 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 the decentralization in health, education, and agriculture, which takes into account stages of capacity building.

The key role of the new organic public finance law

83. **The new organic public finance law will be crucial for containing vertical and horizontal fiscal imbalances**. Following several months of preparations, involving technical assistance from World Bank-financed consultants, the draft organic public finance law is 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 Entités Territoriales Décentralisées. It is crucial that the organic public finance law establish clear regulations for the revenue sharing mechanism, preferably excluding oil revenues, and the allocation of expenditure responsibilities.

84. **The new law will need to ensure appropriate budgetary control**. The central government will need to keep control over provincial spending by enforcing budget monitoring and reporting mechanisms, including expenditure procedures to be used at the subnational levels, particularly in respect of internal and external financial control. This will require giving the Ministry of Finance (MOF) an explicit role in regulating, coordinating, and supervising local government finances. It will be key to include mechanisms for sanctioning provinces that do not comply, preferably in the form of withholding future retrocession.

85. **The new law should also regulate provincial borrowing**. Fund staff has 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. It will not be sufficient to limit provincial borrowing to the level of public investment, as this would not prevent a rapid and unsustainable accumulation of debt. The law should also specify that provinces and local authorities are not allowed to borrow

[23] Besides civil servants working for transferred public services (primary and secondary education, health sector, and agricultural services), this concerns also a part of employees of other deconcentrated services.

from the central bank, and prohibit the use of shared revenue to collateralize subnational borrowing.

86. **In a similar vein, tax assignments and responsibilities 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 responsibility of the central tax administration. In the medium term, it will be crucial to build local government ability to collect own taxes and to reinforce budget preparation and execution, as well as treasury management and the accounting framework.

VI. INDONESIA

Indonesia: Indicators of Fiscal Decentralization

Type of government:	Unitary
Population (millions, 2007)	231.6
Area size (million square Km)	1.9
Levels of government	3
Provinces (including special regions)	33
Districts (regencies and cities)	510
Average district size (population)	498,153
Minimum district size (population)	14,065
FAD TA missions on fiscal decentralization:	1998, 1999, and 2000

Indonesia moved from a centralized model to a relatively decentralized system very quickly after the 1998 crisis, to defuse mounting political tensions. Such a" big-bang" approach has resulted in a significant increase in resources to subnational governments. While initially horizontal inequalities increased (as resource-rich and more advanced regions were privileged), these are now being redressed. Concerns remain about subnational accountability, as the center attempts to monitor fiscal policy implementation and budget execution at the subnational levels.

87. **Indonesia is often quoted 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.[24] With the 1997–98 crisis, demands for increased regional autonomy, and the need to stem a 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.

88. **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), comprising more than 17,000 islands, and with more than 200 languages.

89. **Extensive technical assistance from both FAD 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, were seen as key to minimizing possible risks from a hastened decentralization process.

90. **Despite the call for cautious implementation, a major decentralization reform was implemented as of January 2001**. All public services were delegated to subnational governments, except those expenditures explicitly expected to be carried out by the central government. The framework also led to a sharp increase in transfers to subnational governments, and gave more scope to regional governments' 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 6) and carry out around 50 percent of development expenditure.

91. **Initial implementation surpassed expectations, as no substantial disruption of public services occurred**. By the end of the first year, over 16,000 public service facilities were transferred to the regions, along with responsibility for about 2 million civil servants; and regional spending doubled from the previous year. The effects of the reforms can be seen

[24] Following independence in 1945, earlier 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.

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.[25]

Table 6. Indonesia: Summary of Subnational Governments' Finances, 2006

	In percent of general government	In percent of GDP
Total subnational revenue	40.3	8.2
of which: Own revenue	3.6	0.7
Transfers from the central		
	33.3	6.8
government 1/		0.7
Total subnational expenditure	34.5	6.9
Overall balance (before transfers)	…	-5.5
Overall balance	…	1.3

Sources: World Bank, Indonesian authorities, and staff calculations.
1/ Transfers include shared revenue.

92. **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.[26] These compare to 27 provinces and less than 300 districts before the reform.

The Fund's advice on decentralization

93. **In the early stages of the government reform, FAD advice focused on proper and gradual sequencing of decentralization**. A December 1998 FAD mission first assessed plans for a law on decentralization, covering both government and the services to be devolved. At that early stage of the debate, the staff team noted its fundamental concern with the revenue sharing arrangements, as there was yet no agreement on specific services to be devolved, taxes to be assigned, or borrowing arrangements; analysis of distributional effects across local governments was lacking, along with estimates of the transitional costs; and no detailed plans for the transition had been laid out. Given the political pressures to move

[25] This could have also been the result of the "hold-harmless" policy (stipulating that the regions will not receive lower transfers than in the previous year), as the number of regions grew. This provision was lifted in 2008 (when transfers amounted to 5.8 percent of GDP).

[26] Cities and regencies are also called "level II regions" or districts. Their number has been increasing over the years, and expected to continue to do so in the future.

forward, the mission recommended that legislation be limited to broad principles, without including a specific blueprint for implementation.

94. **Political realities, however, dictated a fast-tracked decentralization, with two decentralization laws being 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. As two separate ministries were drafting these laws under a very tight timetable, some inconsistencies emerged. A second FAD 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.

95. **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

96. **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 have now 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 spanning districts, and held as a fall-back in case a district could not perform an assigned function.

97. **FAD staff advised to link the actual transfer of responsibilities to the institutional capacities of the local governments to take on new responsibilities**. It 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 in order to improve transparency and avoid misuse of public funds.

Revenue arrangements

98. **The scope for own-revenue collection has greatly expanded 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, FAD 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.

99. **The importance of revenue-sharing arrangements greatly increased with decentralization**. The Shared Revenue Fund (DBH) is split into two parts: (i) the Tax DBH and (ii) the Natural Resources DBH. The former includes income tax (20 percent), land/building taxes, and taxes on land/building transfer (80–90 percent).[27] The Natural resource DBH includes revenues collected by the central government on account of natural resources (e.g., oil, gas, forestry, fishery, and mining), shared with subnational governments according to specified rates.[28] The sharing formulae include some element of "redistribution," but not sufficiently so to affect the overall disequalizing impact of the system.

100. **Such arrangements, made after intense negotiations between the center and local governments, led to several weaknesses in the decentralization framework**. FAD had advised against sharing oil and gas revenues on an origin basis as 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.

[27] "Tobacco yield excise" are also shared with for tobacco-producing regions (2 percent); however, this is designed as an earmarked grant.

[28] These rates vary from 15.5 percent of total collection for oil to 30.5 percent for gas revenues and 80 percent for general mining, forestry and fishing. Special (higher) rates originally applied to resource-rich special autonomy regions; however, the peace deal with Aceh in 2005 gave it virtual control over all natural resource revenues.

Intergovernmental grants

101. **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 (SDO) and Presidential instruction grants (Inpres) for sectoral expenditure that existed before 2001. The law required that the central government transfers to the subnational level a minimum of 25 percent of its revenues after tax sharing (26 percent more recently) and minus energy subsidies. Regencies/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).

102. **A special allocation grant (DAK) was established for earmarked transfers**. The law states that DAK 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).[29] Regions are supposed to apply to the central government for the grant, with proposals that meet the allocation criteria. Although nominally DAK-related amounts are small, their share in total grants (excluding revenue sharing) from central government has increased from about 1½ percent in 2001 to 10½ in 2009.[30]

103. **FAD had advised extensively on the grant design**. It recommended an equalization grant system based on relative expenditure needs and revenue capacities—this has been reflected in the Law on Fiscal Balance. It had also recommended that specific grants on sectors/projects be focused on areas where minimum service standards are of social importance. Nevertheless, its main advice against the floor on general allocation fund transfers, set at a minimum of 25 percent of net domestic revenues (PDN), was not included

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[29] The numbers of sectors funded has varied over the years, depending on the government priorities (for example, the 2009 budget includes 13 sectors).

[30] The central government also allocates deconcentration and co-administration funds to regions, funded from the state budget. Deconcentration funds are handed out to governors as representatives of the central government's line ministries in the regions; co-administration 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 co-administration funds (which has similar objectives as DAK) are to be transferred in stages to DAK in the future.

in the law.[31] The FAD'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.

104. **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—had increased with decentralization (according to the World Bank Public Expenditure Review, 2007).

Public financial management arrangements

105. **Given Indonesia's extensive country-wide network of treasury offices, FAD advised the central government to offer to provide subnational governments with treasury services**. These would include tax collection, payments, accounting, rather than leaving each province/district to set up its own arrangements for managing treasury operations. In the event, the authorities opted for letting subnationals set up their own arrangements for budget and treasury management, despite FAD's position that strengthening PFM arrangements should be a pre-requisite for increasing decentralization. This is also one reason why subnational reporting is difficult.

106. **Some progress was made on subnational accounting**. The MOHA drafted its own chart of accounts (COA), which initially was different from the new COA being drafted for the central government. In line with FAD advice, one single COA was eventually adopted (the two separate COAs 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.

107. **Although the legal framework 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 does the 2007 Cash Management Regulations, in practice these only apply to central government. The same applies to the 2004 Planning Law and the External Audit Laws (2004 and 2007). For external audit—important

[31] The provision was actually removed by government but reintroduced by Parliament.

for accountability reasons—only about 60 percent of subnational government accounts are audited regularly.[32]

108. **The fiscal balance and debt rules for general government are not monitored regularly**. Two fiscal rules (3 percent of GDP deficit; 60 percent of GDP gross debt) were adopted, as per the Fiscal Balance Law 33/2003. However, due to irregular reporting by subnationals on their fiscal balances and the nonavailability of comprehensive data for subnational debt, the central government has been unable to monitor compliance with the debt rule and the deficit rule is monitored with an excessively long lag.

Regional borrowing

109. **Both the Law on Regional Governance and the Law on Fiscal Balance allowed regional governments to borrow**. External borrowing is limited to on-lending from the central government. On domestic borrowing, rules-based controls 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 projects in income generating projects. For all lending from the central government to the regions, the central government can withhold the DAU transfers (and/or the shared DBH) if a region fails to meet its debt obligations. These provisions were largely in line with FAD advice from the 1999 mission.

An assessment of recent reforms and remaining challenges

110. **Local governments have witnessed a surge in revenue transfers from the central government, but have struggled to rapidly increase spending, despite large social needs**. As oil and gas revenue are shared with local governments, transfers to the regions have grown threefold from 2002 to 2008. Coupled 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, under-investment and under-spending have occurred in many local governments. Nonetheless, subnational government spending continues to account for about one third of public spending.

111. Subnational **governments have been accumulating large fiscal surpluses**. As a result, sizeable regional government deposits had accumulated, although this trend slowed

[32] "Spending for Development" Indonesia Public Expenditure Review, World Bank, 2007 (p.127 and Figure 7.5)

down somewhat in 2007 and deposit accumulation remained low in 2008 (the stock at end-was estimated to be around 0.2 percent of GDP, possibly suggesting improvements in budget implementation). However, significant heterogeneity exists among districts, with a few (resource-rich) districts accounting for most of the accumulated deposits.

112. **Subnational government debt remains small**.[33] However, lacking adequate mechanisms for coordinated fiscal and cash management, the large bank account balances of subnational governments have complicated the conduct of monetary policy for Bank Indonesia (BI), especially given that regional governments or provincial banks purchase BI short-term securities.

113. **A number of changes to the system of intergovernmental fiscal relations were introduced in 2008-09**.[34]

- The need to increase 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/progressive tax tariffs on motor vehicles and introduce other related charges. While the land and building taxes (earlier recommended by FAD, 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 envisaged provision), if the Indonesian crude oil price exceeds 130 percent of the price assumed in the budget, the additional revenue from oil/gas will be shared with regions as additional DAU on the basis of fiscal gap considerations.

- There has been a significant change in the policy of DAU allocation, now fully based on: (i) basic allocation (AD), computed over total salary of regional civil servants; and (ii) fiscal gap (CF), defined as the difference between fiscal needs and fiscal capacity (both calculated based on specified parameters).

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[33] According to the 2009 budget, outstanding loans of regional government at end-2007 (on-lent foreign loans and domestic loans from the central government) amounted to 0.02 percent of GDP.

[34] The decentralization laws were revised in 2004. Major changes included: an increase in the share of oil/gas receipts to the regions by 0.5 percentage points 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 capacities exceed fiscal needs (based on formulas); and reporting by regions of their borrowing and debt positions to the center twice a year under the threat of delayed transfer payments.

- The definition of net domestic revenue (of which 26 percent funds the DAU) was changed; it now deducts subsidies (including fuel), with the objective of sharing their costs among levels of government. The introduction of such "burden sharing policy" means that total DAU pool in 2009 has 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 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.

114. **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.[35] Fiscal policy is therefore conducted on the basis of the central government balance. While regular monitoring of the local governments' fiscal stance is still feasible by examining 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.[36]

115. **More generally—and as highlighted by a 2007 FAD mission—fiscal risks could arise from subnational governments in the future**.[37] While immediate risks to the central government budget appear limited, they could rise over time as a result of (i) insufficient coverage of the government sector that can distort the assessment of the fiscal stance; (ii) weak decentralization framework with limited information systems in place; and (iii) high dependence of local governments on potentially volatile transfers. The latter is to be

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[35] Submission of local government budgets to the ministry of finance has significantly improved starting with the 2008 budget, particularly as a result of 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 LGs were penalized, down from five in 2008 (out of 510 districts).

[36] A mission from the IMF Statistic 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.

[37] Davis, J. et al. (2007). The issue of weak and untimely reporting and its possible implications also featured prominently in the 2006 ROSC Report on Fiscal Transparency (IMF Country Report No. 06/330).

somewhat moderated by the implementation of the new formula for calculating DAU transfers, which excludes fuel subsidies from the calculation base.[38] 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/monitoring still remains an issue of concern; the 2009 budget mentions steps that the government is taking to strengthen sanctions for violating regional loan provisions, as well as 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.

VII. Kosovo

Kosovo: Indicators of Fiscal Decentralization

Type of government:	Unitary
Population (millions, 2007)	2.2
Area size (thousands square Km)	10.9
Levels of government	2
States/provinces	-
Municipalities	33
Average municipality size (population)	67,758
Minimum municipality size (population)	5,000
FAD TA missions on fiscal decentralization:	2007

Political reasons drive the ongoing decentralization reform in Kosovo—a small country already partly decentralized. The main challenge is to implement this reform in a well-sequenced way that safeguards macroeconomic stability gains and strengthens public accountability.

116. **Significant changes in Kosovo's fiscal decentralization system are taking place**.[39] Following Kosovo's unilateral declaration of independence (UDI) in February 2008, the recently elected government has started enacting legislation needed for sovereignty,

[38] Based 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.

[39] Kosovo has applied for Fund membership, which is expected later in 2009.

including a constitution, and laws on elections, local self-government and municipal boundaries.[40] Such efforts have been largely based on the so-called Ahtisaari Proposal.[41]

117. **Kosovo is based on a two-tier government system, comprising the central government and municipalities**. Thirty municipalities were established in 2001, when municipal boundaries were defined on the basis of cadastral zones, rather than the pre-conflict government units. An additional five pilot municipalities were later allowed within existing ones. 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 populated Novo Bordo, with a population of 5,000) by a factor of 80.

118. **Decentralization is viewed as a way to lay the foundations for representative public institutions in an ethnically fragmented nation**.[42] While Kosovo has already a fairly decentralized structure—municipal spending accounts for one quarter of total spending (Table 7), the Ahtisaari Proposal was inspired by the belief that increased local autonomy would allow local governments to better cater to local preferences and needs, through a more participatory process with strengthened accountability in the use of public money. Asymmetric arrangements for the five Serb-majority municipalities, de facto already in place, would recognize "enhanced" competencies for higher education and secondary health care in these municipalities, while allowing financial assistance from the Republic of Serbia as well as additional funding from the central budget based on minimum quality and quantity standards for services.

Table 7. Kosovo: Summary of Subnational Governments' Finances, 2008

[40] Since the end of the conflict with Serbia in 1999, Kosovo had been administered by the United Nations. Following the withdrawal of the Ahtisaari Proposal from the UN Security Council due to a veto threat by Russia in the summer 2007, a Troika Group (European Union, Russia, and United States) subsequently attempted to facilitate bilateral negotiations between Serbia and Kosovo. As these negotiations failed to produce a mutually agreeable outcome, the Kosovo government unilaterally declared independence in February 2008.

[41] "Comprehensive Proposal for Final Status Resolution," presented to the United Nations' Security Council by Special Envoy Marti Ahtisaari in March 2007.

[42] According to "Kosovo in Figures" (the 2005 Survey of the Statistical Office of Kosovo), Kosovo's total population is estimated between 1.9 and 2.2 million in the following ethnic proportions: 90 percent Albanians; 5 percent Serbs; 3 percent Bosniak and Gorans; 1 percent Roma; and 1 percent Turks. It is also believed that many pre-1999 Kosovar Serbs and individuals from other ethnic groups originally from Kosovo now live in Central Serbia (about 250.000-350.000); and other regions.

	In percent of general government	In percent of GDP
Total subnational revenue	21.3	5.3
Own revenue	4.5	1.1
Transfers from the central government	16.7	4.1
Total subnational expenditure 1/	21.3	5.3
Wages and salaries	11.9	2.9
Goods and services	3.5	0.9
Subsidies and transfers	0.4	0.1
Capital	5.5	1.4
Overall balance (before transfers)	…	-4.1
Overall primary balance 1/	…	0.0

Source: Kosovo authorities, and IMF staff estimates.
1/ Primary expenditures only (Kosovo and Serbia have not finalized an agreement on the allocation of debts of the former Yugoslavia).

119. **New legislation aims at reinforcing municipal competencies in key areas, in particular health and education**. In addition, new functions will be delegated to municipalities, including responsibility for cadastral records, civil registries, business registration and licensing, and distribution of social assistance payments. These factors would also contribute to efficiency gains and improved service delivery.

120. **Technical assistance on fiscal decentralization was provided in the run-up to Kosovo's UDI**. An initial FAD visit in the summer of 2007 took stock of the current challenges and provided advice on the overall framework for decentralization; this 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 international agencies actively involved, most notably the World Bank, the European Union, and USAID, have closely collaborated with the Fund on these issues.

Overall framework for the Fund's advice

121. **The government's decentralization agenda has been driven by the Ahtisaari Proposal** (Box 2). In line with the authorities' intentions, the Proposal also provided the basis for FAD's work and policy advice on fiscal decentralization.

122. **At the time of the mission, there was a general awareness that the planned fiscal decentralization process was not without risks**. From a *macroeconomic perspective*, there was a concern that the planned increased autonomy of municipalities—the basic building block of local governments in Kosovo—may exert pressure on an already tight spending

envelope, and put further strain on the limited, albeit improving, capacity in municipal fiscal management, possibly leading to deterioration in public service delivery and macroeconomic stability. From a *political economy perspective*, provisions in the Ahtisaari Proposal relating to asymmetric arrangements for Serb-majority municipalities could also further complicate an already delicate political economy context.[43]

123. **In this context, FAD's advice aimed at providing a possible framework for fiscal decentralization**. Taking into account the many initiatives in this area, it sought to provide policy options to address the challenges related to the implementation of the Ahtisaari Proposal, subject to two basic principles:

- *The proposed reforms should be phased in*, to allow institutional capacity to keep pace with policy changes. A "big bang" approach should be avoided, and necessary legislation should be carefully sequenced to avoid creating a "policy vacuum."

- *As the various stakeholders have conflicting interests at heart, reforms should provide incentives for "buy-in."* This was particularly relevant as there appeared to be, as expected, tensions between the center and municipalities, and with municipalities of different ethnical composition. Hence, the reform should be designed in a way to protect possible "losers" and ensure that no entity would be made worse-off by its implementation.

Box 2. The Ahtisaari Proposal on Decentralization in Kosovo

The following are the main elements of the Proposal, which provided the platform for the Fund's advice on fiscal decentralization.

Local Self-government

- Enactment of a law on local self-government based on the European Charter respecting, in particular, the principle of subsidiarity.
- Delineation of new municipalities to strengthen minorities in certain areas.
- Reinforcement of municipal competencies in key areas, in particular health and education.
- New functions delegated to municipalities, including responsibility for cadastral records, civil registries, business registration and licensing, and distribution of social assistance payments.
- Enhanced municipal competencies for higher education and secondary health care in certain "named" Serb-majority municipalities.
- Limitation of central authorities' role in areas of municipal competencies to that of ensuring

[43] These municipalities would be allowed to receive transfers from Serbia that should not be offset or taxed away by the Kosovo government; the latter, in turn, will need to provide financing for minimum service standards in these municipalities for tertiary education (a university) and secondary health (a hospital)—while similar services in the rest of Kosovo will continue to be managed centrally.

compliance with the Constitution and applicable law.

- Strengthening of inter-municipal cooperation.

Local Finance

- Assurances of increased independence of municipalities with regard to the allocation of budget resources in areas of municipal competencies.
- Own revenue assurance, and enlarged definition of own revenue sources.
- Revision of the existing earmarked grants to include a fair and transparent block grant system ensuring greater municipal fiscal autonomy, defined as a percentage of the total government budget.
- Definition of criteria for the horizontal allocation of the block grant, and formula allocation in line with international practice.
- Additional funding for enhanced competencies from the central government budget based on minimum quality and quantity standards for services.
- Immunity of financial assistance from the Republic of Serbia against offsets in grant allocations, taxes, fees, or surcharges of any kind.

Other

- Call for a population census one year after settlement of Kosovo's status.

124. **Under the current legal framework, municipalities already have extensive responsibilities for delivering some public services**. However, the 2007 mission noted that current legal provisions were not fully implemented (for example, concerning public investment in primary health and primary education, still under the respective line ministries' full control, contrary to legal provisions). Municipal competencies should therefore be clarified, especially "enhanced" competencies for the Serb-majority municipalities; service standards for such competencies should be developed; and their monitoring and verification should be strengthened.

125. **There is scope to strengthen municipal own source revenue, in particular the property tax**. At present, property tax collections are low (equivalent to less than 0.3 percent of GDP in 2007) reflecting both policy and administration shortcomings. The 2007 mission advised in favor of establishing a national fiscal cadastre, as a measure to stem a possible erosion of the property tax base and ensure common and harmonized valuation procedures.

126. **The FAD mission found that the current grant system had a number of desirable features that should be preserved**. Its resource envelope was closed-ended (as grants were defined as a share of revenue, namely 20 percent), thus helping contain possible macroeconomic risks; and it provided a significant amount of equalization. Its structure was also relatively simple, based on two earmarked grants (for health and education) and a residual general grant.

127. **Reforms of the grant system were inspired by the Ahtisaari Proposal, mandating a "fair and transparent block grant system ensuring greater municipal autonomy**.**"** In

the view of the mission, this provision was not to be interpreted as aiming to free central funding to municipalities from any form of "earmarking." On the contrary, the mission expressed the view that greater flexibility *within* the current grant system could be allowed, via a new block grant consisting of the following elements: (i) a normalized (i.e., based on some standard measure of salaries) payroll for teachers; (ii) a normalized payroll for health workers, and (iii) an unconditional grant, as a residual. The latter would be distributed to municipalities on the basis of criteria governed by an equalization formula—including some of the key parameters in the Ahtisaari Proposal, such as population, size, and minority shares.

128. **As the transition to a new municipal financing scheme could entail budget shocks for municipalities, 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. Simulations prepared by the mission showed that such adjustments would be overall affordable, especially if they were to be phased in gradually. Such advice would make the reform more acceptable by the reform "losers." At the same time, the creation of "enhanced municipal competencies" will require a separate mechanism for financing the Serb-majority municipalities. These could be funded through specific transfers for secondary health and tertiary education from the existing budgets of the respective line ministries, but avoiding a significant increase in overall spending.

129. **While significant progress in planning, execution, and control of municipal budgets has been achieved in recent years, further improvements in public financial management are needed**. The mission noted a need for further improvements, as actual practices lagged behind generally well-developed procedures and guidelines. In particular, the capacity of municipalities in public financial management should continue to be strengthened; the mission recommended establishing a more stringent and permanent certification scheme by the central government for municipal financial management. The process for budgeting municipal capital projects should also be strengthened. While municipalities claimed that central financing was not adequate to address their investment needs, in the view of the mission, poor quality investment and underexecution of projects were actually not explained by reportedly low financing levels, but rather by structural weaknesses such as inadequate planning across government levels.

130. **While the Ahtisaari Proposal called for municipal borrowing, FAD's advice focused on minimizing fiscal risks from such borrowing**. Developing municipal borrowing rights should be linked to the broader reforms in public investment and municipal financial management; similarly, the necessary institutional, legal, and policy framework should be in place before municipalities should consider private-public partnerships (PPPs). Over time, the more advanced municipalities could be allowed to access borrowing, but

subject to well-defined preconditions for eligibility to avoid possible fiscal risks arising from excessive—and/or poorly regulated—municipal borrowing.

Recent changes and remaining challenges

131. **The Law of Local Government Finance (LLGF) was enacted in March 2008**. The LLGF followed many recommendations from FAD TA.[44] The 2009 budget already includes a number of changes to the current system:

- Municipalities have received additional competencies (e.g., primary education and primary healthcare), without prior improvements in their administrative capacity to manage them.

- There is a significant increase in municipal resources transferred from the center (from €141.3 million in 2008 to €194.3 million in 2009 (from 3.8 to 4.8 percent of GDP, or from 16 percent to 22 percent of total revenues, based on budget data).

- The two specific grants in education and health are now "open-ended," so that an increase in the variables included in their calculation would lead to an increase in the grants (as opposed to previous practice, when amounts were capped in nominal terms regardless of variations in parameters).[45]

- A significant component of the total increase is due to the general grant (still a residual within the overall transfer envelope), increasing from about €39 million in 2008 to €85 million in 2009 (equivalent to an additional 1.1 percent of GDP). Such a sizeable increase in funding to municipalities that is not tied to specific spending would allow greater municipal autonomy.

132. **While the increase in municipal transfers, and the shift to untied funding, are in line with the Ahtisaari Proposal, a number of issues remain to be defined**. First, changes are front-loaded in 2009. Second, the doubling of the general grant should be accompanied by a careful assignment of additional functions to municipalities (that is, increased resources should be destined to increased spending mandates, so as to preserve overall budget discipline). Finally, given the nature of the general grant and the possibility of inadequate use

[44] An initial draft had been prepared by an FAD short-term expert.

[45] For example, if the number of enrolled students (one of the variables used to compute the education grant) increased, this would lead to a corresponding increase in such grant.

of funds, institutional arrangements should be in place to ensure that such increase in resources is utilized efficiently and in line with budget priorities.[46]

133. **A draft public debt law provides a framework for municipal borrowing**. At this stage the draft is still under review. The main concern is that municipalities would have access to borrowing regardless of their proven capacity in public financial management. Fund staff has recommended the inclusion of a "competence clause," which would allow the Ministry of Economy and Finance to refuse permission to borrow on grounds of lack of financial management capacity; formal certification of municipalities by the central government should be a pre-condition for borrowing.[47]

134. **As a possible alternative, once the Kosovo central government is granted authority to borrow, it could do so on behalf of the municipalities and on-lend funds to them**. This would offer several advantages: (i) the central government would have greater information and control over general government borrowing; (ii) the municipalities would benefit from lower borrowing costs; and (iii) as financial market skills are typically in short supply in the public sector, a centralized body should be tasked with raising funds for the government sector in the most cost effective way and with the lowest risk profile possible. The central government could charge a fee for this service, to recoup its costs and to pay for the risks associated with borrowing on behalf of lower government levels; even with the fee, the cost of borrowing should still remain attractive for municipalities.

135. **While decentralization is understandably a high political priority, properly sequenced implementation is warranted**. The plans outlined in the 2009-2011 Medium-Term Expenditure Framework are broadly consistent with reforms needed to successfully achieve the fiscal decentralization objectives of the Ahtisaari Proposal; however, hasty implementation may pose fiscal risk. A more gradual approach would be preferable, with emphasis placed initially on strengthening municipalities' own source revenues and their financial management systems, introducing a new block grant system, and avoiding early direct municipal borrowing while defining clear and monitorable pre-conditions for its eventual realization.

[46] At the time this case study was prepared, it was not yet known how the changes in the transfer will affect municipalities, and whether hold-harmless mechanisms had been put in place.

[47] The FAD public financial management advisor for South East Europe provided advice along these lines in March 2009.

VIII. Liberia

Liberia: Indicators of Fiscal Decentralization

Type of government:	Unitary
Population (millions, 2007)	3.5
Area size (million square Km)	1.0
Levels of government	3
Counties	15
Cities	126
FAD TA missions on fiscal decentralization:	2009

Fiscal decentralization is currently much debated in Liberia, as a greater involvement of subnational entities in government matters is viewed as crucial to improve the effectiveness of public services, and help redress some of the past inequities due to a government model historically centered around the capital Monrovia. Overcoming the centralized system will require carefully sequenced reforms to strengthen capacity and improve accountability at all government levels.

136. **Liberia has historically been a very centralized country**.[48] The political decision-making has been 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 are therefore viewed as key means for 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.

137. **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.[49] The

[48] Since independence in 1847, the government has been largely composed of an elite 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; while 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 pre-existing communal rules.

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

functions and competences 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 respective 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. All the chiefs essentially perform a consultative role to the appointed officials at the county and district levels; they are also responsible for law and order under customary (traditional) law.

138. **Some political quarters 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, implementing fiscal decentralization faces significant challenges. Basic central government functions are being re-established and strengthened, yet 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.

139. **FAD provided technical assistance on fiscal decentralization in early 2009**. While 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 decentralization. On this basis, the mission advised on 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 would allow increased deconcentration,[50] 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

[50] Deconcentration refers to internal managerial and financial assignment of responsibility in the execution of a ministry's agents at the local level. Accountability, under deconcentration, remains in the hands of the parent ministry.

responsibilities over time; and it would also 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.

Stage 0: Administrative Rationalization

140. **There are currently 15 counties in Liberia**.[51] They differ in terms of population, density, geography and ethnic composition; about one third of the 3.5 million population of Liberia is concentrated in Monrovia. All relevant 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 all officials are not directly accountable to local citizens.

141. **Relative to its size and population, Liberia's current administrative structure appears unnecessarily complex**. The number of local governments and officials (which increased over 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. Some of these issues are being addressed by a new legislative proposal;[52] if implemented, it would sstreamline significantly current administrative structures. The elimination of redundant government levels would free considerable resources, which could then be used to strengthen functions and responsibilities of the remaining ones.

142. **The rationalization of county and sub-county administrations should be an integral part of any fiscal decentralization strategy**—as some current local jurisdictions are too small to be viable, and they will be even less so when decentralization will put strain on 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 to allocate staff and spending at local level by ministries, and rationalize county-level staffing assignments by ministry.

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[51] In 1833, Liberia was composed of three counties and the hinterland; over time, several new counties were created, especially in the last 20 years.

[52] "The Electoral Reform Law Relating to Municipalities, Counties, Districts, Townships and Chiefdoms and other political subdivisions of Liberia" prepared by the Ministry of Internal Affairs.

Stage 1: Strengthening Subnational Roles Ahead of Decentralization

143. **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 effectively decided 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 (see below). The prospective assignment of social contributions to affected communities under concession agreements in resource sectors (mining, oil exploration, forestry and agriculture) also imply some degree of spending autonomy outside of current fiscal arrangements.

144. **The County Development Fund (CDF) is a first attempt at allowing counties some limited spending autonomy**. It is financed by appropriations from the budget, progressively increased 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 and needs. There appear to be delays in spending the allocated CDF funds, despite the development needs of counties, due to a number of factors: (i) lags in identifying and executing projects; (ii) inadequate project selection (in some cases, projects are started and then abandoned because of insufficient planning and prioritization); and (iii) problems in procuring construction supplies.[53]

145. **Subnational entities have virtually no taxing powers, as all taxes and duties under the 2000 Liberia Revenue Code (LRC) are levied and collected by the central government**.[54] Under the LRC, local authorities can, however, levy fees and charges in exchange for services provided. The legal basis for cities' fees and charges also needs clarification, as uncertainty over municipal taxation is unhelpful, both to business and traders, and to the municipalities.

146. **In contrast to such de facto 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

[53] Aware of these shortcomings, the President has alluded to changes in the CDF procedures in her Annual Message in January, although details are not known.

[54] The LRC 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 first half of 2009. For a summary of the main taxes in Liberia, see Appendix I.

nonetheless are not legally defined and do not necessarily match a subnational jurisdiction). A similar payment features in new *petroleum exploration* agreements.

- In *agriculture*, new concession agreements include provisions on "community development funds"—again, destined to affected communities—although the implementation framework has not yet been worked out.

- *Forestry* concessions provide the only example of formal tax sharing arrangements, as the law mandates that land rental fee 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.

147. **The public financial management arrangements in counties remain highly centralized and Monrovia-based**. Each line ministry's representation in the counties deals directly with its own headquarter offices. As most financial transactions take place in Monrovia, county-based staff have to travel frequently back and forth to Monrovia 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 the jobs for long periods of time). 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 the County Development Fund projects. This centralized approach, while essential to reestablish central government control in the early post-conflict years, will be at odds with fiscal decentralization—and with the increased provision of services at the county level.

148. Against this background, FAD advised the following:

- The MoF should start collecting and consolidating data on fiscal operations at the county level, to inform better 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 no implications for, fiscal decentralization—and this is appropriate in the short term.[55]

- Subnational governments should be allowed limited access to fees and duties, as contemplated by the Liberia Revenue Code, as this would help start 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—as these represent a de facto revenue assignment for communities and counties. These should approximate the fixed contribution now customary in mining concessions. For example, for existing agricultural concessions, this could be achieved without disturbing the terms of the concessions, by arranging a swap between the central government and the affected communities.[56]

- 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 county level provides an opportunity for the Ministry of Finance to also strengthen its presence at county level. This could be done through the establishment of county treasuries, which would provide treasury services to the county operations of line ministries.[57] These treasury offices would help to ensure efficient use of cash resources, and provide regular reporting of county financial transactions. For line ministries, the presence of a local

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

[56] The percentage of sales contribution to a community development fund could be transferred to the central government; in return, communities could receive a fixed payment from government (as long as production continues) approximating the estimated value of the contribution, less a discount for the assumption of price and volume risk by government.

[57] The notion of local treasuries is not new, as these can be found in most countries which have not yet established devolved government. 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.

treasury would reduce the need to make frequent trips to Monrovia in pursuit of transactions. The implementation of county treasuries should be done in a phased manner, starting with the five counties in which the Central Bank of Liberia has an established branch. Roll-out to other counties could be done gradually as accessibility improves and demand increases.

Stage 2: Toward a Framework for Fiscal Decentralization

149. **Fiscal decentralization is a political choice for the Liberian government to take**. In the view of the 2009 mission, creating new political/administrative structures would be very costly, hence the needed rationalization/streamlining of existing ones would be critical to strengthening their capacity. As the capacity at the county level 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/municipalities with better performance.

150. **As devolution of spending would initially be limited, there would be no initial need to accompany it with 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 towards its decentralization. Minor fees and levies, including business license and registration fees, are also suitable for decentralization.

151. **While Liberia holds the promise of significant natural resource revenue over time, these should not be subject to direct sharing arrangements with subnational governments**. Resource revenue sharing is problematic; the administration of royalties, taxes and other resource revenue instruments is often complex and more efficiently done 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; that would lead to huge horizontal imbalances among areas of the country.

152. **As 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 and should complement the choices on the responsibilities and own-source revenues assigned to subnational governments. Simple criteria, such as per capita allocations, could guide the initial formulation of transfers; and the large variance in per capita spending per county would suggest that objective expenditure indicators of costs and needs should be used.

153. **Establishing the appropriate legal framework for fiscal decentralization will likely take several years**. This 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.

154. **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. This will require the establishment of a specialized unit which will handle inter-governmental fiscal relations at the Ministry of Finance.

IX. FYR Macedonia

Macedonia: Indicators of Fiscal Decentralization

Type of government:	Unitary
Population (millions, 2007)	2.0
Area size (thousands square Km)	25.4
Levels of government	2
States/provinces	-
Municipalities	84
Average municipality size (population)	24,245
Minimum municipality size (population)	1,331
FAD TA missions on fiscal decentralization:	2002 and 2004

Macedonia's transition from a relatively centralized system to a decentralized framework has been devised in sequenced steps. For decentralization to hold its promise of increased public service quality, additional reforms are needed, including a clear assignment of spending responsibilities across government levels, greater municipal revenue sufficiency, and more transparent and objective transfer system.

155. **Despite significant political changes in the 1990s, FYR Macedonia remained a largely centralized country**. The 1991 Constitution (enacted following independence from former Socialist Federal Republic of Yugoslavia) defined municipalities as the basic unit of local government (abandoning the old communal system); it 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 vertical structure of the public sector highly concentrated at the central government level; accordingly, municipalities accounted for about 5 percent of general government spending over the period.

156. **Pressures towards higher degree of decentralization became dominant in the late 1990s and precipitated substantial changes**. The Ohrid Framework Agreement (OFA) 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 quarter of the 2 million population) since the establishment of sovereign FYR Macedonia a decade earlier. As a result of the OFA, the Constitution was amended in November 2001, defining a new democratic order based on the principle of multi-ethnicity; while the form of government remained unitary, a higher degree of decentralization was envisaged.

157. **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 and the city of Skopje (partitioned in 10 additional municipalities);[58] and by a 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.

FAD advice on fiscal decentralization

158. **FAD has 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 their recommendations were also echoed in the 2006 ROSC on Fiscal Transparency, in particular regarding the appropriate sequencing and alignment of expenditure devolution in line with strengthened monitoring of local finances and improved capacity at the local level.

159. **The focus of the first 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.[59] Second, fiscal decentralization

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[58] Municipal boundaries were redrawn, to reflect local preferences of association. Municipal elections were held in March 2005.

[59] At 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 less than 5,000 inhabitants. It was felt that many were not viable economic entities.

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 fully costed.

160. **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 alongside with adequate financial resources.

161. **Four general phases were recommended, covering the reorganization of expenditure responsibilities, financing, and structural reforms needs arising in the context of fiscal decentralization**. Phase Zero would start immediately, based on some restructuring and aligning institutional incentives. In Phase I, physical assets (e.g., buildings owned by the central government) would be handed over to the municipalities to manage; while in Phase II, municipalities would assume larger responsibilities for personnel and staffing decisions in specific sectors, with the central government retaining control over the overall expenditure envelope (e.g., salary levels, number of posts). In the final Phase III, some expenditure functions with major outlays or national policy implications would be devolved, at least partially (e.g., the wage bill). Box 3 summarizes the main elements of each recommended phase.

162. **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/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.

163. **The proposed explicit phasing of decentralization allowed establishing explicit criteria to advance 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 main advantage was to provide a" stick-and-carrot" approach that would safeguard macroeconomic sustainability while setting out concrete steps for advancing with fiscal decentralization.

164. **Based on this framework, the second FAD mission focused on the definition of "triggers" to proceed from one phase to the other**. All municipalities were to implement the first phase simultaneously. Further advances would be made on the basis of performance contracts, allowing asymmetries in the process of decentralization. These would allow

advancing with fiscal decentralization in a controlled manner to ensure maintenance of macroeconomic sustainability, a precondition for the ultimate success of the process. These contracts would be geared to advancing the necessary administrative reforms and capacity building at the local level, before proceeding with fiscal decentralization.

165. **FAD 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 the Fund. More specifically, the LLGF 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 quarterly financial reports that municipalities submit to the MOF.

Box 3. Phased Implementation of Fiscal Decentralization in Macedonia

The following are the main elements of the four phases recommended by the 2002 decentralization mission.

Phase Zero

During Phase Zero, municipalities would assume some minor additional administrative tasks (issuing building permits, zoning regulations) with virtually no financial implications. Still, this phase would addresses three main problems on the revenue side: (i) municipal revenue were capped and revenues in excess of the cap were subsequently reallocated using not fully transparent redistribution criteria; (ii) there was no mechanism for local taxpayers to express their willingness to pay for higher levels of municipal services; and (iii) 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 territory.
- Introduce a new equalization scheme, based on clearly defined allocation rules to support municipalities with weak tax bases.

Phases I-II

Municipalities would assume some additional expenditure responsibilities, initially related to the transfer of assets and related maintenance costs, to be followed by the transfer of decision-making powers (such hiring and firing of teachers). Control over the financial envelope (teacher salaries, numbers of posts) would remain centrally determined. 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

- Introduce additional horizontal equalization
- Address rebalancing needs by introducing limited central government-municipal revenue sharing. This should be done using a transparent & formula-based allocation mechanism, possibly based on the VAT

Phase III

The last phase would be based on the decentralization of major expenditure functions. This would only be feasible in the longer term, as 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 a specific purpose grant, whose allocation criteria would be tailored to the program or responsibility that is being transferred. The specific strategies to be adopted, and their timing, would vary by sectors (such as education, health, and social welfare).

The current intergovernmental fiscal arrangements

166. **The 2004 territorial reorganization significantly increased the average number of residents per municipality**. Even more important than that, it also reduced the number of municipalities with less than 5,000 residents (below a minimum efficient scale) from 40 to 20 percent. However, there is a wide range of population densities: some municipalities have slightly more than 1,000 residents, while others have more than 100,000.

167. **The degree of fiscal decentralization has been increasing since 2005**. Since the first phase of the decentralization process started in June 2005, the share of municipalities' spending gradually increased and reached around 13 percent in 2008 (Table 8).[60]

Table 8. Macedonia: Summary of Subnational Governments' Finances, 2008

	In percent of general government	In percent of GDP
Total subnational revenue		2.5
Own revenue		1.5
Transfers from the central government 1/		1.0
Total subnational expenditure	7.0	2.4
Overall balance (before transfers)		-0.9
Overall balance		0.1

Source: Staff calculations based on data in Feruglio, Martinez-Vazquez and Timofeev (2007).
1/ Includes PIT and VAT sharing.

168. **The LLSG enacted in 2002 describes the assignment of "competencies" to municipal governments**. Article 22 of the LLSG allocates shared or concurrent responsibilities in specific areas (urban and rural planning, environmental protection, local economic development, communal activities, culture, sports and recreation, education, social

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

welfare, health care, firefighting and protection and rescuing activities in case of natural disasters or wars). Still, the LLSG leaves it up to subsequent legislation to determine the exact role of municipalities in each area.

169. **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-contribution, 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.

170. **Own source revenues of municipalities are complemented by shared taxes, collected by the central government.** Municipalities receive 3 percent of the PIT of the salaries of natural persons in the municipalities where they are declared to live (100 percent of the PIT of the natural persons performing craft activities, registered in the territory of a municipality). They also receive 3 percent of the VAT 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).

171. **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.

172. **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.[61]

[61] Municipal borrowing is allowed only after municipalities report continuously to the MOF on their financial position and are free of arrears (both conditions applying for a period of 24 months).

Remaining Challenges

173. **The assignment of expenditure responsibilities at the central and local levels remains unclear.** This is a key challenge that should 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 development 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 posts in each school. Absent such clarity, there is a risk that public services may be under-provisioned, especially in a tight budgetary environment; or, at the opposite end of the spectrum, overlaps, duplications and wasteful spending might take place.

174. **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 same expenditure responsibilities may have different expenditure needs depending on the size/age profile of their population.

175. **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 Public Revenue Office has not proceeded as planned due to institutional problems.

176. **The system of unconditional transfers does not provide adequate equalization**. Revenues from PIT are very low; coupled with a 3 percent sharing rate, this makes it difficult to correct vertical imbalances. The criteria for the allocation of funds from the VAT revenue transfer reflect expenditure needs only in an approximated way. Refinements to the formula, by including criteria that better capture differences in the ability to provide given standards of public services, could be considered, along with possible criteria of revenue raising capacity.

177. **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 penalized municipalities (poorer rural municipalities) where these facilities do not exist.

178. **Overall, while the phased decentralization approach is appropriate, additional steps are crucial for decentralization to hold 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 and/or allocation of block grants on a meaningful formula basis will require significant preparatory work by ministries and municipalities.

X. MEXICO

Mexico: Indicators of Fiscal Decentralization

Type of government:	Federal
Population (millions, 2007)	103.1
Area size (million square Km)	1.9
Levels of government	3
States/provinces	32.0
Municipalities	2454.0
Average municipality size (population)	42,009
Minimum municipality size (population)	102
FAD TA missions on fiscal decentralization:	2007

The debt crisis in the mid-1990s has induced a shift toward market-based fiscal discipline, also at the subnational level. Still, reforms of the intergovernmental fiscal relations are needed to increase incentives for subnational governments to use their spending powers, especially if service delivery is to be improved.

179. **Mexico's constitution provides for a federal system characterized by a complex system of intergovernmental fiscal relations**. The federation includes the Federal District, 31 states, and 2,392 municipal governments.

180. **During the 1990s, intergovernmental fiscal relations in Mexico were reorganized, with a major shift towards decentralization**. This happened against the backdrop of multiparty democracy taking root at all levels of government; and coming out of the 1994-95 financial crisis. The process has however remained incomplete and has evolved little since. 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 states 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, in particular 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 in this area.[62]

181. **In Mexico, as in other Latin American countries, decentralization of key education or health-care functions has been only partial**. While substantial spending responsibilities have been transferred, the federal government retains extensive regulatory and financing powers. This partly reflects the influence of national unions, and the federal government's concern of 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 overlapping responsibilities.

182. **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 OECD (2004) found that the decentralization process in Mexico remains incomplete. Despite a major increase in coverage of the social programs, performance indicators in health and education, remain well below OECD averages, and even Latin American levels.[63] 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.

183. **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 governments—has been maintained relatively stable at low levels (1.6 percent of GDP in 2007—government estimate) 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 have played a significant role in coming out of the crisis and maintaining stability since then. Further, subnational debt is not subject to currency risk since, as established in the legislation, it is entirely denominated in Mexican pesos.[64] Still, some areas of concern—and room for further reform and progress—remain.

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[62] See David Coady and S. Parker (2002), "A cost-effectiveness analysis of demand and supply-side education interventions: the case of PROGRESA in Mexico," Discussions Paper 127, IFPRI.

[63] World Bank, *Decentralized Services for the Poor*, 2006, Washington D.C. and OECD, *Getting the Most out of Public Sector Decentralization in Mexico*, 2005, Paris, are two recent examples of extensive studies of the subnational spending assignments and decentralization in Mexico.

[64] In 2006, subnational debt grew in real terms (5 percent growth in real terms and 0.7 percent above the national GDP growth at constant prices) while the public sector debt declined, In 2007, both federal and local government debt declined as a percentage of GDP.

The subnational debt crises of the mid-1990s

184. **The risk to federal government finances posed by subnational governments was brought to the fore in the 1994-95 financial crises**. Due to 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 to 2.2 percent of GDP.[65] While still comparing favorably in terms of debt stock in percentage of GDP with other Latin American countries experiencing debt crises, Mexican states were not able to service their debt. Such 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.[66] In 1995, the ratio of subnational debt to *participaciones* stood at 80 percent, significantly higher than 44 and 64 percent in 1993 and 1994, respectively.

185. **After the 1995 Tequila crisis, the federal government took over the debt of the states**. The Fund for Strengthening State Finances, set as a federal government budgetary item, provided for extraordinary cash transfers, with a cost of MXN$7 billion in 1995; it continued at that level in real terms until 1998. States were required to restructure their debts 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 (SHCP). In particular, states needed to commit themselves to balance their budgets, reduce debt ratios, present their financial accounts in a uniform way, and update and publish a state debt law to regulate and limit debt.

186. **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

187. **Since the 1995 crisis, considerable progress has been made to move towards a market-based system to ensure fiscal discipline**. Previously, subnational governments could run deficits or issue debt. Following the subnational debt crises of the 1990s, there has been a considerable change in the attitude to borrowing, and a strengthening of banking

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[65] One-month cetes rate rose from 14 percent in November 1994 to 75 percent in April 1995. A few states (Campeche, Coahuila, Chiapas and Nuevo León) experienced debt increases exceeding 150 percent during 1993–95. Out of the 32 states, five (Federal District, State of Mexico, Nuevo León, Jalisco and Sonora) were responsible for nearly 75 percent of the stock of debt.

[66] Average maturity of subnational debt stood at 6.6 years by end-1994.

regulations and provisioning requirements. Additional requirements for credit ratings have also been a positive development.

Current intergovernmental fiscal arrangements

188. **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, as subnational governments account for a high share of public spending, but with insufficient resources (especially own taxes at the margin), significant vertical fiscal imbalances persist.

189. **Subnational governments have limited own-tax handles**. States have been given hard-to-tax bases, including the small taxpayers (the *REPECOS*) that yield little revenue while generating considerable political and administrative costs. They also have the option of piggybacking on the income tax, but this measure has only been adopted by three states due to the concern that, by doing so, they will lose competitiveness. For municipalities, the key tax is the property tax. It raises remarkably little revenue (0.3 percent of GDP over the period 2000–2004, compared to the OECD average of 1.9 percent of GDP). Low property tax collections are not attributable to low tax rates, but rather to its administration (e.g., outdated cadastre and valuations of property, and low collection efforts).[67] States keep the cadastre and all cadastral functions but have little incentive to update them since collections accrue to the municipalities. State legislatures also approve changes to the property tax rate.

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

191. **The present transfer system is complex and 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, as it is based on initial conditions that do not reflect recent trends in needs or demand for public services, or fiscal capacities.

[67] On average the property tax rate range around 2 percent of value of property, being thus close to prevailing tax rates around the world.

- The pool of *participaciones* is composed of the main federal taxes, such as the personal and corporate income tax, the tax on assets, the VAT and the excises. It 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.[68]

- 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 to education. The health sector also benefits from a basket of earmarked funds. As in the case of education, the amount of transfers for health was determined according to wage and other expenditure in the health sector and has been adjusted yearly according to increases in such expenditure.

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

Fund's advice on fiscal decentralization

193. **An FAD mission in 2007 provided technical assistance in the area of intergovernmental fiscal relations**.[69] The mission stressed that states should be given more significant tax handles to promote greater accountability at the subnational level, and also to have the states play a more active role in revenue-generation. The mission analyzed different alternatives. One alternative was for the states to piggy back on the single-rate corporate tax (IETU)—a new tax that was approved in September 2007 and implemented in 2008—

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[68] The 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 9.66 percent is allocated according to the inverse of the per capita allocations of the previous components.

[69] The mission included participation of World Bank staff.

because of the potential revenue generation, its likely administration by the federal SAT, and the fact that it would represent a major tax handle for the states. If allocated on the basis of the income taxes (ISR), it would provide more revenues 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 piggy-back. Other alternatives would be to put a floor on the ISR-piggyback, to eliminate concerns over tax competition; the consolidation of all taxation of vehicles at the state level; and the introduction of 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. Further, introducing a piggyback on the VAT would replicate the existing problems with unequal bases.

194. **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 the state legislatures—which could enact a band within which rates might be set).

195. **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 usefully follow an equalization criterion, such as population and inverse of income per capita, or spending needs and fiscal capacities. In order 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 in the year preceding the reforms, so as to ensure that that no entity would be made worse off by the reform.

196. **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).

197. **Regarding subnational debt, a number of measures were suggested**: establishing prudential limits for borrowing, linked to fiscal rules and targets; evaluating the budgetary and debt treatment of new instruments, including securitization; assessing carefully the fiscal risks associated to Private Public Partnerships (PPPs) and developing a sound legal framework for these operations; and improving the oversight on credit rating assessments.

198. **A package of measures in public financial management (PFM) would help improve transparency and good governance:**

- Introducing a common budget classification and accounting framework consistent with international standards, at all levels of governments. Subnational governments should follow specific reporting standards and a common database on their fiscal operations should be established.. Sanctions for subnational entities that do not comply 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 the minimum common standards and design of interfaces for an effective flow of information.

- Implementing Treasury single accounts (TSAs) at all levels of government. This would allow to minimize borrowing requirements and manage cash 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

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

200. **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 (e.g., a single-rate corporate tax (IETU) 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.

201. **The September reform also included measures to address subnational government PFM weaknesses**. In particular, 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. This 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.

202. **While the recent 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 key to ensuring accountability and providing incentives for subnational governments to utilize these powers. Debt management could be improved by ensuring that all debt—as well as commitments associated to PPPs and guarantees—is registered with the federal government; and by limiting the use of federal government transfers as guarantee for subnational government borrowing. Finally, adopting a common budget classification and reporting standards, as well as developing modern GFMISs to be interfaced with a new federal system, would allow monitoring subnational finances and assessing the general government fiscal position.

XI. Nigeria

Nigeria: Indicators of Fiscal Decentralization

Type of government:	Federal
Population (millions, 2007)	136.3
Area size (million square Km)	0.9
Levels of government	3
States/provinces	37
Municipalities	774
Average municipality size (population)	176,037
Minimum municipality size (population)	19,710
FAD TA missions on fiscal decentralization:	2001

Resource-revenue allocation and management complicate intergovernmental fiscal relations in Nigeria; safeguarding oil wealth while addressing development needs and poverty reduction requires careful design and implementation of macroeconomic policies, with ownership and accountability at all government levels.

203. **Nigeria is a federal state where 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.[70]

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

205. **The high share of spending by states and local governments (SLGs) represents a challenge for the execution of macroeconomic policy**. SLGs account for about half of general government spending (Table 9). As a result, it is difficult to coordinate policies across a very large number of SLGs, in particular in the context of large and volatile oil revenue. In addition, it is very complex to set a vast network of strong institutions and processes to minimize duplications and ensure effective service delivery in a country with a large population (more than 140 million people) with substantial needs (nearly 55 percent of the population lives in poverty). Hence, 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.

Table 9. Nigeria: Summary of Subnational Governments' Finances, 2006

	In percent of general government	In percent of GDP	In percent of non-oil GDP
Total subnational revenue	37.5	12.7	20.5
Own revenue 1/	2.3	0.8	1.3
Transfers from the federal government 1/	35.2	11.9	19.2
Total subnational expenditure	48.7	13.1	21.2
Overall balance (before transfers)		-12.4	-20.0
Overall balance		-0.4	-0.7

Source: Data provided by the authorities; and staff calculations.
1/ State and local governments (SLGs) coparticipate 54 percent of budgeted oil revenue, 85 percent of VAT, and 47 percent of CIT and import duties. PIT is directly assigned as own revenue of SLGs.

[70] The Nigerian federation includes 36 state authorities and the Federal Capital Territory of Abuja.

Fund's advice on fiscal decentralization

206. **A mission from FAD in early 2001 provided comprehensive technical assistance on decentralization issues**. The mission included participation of 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 the administrative arrangements to improve tax collection and the management of public funds.

207. **The mission stressed the deficiencies of the current transfer system**. This transfer 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, the current arrangement makes most subnational budgets highly sensitive to volatile oil revenue, and complicates macroeconomic management by fostering increases in spending as oil prices rise, and leading to significant deficits or arrears at subnational levels when oil prices decline.

208. **Greater clarification and understanding between all government levels with regard to the execution of their expenditure assignments was also 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 (as 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, the lack of accountability in the 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, as the lower levels could not assure 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 be broadly commensurate with its assigned expenditure responsibilities .

209. **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

210. **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 a number of weaknesses, including limited non-oil revenue collections with largely unexploited tax bases, lack of control by SLGs on the rates of most of the taxes that 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 SLGs accountability to finance their expenditure at the margin from own-revenue sources. In that context, specific recommendations included:

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

211. **Public financial management in SLGs should be strengthened**. At the time of the mission, there was no common macroeconomic framework for all government levels; reporting of fiscal operations by SLGs was lacking, partly due to the lack 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 governments should be consistent with 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.

212. **Setting limits to borrow by different government levels is crucial to maintaining macroeconomic balance**. The mission recommended a set of rules, namely to limit the domestic borrowing to a certain percentage of SLG revenue; maintain the practice of not allowing external borrowing by the SLGs; create professional capacity for debt management in the states' ministries of finance; and, establish a system to provide the Debt Management Office (DMO) with information on all aspects of debt.

Recent progress

213. **There has been limited progress to date in implementing the recommendations on decentralization issues, and the challenges might have increased in recent years, in the context of unusually volatile oil prices**. Following the return to democratic rule after a long period of dictatorships, building trust in the relationship 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.

214. **Since 2004, informal agreements have been reached by all government levels to follow an oil price-based fiscal rule**.[71] Windfall oil revenue on the basis of a conservative oil price has been set aside in a dedicated account (excess crude account) at the central bank.[72] This has facilitated the conduct of macroeconomic policy in the context of very high oil prices, and should help to smooth spending in the current downturn. Recently, however, some states have challenged the constitutionality of this arrangement.

215. **The Nigerian authorities started working on the implementation of service delivery benchmarks for poverty-related spending by SLGs**. The federal government had coordinated, with support from the World Bank and DFID, the design of benchmarks for service delivery to be followed by most state governments in the context of their own reform agenda—State Economic Empowerment and Development Strategy (SEEDS). A first SEEDS benchmarking report was published in 2007; however, the program was recently suspended.

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[71] The 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 by all levels of government, and to finance the explicit fuel subsidy.

[72] About US$12 billion were 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.

216. **Fiscal responsibility legislation is being prepared as a means to improve intergovernmental fiscal relations**. A Fiscal Responsibility Act (FRA) in 2007 was approved by the National Assembly and signed by the President. It 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, while it encourages states to follow similar practices. Political agreement has been reached for states to each draw up their own fiscal responsibility legislation, which are meant to be supportive of the objectives of the federal law. Drafting of state-level laws has commenced, a few have been enacted, and the federal government and donors are providing support. A key measure aimed at enhancing transparency and accountability that is already in place is the publication of the transfers from the Federation Account to the federal government and each SLG.

217. **Borrowing by SLGs appears to have been limited in recent years**. Part of this can be explained by the sharp increase in resources available for SLGs in the context of booming oil prices. But in addition, 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, including a number of restrictive provisions and guidelines regarding subnational borrowing. It includes 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

218. **A comprehensive reform of intergovernmental relations remains critical to ensure macroeconomic stability and safeguard Nigeria's oil wealth**. SLGs are reasserting their constitutional right to utilize 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 accumulation and withdrawal rules might be adjusted. Another source of fiscal risk is linked to the new policy to discontinue the withholding of states' external debt service obligations from their allocations from the excess crude account. The recently approved FRA enshrines the oil-price-based fiscal rule, but it cannot bind subnational governments.

219. **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, it will need to be ensured that the availability of financial resources for each level of government broadly matches its expenditure responsibilities.

220. **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**. While changes along the lines of FAD recommendations are politically difficult, some of the recent measures—the current 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 linking more closely spending units' objectives with costed projects/programs. A further stimulus to discuss revenue allocations could come from current proposals to make the non-oil revenue system more business friendly.[73] SLGs currently receive 85 percent of VAT 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 VAT sharing agreement. Hence, there is already some ground on which to discuss proposals to change the current revenue sharing system. Even though revenue sharing will continue to be the dominant source of revenue, financing SLGs' expenditures at the margin from own-revenue sources should increase their accountability.

221. **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 (50 percent) and the difficulty most states have in accessing domestic capital markets at non-prohibitive rates (only a small number of states have obtained financial ratings). Further, the Fiscal Responsibility Act requires that all tiers of government present a cost-benefit analysis of their borrowing. It is critical that these constraints be fully enforced, especially at times of lower oil prices when the sharp reduction in monthly oil allocations is likely to prompt states to seek more borrowing to insulate partially 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.

[73] These issues were discussed by an FAD tax policy mission in December 2007.

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